University of Mississippi
eGrove

Industry Developments and Alerts | American Institute of Certified Public Accountants (AICPA) Historical Collection

2008

# Not-for-profit organizations with conforming changes as of March 1, 2008; Audit and accounting guide:

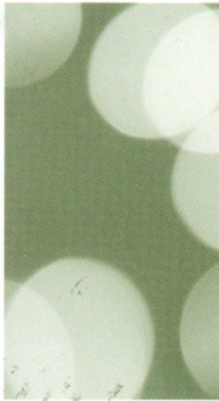
American Institute of Certified Public Accountants. Not-for-Profit Organizations Committee

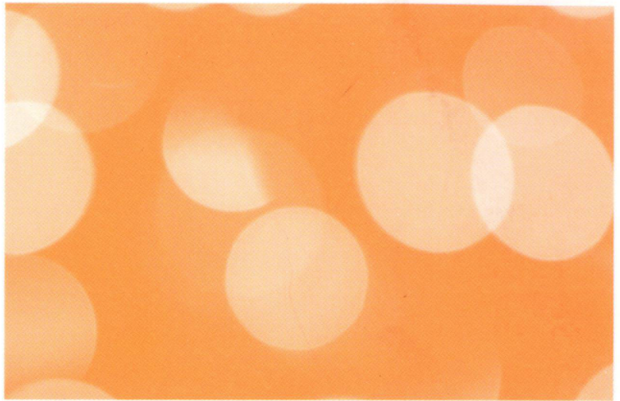
Follow this and additional works at: https://egrove.olemiss.edu/aicpa_indev

Part of the Accounting Commons, and the Taxation Commons

Recommended Citation
American Institute of Certified Public Accountants. Not-for-Profit Organizations Committee, "Not-for-profit organizations with conforming changes as of March 1, 2008; Audit and accounting guide:" (2008). *Industry Developments and Alerts*. 532.
https://egrove.olemiss.edu/aicpa_indev/532

This Book is brought to you for free and open access by the American Institute of Certified Public Accountants (AICPA) Historical Collection at eGrove. It has been accepted for inclusion in Industry Developments and Alerts by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.





AUDIT & ACCOUNTING GUIDE

# Not-for-Profit Organizations

MARCH 1, 2008

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA®

AUDIT & ACCOUNTING GUIDE

# Not-for-Profit Organizations

WITH CONFORMING CHANGES AS OF
MARCH 1, 2008

American Institute of Certified Public Accountants

AICPA®

This edition of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*, which was originally issued in 1996, has been modified by the AICPA staff to include certain changes necessary because of the issuance of authoritative pronouncements since the guide was originally issued and other changes necessary to keep the guide current on industry and regulatory matters. The changes made are identified in a schedule in appendix H of the guide. The changes do *not* include all those that might be considered necessary if the guide were subjected to a comprehensive review and revision.

Copyright © 2008 by
American Institute of Certified Public Accountants, Inc.
New York, NY 10036-8775

All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please visit www.copyright.com or call (978) 750-8400.

1 2 3 4 5 6 7 8 9 0 AAP 0 9 8

ISBN 978-0-87051-731-0

The *Instructor's Manual* for the FASB course of *Accounting and Reporting by Not-for-Profit Organizations: A Comprehensive View of Statements 116 and 117* is copyrighted by the Financial Accounting Standards Board, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116, U.S.A. Portions are reprinted with permission. Copies of the complete course are available from the FASB.

# Notice to Readers

This AICPA Audit and Accounting Guide has been prepared by the AICPA Not-for-Profit Organizations Committee to assist preparers of financial statements in preparing financial statements in conformity with generally accepted accounting principles (GAAP) and to assist auditors in auditing and reporting on such financial statements in accordance with generally accepted auditing standards (GAAS).

Descriptions of accounting principles and financial reporting practices in Audit and Accounting Guides are approved by the affirmative vote of at least two-thirds of the members of the Accounting Standards Executive Committee (AcSEC), which is the senior technical body of the AICPA authorized to speak for the AICPA in the areas of financial accounting and reporting. AU section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles (AICPA, *Professional Standards*, vol. 1), identifies AICPA Audit and Accounting Guides that have been cleared by the Financial Accounting Standards Board (FASB) as sources of accounting principles in category *b* of the hierarchy of GAAP that it establishes. This Audit and Accounting Guide has been cleared by the FASB. AICPA members should consider the accounting principles described in this Audit and Accounting Guide if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatments specified by this Audit and Accounting Guide should be used, or the member should be prepared to justify another treatment, as discussed in paragraph .07 of AU section 411.*

This AICPA Audit and Accounting Guide, which contains auditing guidance, is an interpretive publication pursuant to AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Interpretive publications are recommendations on the application of Statements on Auditing Standards (SAS) in specific circumstances, including engagements for entities in specialized industries. Interpretive publications are issued under the authority of the Auditing Standards Board (ASB). The members of the ASB have found this guide to be consistent with existing SASs.

---

* In April 2005, the Financial Accounting Standards Board (FASB) issued an exposure draft of a proposed FASB statement, *The Hierarchy of Generally Accepted Accounting Principles*, objectives of which include moving responsibility for the GAAP hierarchy for nongovernmental entities from the AICPA Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles (AICPA, *Professional Standards*, vol. 1, AU sec. 411), to FASB literature. Additionally, the proposed FASB statement expands the sources of category (a) to include accounting principles that are issued after being subject to the FASB's due process (including, but not limited to FASB Staff Positions and FASB Statement 133 Implementation Issues, which are currently not addressed in SAS No. 69.)

Among other matters, the proposed FASB statement would not carry forward the Rule 203 exception from paragraph .07 of AU section 411. Accordingly, the proposed FASB statement states that an enterprise shall not represent that its financial statements are presented in accordance with generally accepted accounting principles (GAAP) if its selection of accounting principles departs from the GAAP hierarchy set forth in this statement and that departure has a material impact on its financial statements.

In response to the proposed FASB statement, in May 2005, the AICPA issued an exposure draft of a proposed SAS, *Amendment to Statement on Auditing Standards No. 69 for Nongovernmental Entities*, which deletes the GAAP hierarchy for nongovernmental entities from SAS No. 69. The final FASB statement and SAS on GAAP hierarchy will be issued concurrently and will have a uniform effective date. For more information, please visit the FASB Web site at www.fasb.org and the AICPA Web site at www.aicpa.org.

An auditor should be aware of and consider interpretive publications applicable to his or her audit. Interpretative publications are not as authoritative as a pronouncement of the ASB; however, if an auditor does not apply the auditing guidance included in an applicable AICPA Audit and Accounting Guide, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance.

## *FASB Accounting Standards Codification™*

On January 15, 2008, the FASB launched the one-year verification phase of the *FASB Accounting Standards Codification™* (codification). After the verification period, during which constituents are encouraged to provide feedback on whether the codification content accurately reflects existing U.S. GAAP for nongovernmental entities, the FASB is expected to formally approve the codification as the single source of authoritative U.S. GAAP, other than guidance issued by the Securities and Exchange Commission (SEC). The codification includes all accounting standards issued by a standard-setter within levels A–D of the current U.S. GAAP hierarchy, including FASB, AICPA, Emerging Issues Task Force (EITF), and related literature. The codification does not change GAAP; instead it reorganizes the thousands of U.S. GAAP pronouncements into roughly 90 accounting topics, and displays all topics using a consistent structure. The SEC guidance will follow a similar topical structure in separate SEC sections.

This edition of the guide has not been conformed to the new codification. AICPA Audit and Accounting Guides, as well as other AICPA literature, will be conformed to reflect the codification after the verification phase and upon formal approval by the FASB.

## Defining Professional Requirements

AU section 120, *Defining Professional Requirements in Statements on Auditing Standards*, and AT section 20, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AICPA, *Professional Standards*, vol. 1), which were issued in December 2005, set forth the meaning of certain terms used in SASs and Standards for Attestation Engagements (SSAE), respectively, issued by the ASB in describing the professional requirements imposed on auditors and practitioners. The specific terms used to define professional requirements in these sections are not intended to apply to interpretive publications issued under the authority of the ASB because interpretive publications are not auditing or attestation standards. It is the ASB's intention to make conforming changes to the interpretive publications over the next several years to remove any language that would imply a professional requirement where none exists.

In December 2007, the Accounting and Review Services Committee (ARSC) also issued AR section 20, *Defining Professional Requirements in Statements on Standards for Accounting and Review Services* (AICPA, *Professional Standards*, vol. 2), which sets forth the meaning of certain terms used in Statements on Standards for Accounting and Review Services (SSARS) issued by the ARSC in describing the professional requirements imposed on accountants performing a compilation or review of a nonissuer. The specific terms used to define professional requirements in this section are not intended to apply to interpretive publications issued under the authority of the ARSC because interpretive

publications are not SSARSs. It is the ARSC's intention to make conforming changes to the interpretive publications to remove any language that would imply a professional requirement where none exists.

AU section 120, AT section 20, and AR section 20, which were effective upon issuance, define the terminology that the ASB and ARSC will use going forward to describe the degree of responsibility that the requirements impose on the auditor, practitioner, or accountant in engagements performed for nonissuers. SASs, SSAEs, and SSARSs will use the words "must" or "is required" to indicate an unconditional requirement, with which the auditor, practitioner, or accountant is required to comply. SASs, SSAEs, and SSARSs will use the word "should" to indicate a presumptively mandatory requirement. The auditor, practitioner, or accountant is required to comply with a presumptively mandatory requirement in all cases in which the circumstances exist to which the presumptively mandatory requirement applies; however, in rare circumstances, the auditor, practitioner, or accountant may depart from a presumptively mandatory requirement provided he or she documents the justification for the departure and how the alternative procedures performed in the circumstances were sufficient to achieve the objectives of the presumptively mandatory requirement. If a SAS, SSAE, or SSARS provides that a procedure or action is one that the auditor, practitioner, and accountant "should consider," the consideration of the procedure or action is presumptively required, whereas carrying out the procedure or action is not.

This guide has been updated as applicable for AU section 120, AT section 20, and AR section 20. Refer to the Schedule of Changes appendix for additional information.

## Recognition


Benjamin S. Neuhausen, *Chair*
*Accounting Standards Executive Committee*

Harold L. Monk, Jr., *Chair*
*Auditing Standards Board*

**Not-for-Profit Organizations Committee (1995-1996)**

Kenneth D. Williams, *Chair*
Elaine T. Allen
Katherine K. Anderson
Martha L. Benson
Walter D. Bristol
Gregory B. Capin
Gregory A. Coursen
Lawrence A. Dollinger
John H. Fisher
Mary F. Foster
Stephen H. Kattell
Robert C. Kovarik, Jr.
Richard F. Larkin
Louis J. Mezzina
Richard E. Mills

**AICPA Staff**

Christopher Cole, CPA, CFE
*Technical Manager*
*Accounting and Auditing Publications*

Joel Tanenbaum, CPA
*Technical Manager*
*Accounting Standards*

The AICPA gratefully acknowledges Gregg Capin, CPA; Frank Jakosz, CPA; Betsy Krisher, CPA, CGFM; Richard Larkin, CPA; Amanda Nelson, CPA; John Ring, CPA; Steve Kattell, CPA; Sheila Birch, CPA; and Nancy E. Shelmon, CPA, for their assistance in reviewing the conforming changes for the March 2008 edition of this guide.

Special thanks to Susan E. Budak, CPA, for her invaluable help in updating and maintaining the guidance in the guide.

The Not-for-Profit Organizations Committee gratefully acknowledges the contributions made to the development, content, and writing of this Audit and Accounting Guide by Alan S. Glazer, Professor of Business Administration, Franklin and Marshall College, and Henry R. Jaenicke, C.D. Clarkson Professor of Accounting, Drexel University.

## Guidance Considered in This Edition

This edition of the Audit and Accounting Guide *Not-for-Profit Organizations* has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative pronouncements since the guide was originally issued. Relevant accounting and auditing guidance contained in official pronouncements issued through March 1, 2008, have been considered in the development of this edition of the guide. This includes relevant guidance issued up to and including the following:

- FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51*
- Revised FASB statements issued through March 1, 2008, including FASB Statement No. 141(R), *Business Combinations*
- FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*
- FASB Technical Bulletin 01-1, *Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets*
- FASB EITF consensus ratified by the FASB through March 1, 2008
- FASB Staff Positions issued through March 1, 2008
- FASB Derivatives Implementation Group Statement 133 Implementation Issues cleared by the FASB through March 1, 2008
- AICPA Statement of Position (SOP) 07-1, *Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies* (AICPA, *Technical Practice Aids*, ACC sec. 10,930)
- AICPA Practice Bulletin (PB) No. 15, *Accounting by the Issuer of Surplus Notes* (AICPA, *Technical Practice Aids*, PB sec. 12,150)
- AICPA SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380)
- Interpretation No. 1, "Communicating Deficiencies in Internal Control Over Compliance in an Office of Management and Budget (OMB) Circular A-133 Audit" of AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 9325 par. .01–.04)
- SOP 07-2, *Attestation Engagements That Address Specified Compliance Control Objectives and Related Controls at Entities That Provide Services to Investment Companies, Investment Advisers,*

*or Other Service Providers* (AICPA, *Technical Practice Aids*, AUD sec. 14,430)

- SSAE No. 14, *SSAE Hierarchy* (AICPA, *Professional Standards*, vol. 1, AT sec. 50)
- Interpretation No. 6, "Reporting on Attestation Engagements Performed in Accordance With Government Auditing Standards" of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 9101 par. .56–.58)
- SSARS No. 17, *Omnibus Statement on Standards for Accounting and Review Services—2008* (AICPA, *Professional Standards*, vol. 2)
- Interpretation No. 29, "Reporting on an Uncertainty, Including an Uncertainty About an Entity's Ability to Continue as a Going Concern" of AR section 100, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 9100 par. .120–.129)

Users of this guide should consider pronouncements issued subsequent to those listed previously to determine their effect on entities covered by this guide. In determining the applicability of a pronouncement, its effective date should also be considered.

The changes made for the current year are identified in a schedule in appendix H of the guide. The changes do not include all those that might be considered necessary if the guide was subjected to a comprehensive review and revision.

Appendix D, which was SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, has been converted to a separate AICPA Audit Guide Government Auditing Standards *and Circular A-133 Audits*. Auditors who perform audits under *Government Auditing Standards,* the Single Audit Act Amendments of 1996, and Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations,* should refer to that separate guide.

## Auditing Guidance Included in This Guide

### Risk Assessment Standards

In March 2006, the ASB issued SAS Nos. 104–111 (the "risk assessment standards"). Collectively, the risk assessment standards establish standards and provide guidance concerning the auditor's assessment of the risks of material misstatement (whether caused by fraud or error) in a nonissuer financial statement audit; design and performance of tailored audit procedures to address assessed risks; audit risk and materiality; planning and supervision; and audit evidence. The most significant changes to existing practice that the auditor will be required to perform are as follows:

- Obtain a more in-depth understanding of the audited entity and its environment, including its internal control
- Perform a more rigorous assessment of the risks of where and how the financial statements could be materially misstated (defaulting to a maximum control risk is not acceptable)

- Provide a linkage between the auditor's assessed risks and the nature, timing, and extent of audit procedures performed in response to those risks

The statements are effective for audits of financial statements for periods beginning on or after December 15, 2006. Early adoption is permitted. See appendix G in this guide for a more detailed comparison between the risk assessment standards and the existing standards. This guide has been conformed to the new risk assessment standards.

For additional guidance on the risk assessment standards, please refer to the AICPA Audit Guide *Assessing and Responding to Risk in a Financial Statement Audit* (product no. 012456) and the AICPA Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526).

## Defining Professional Requirements

As previously stated, this guide has been conformed, as applicable, to the standards found in AU section 120, AT section 20, and AR section 20, which were effective upon issuance (December 2005, except for AR section 20, which was issued in December 2007). These new standards define the terminology that the ASB and ARSC will use going forward to describe the degree of responsibility that the requirements impose on the auditor, practitioner, or accountant in engagements performed for nonissuers. Refer to the Schedule of Changes appendix for additional information.

# Preface

## Purpose and Applicability

This AICPA Audit and Accounting Guide (guide) has been prepared to assist nongovernmental not-for-profit organizations in preparing financial statements in conformity with generally accepted accounting principles (GAAP) and to assist independent auditors in auditing and reporting on those financial statements.

This guide applies to organizations that meet the definition of a not-for-profit organization included in appendix D of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 116, *Accounting for Contributions Received and Contributions Made.*

### Limitations

This guide does not discuss the application of all GAAP and all generally accepted auditing standards (GAAS) that are relevant to the preparation and audit of financial statements of not-for-profit organizations. This guide is directed primarily to those aspects of the preparation and audit of not-for-profit organizations' financial statements that are unique to those organizations or are considered particularly significant to them.

### Impact on Other Literature

This guide incorporates certain provisions of FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, and No. 117, *Financial Statements of Not-for-Profit Organizations.* Not all guidance that is included in those statements, however, is incorporated, repeated, or summarized in this guide. Accordingly, those statements should be read in conjunction with this guide. Like FASB Statement Nos. 116–117, this guide is directed at not-for-profit organizations in general, and not at specific kinds of such organizations, such as voluntary health and welfare organizations or private colleges and universities. It is expected that various industry associations will publish guidance on applying both the FASB statements and this guide to specific kinds of organizations.[1]

This guide supersedes the following AICPA Audit and Accounting Guides:[2]

---

[1] AU section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles (AICPA, *Professional Standards*, vol. 1), establishes a hierarchy of sources of generally accepted accounting principles (GAAP). The hierarchy is described in appendix G [paragraph 1.30] to chapter 1, "Introduction," of this guide. AU section 411 notes that in the absence of established accounting principles described in categories (a)–(d) of the hierarchy of GAAP, the auditor may consider other accounting literature, including pronouncements of other professional associations, depending on its relevance in the circumstances. Guidance published by industry associations may be considered "other accounting literature" in the hierarchy of sources of accounting principles established by AU section 411.

[2] As noted previously in this preface, this guide applies to nongovernmental not-for-profit organizations. (Paragraph 1.03 of this guide discusses the determination of whether an entity is a nongovernmental organization.)

Governmental not-for-profit organizations should follow the Governmental Accounting Standards Board's (GASB) financial reporting model standards, GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, and GASB Statement No. 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities—an amendment of GASB Statement No. 34*, other standards for governmental organizations, and the AICPA Audit and Accounting Guide *State and Local Governments*, as applicable.

- Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations*
- Industry Audit Guide *Audits of Colleges and Universities*
- Audit and Accounting Guide *Audits of Certain Nonprofit Organizations*

It also supersedes the following AICPA Statements of Position (SOP):

- SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*
- SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*
- SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*
- SOP 94-2, *The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations*

## Effective Date and Transition

The provisions of this guide, other than those included in paragraphs 1.06–.17, which are discussed in the following, are effective for financial statements for fiscal years ending on or after December 31, 1996.[3] Earlier application is permitted.

The provisions included in paragraphs 1.06–.17 are effective for financial statements issued for fiscal years beginning after December 15, 1994, except for organizations with less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date is fiscal years beginning after December 15, 1995. Earlier application is permitted.

Unless the provisions of this guide, other than those included in paragraphs 1.06–.17, are applied retroactively under the provisions of the following paragraph, the effect of initially applying this guide should be reported as the effect of a change in accounting principle, in a manner similar to the cumulative effect of a change in accounting principle (Accounting Principles Board [APB] Opinion No. 20, *Accounting Changes*, paragraph 19). The amount of the cumulative effect should be based on a retroactive computation. Organizations should report the cumulative effect of a change in accounting on each class of net assets in the statement of activities, after the caption "extraordinary items" (if any) and before the captions "change in unrestricted net assets," "change in temporarily restricted net assets," and "change in permanently restricted net assets."

This guide, other than the guidance in paragraphs 1.06–.17, may be applied retroactively by restating the opening net assets for the earliest year presented or for the year this guide is first applied if no prior years are presented. In the period in which this guide is first applied, organizations should disclose the nature of any restatement and its effect on the change in net assets for each period presented.

---

[3] This guide does not defer the effective date of any pronouncements that cover not-for-profit organizations.

In implementing the guidance in paragraphs 1.06–.17, which incorporates the provisions of SOP 94-2 into this guide, the transition rules of the APB opinions and FASB statements adopted, other than their effective dates, should be followed. However, if there is more than one change in accounting principle as a result of applying the guidance in paragraphs 1.06–.17, organizations have the option of including the cumulative effect of adopting those accounting principles in the statement of activities in the year this guide is adopted, regardless of the transition rules of the APB opinions and FASB statements adopted,[4] and the financial statements should disclose the nature of the cumulative adjustment. (Paragraphs 19–20 of APB Opinion No. 20 discuss reporting the cumulative effects of changes in accounting principles.) In circumstances in which there is more than one change in accounting principle resulting from applying this guide and the cumulative effect of adopting those accounting principles is included in the statement of changes in net assets in the year the guidance in paragraphs 1.06–.17 is adopted, this guide does not require the pro forma disclosures required by paragraphs 19(d) and 21 of APB Opinion No. 20.

Practitioners should follow the effective dates and transitional guidance for authoritative pronouncements issued for fiscal years ending on or after December 31, 1996.

## References to Professional Standards

In citing the professional standards, references are made to the AICPA *Professional Standards* publication. Additionally, when referencing professional standards, this guide cites section numbers and not the original statement number, as appropriate. For example, Statement on Auditing Standards (SAS) No. 54 is referred to as AU section 317.

---

[4] Organizations that adopt the guidance in paragraphs 1.06–.17 in the same year in which they adopt FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, are permitted to apply the provisions of paragraph 17 of that statement, concerning recognition of expirations of restrictions, prospectively, as specified in that statement, regardless of whether they report the cumulative effect of adopting other accounting principles as a result of applying the guidance in paragraphs 1.06–.17 of this guide.

# TABLE OF CONTENTS

| Chapter | | Paragraph |
|---|---|---|
| 1 | Introduction | .01-.30 |
| | Scope | .01-.04 |
| | GAAP Hierarchy for Not-for-Profit Organizations | .05-.17 |
| | APB Opinion No. 16, *Business Combinations* | .15-.16 |
| | Provisions of Certain Pronouncements Concerning Financial Statement Display | .17 |
| | Fund Accounting and Net Asset Classes | .18-.23 |
| | Appendix A—Financial Reporting Pronouncements That Specifically Exempt Not-for-Profit Organizations From Their Application | .24 |
| | Appendix B—Financial Reporting Pronouncements That, by the Nature of Their Subject Matter, Generally Do Not Apply to Not-for-Profit Organizations | .25 |
| | Appendix C—Financial Reporting Pronouncements Whose Application to Not-for-Profit Organizations Is Subject to Additional FASB or AICPA Guidance | .26 |
| | Appendix D—Financial Reporting Pronouncements Pertaining to Specialized Industry Practices of Business Enterprises | .27 |
| | Appendix E—Financial Reporting Pronouncements Not Subsequently Superseded and Not Included in Appendixes A–D of This Chapter | .28 |
| | Appendix F—All Financial Reporting Pronouncements, Cross-Referenced by Appendix | .29 |
| | Appendix G—The Hierarchy of GAAP | .30 |
| 2 | General Auditing Considerations | .01-.79 |
| | Overview | .01 |
| | Planning and Other Auditing Considerations | .02-.18 |
| | Audit Planning | .03-.04 |
| | Using the Work of a Specialist | .05 |
| | Scope of Services | .06-.07 |
| | Independence | .08-.10 |
| | Audit Risk | .11-.13 |
| | Planning Materiality | .14-.18 |
| | Qualitative Aspects of Materiality | .19-.33 |
| | Related-Party Transactions | .21-.23 |
| | Errors and Fraud | .24 |
| | Illegal Acts | .25-.28 |
| | Compliance Auditing Under Government Auditing Standards | .29 |
| | Single Audits and Related Considerations | .30-.32 |
| | Processing of Transactions by Service Organizations | .33 |
| | Use of Assertions in Obtaining Audit Evidence | .34-.38 |

| Chapter | | Paragraph |
|---|---|---|
| 2 | General Auditing Considerations—continued | |
| | Understanding the Entity, Its Environment, and Its Internal Control | .39-.59 |
| | Risk Assessment Procedures | .41 |
| | Analytical Procedures | .42-.43 |
| | Discussion Among the Audit Team | .44 |
| | Understanding of the Entity and Its Environment | .45-.53 |
| | Understanding of Internal Control | .54-.59 |
| | Risk Assessment and the Design of Further Audit Procedures | .60-.71 |
| | Assessing the Risks of Material Misstatement | .61-.63 |
| | Designing and Performing Further Audit Procedures | .64-.71 |
| | Evaluating Misstatements | .72-.73 |
| | Completing the Audit | .74-.78 |
| | Management Representations | .75-.76 |
| | Going-Concern Considerations | .77-.78 |
| | Appendix A—Consideration of Fraud in a Financial Statement Audit | .79 |
| 3 | Basic Financial Statements and General Financial Reporting Matters | .01-.51 |
| | Introduction | .01-.02 |
| | Statement of Financial Position | .03-.07 |
| | Statement of Activities | .08-.14 |
| | Reporting Expenses | .14 |
| | Statement of Cash Flows | .15-.21 |
| | Comparative Financial Information | .20-.21 |
| | Reporting of Related Entities and Collaborative Arrangements | .22-.23 |
| | The Use of Fair Value Measures | .24-.46 |
| | Definition of Fair Value | .26-.31 |
| | Valuation Techniques | .32-.38 |
| | The Fair Value Hierarchy | .39-.42 |
| | Disclosures | .43 |
| | Fair Value Option | .44-.46 |
| | Financial Statement Disclosures Not Considered Elsewhere | .47-.51 |
| | Noncompliance With Donor-Imposed Restrictions | .48-.50 |
| | Risks and Uncertainties | .51 |
| 4 | Cash and Cash Equivalents | .01-.05 |
| | Introduction | .01-.02 |
| | Financial Statement Presentation | .03-.05 |

| Chapter | | Paragraph |
|---|---|---|
| 5 | Contributions Received and Agency Transactions | .01-.88 |
| | Introduction | .01-.02 |
| | Distinguishing Contributions From Other Transactions | .03-.31 |
| | Agency Transactions | .05-.12 |
| | Variance Power | .13-.14 |
| | Financially Interrelated Organizations | .15-.17 |
| | Similar Transactions That Are Revocable, Repayable or Reciprocal | .18-.21 |
| | Exchange Transactions | .22-.31 |
| | Recognition Principles for Contributions | .32-.60 |
| | Donor-Imposed Conditions | .35-.37 |
| | Donor-Imposed Restrictions | .38-.46 |
| | Promises to Give | .47-.51 |
| | Contributed Services | .52-.53 |
| | Gifts in Kind | .54-.56 |
| | Contributed Utilities and Use of Long-Lived Assets | .57-.58 |
| | Contributed Collection Items | .59 |
| | Split-Interest Agreements | .60 |
| | Measurement Principles for Contributions | .61-.76 |
| | Discounting | .67-.69 |
| | Subsequent Measurement | .70-.76 |
| | Financial Statement Presentation | .77-.80 |
| | Illustrative Disclosures | .81 |
| | Auditing | .82-.88 |
| 6 | Split-Interest Agreements | .01-.48 |
| | Introduction | .01 |
| | Types of Split-Interest Agreements | .02-.03 |
| | Recognition and Measurement Principles | .04-.19 |
| | Recognition of Revocable Agreements | .06 |
| | Initial Recognition of Unconditional Irrevocable Agreements | .07-.10 |
| | Recognition During the Agreement's Term | .11-.18 |
| | Recognition Upon Termination of Agreement | .19 |
| | Financial Statement Presentation | .20 |
| | Examples of Split-Interest Agreements | .21-.42 |
| | Charitable Lead Trust | .22-.26 |
| | Perpetual Trust Held by a Third Party | .27-.29 |
| | Charitable Remainder Trust | .30-.34 |
| | Charitable Gift Annuity | .35-.38 |
| | Pooled (Life) Income Fund | .39-.42 |

| Chapter | | Paragraph |
|---|---|---|
| 6 | Split-Interest Agreements—continued | |
| | Auditing | .43-.46 |
| | Appendix A—Journal Entries | .47 |
| | Appendix B—Derivatives Implementation Group | .48 |
| 7 | Other Assets | .01-.20 |
| | Introduction | .01 |
| | Inventory | .02-.03 |
| | Prepaid Expenses, Deferred Charges, and Similar Costs | .04 |
| | Collections | .05-.14 |
| | Financial Statement Presentation | .11-.13 |
| | Illustrative Disclosures | .14 |
| | Auditing | .15-.20 |
| | Inventory | .16-.20 |
| 8 | Investments | .01-.37 |
| | Introduction | .01-.07 |
| | Initial Recognition | .08 |
| | Investment Income | .09-.10 |
| | Valuation Subsequent to Acquisition | .11 |
| | Unrealized and Realized Gains and Losses | .12-.13 |
| | Investment Pools | .14-.15 |
| | Donor-Restricted Endowment Funds | .16-.18 |
| | Financial Statement Presentation | .19-.27 |
| | Accounting for Derivative Instruments and Hedging Activities | .28-.31 |
| | Auditing | .32-.35 |
| | Net Appreciation on Endowment Funds | .34-.35 |
| | Appendix A—Measuring Other Investments | .36 |
| | Appendix B—Statement of Position 94-3, *Reporting of Related Entities by Not-for-Profit Organizations* | .37 |
| 9 | Property and Equipment | .01-.18 |
| | Introduction | .01-.02 |
| | Recognition and Measurement Principles | .03-.12 |
| | Contributed Property and Equipment | .05-.06 |
| | Depreciation | .07-.08 |
| | Impairment or Disposal of Long-Lived Assets | .09-.10 |
| | Asset Retirement Obligations | .11 |
| | Gains and Losses | .12 |
| | Financial Statement Presentation | .13-.15 |
| | Auditing | .16-.18 |

| Chapter | | Paragraph |
|---|---|---|
| 10 | Debt and Other Liabilities | .01-.17 |
| | Introduction | .01 |
| | Tax-Exempt Financing | .02 |
| | Current and Deferred Tax Liabilities | .03-.04 |
| | Deferred Revenue | .05 |
| | Refunds Due to and Advances From Third Parties | .06 |
| | Promises to Give | .07-.09 |
| | Annuity Obligations | .10 |
| | Amounts Held for Others Under Agency Transactions | .11 |
| | Exit or Disposal Activities | .12 |
| | Guarantees | .13 |
| | Contingencies | .14 |
| | Pension and Other Defined Benefit Postretirement Plan Obligations | .15 |
| | Auditing | .16-.17 |
| 11 | Net Assets | .01-.17 |
| | Introduction | .01-.02 |
| | Net Asset Classes | .03-.04 |
| | Permanently Restricted Net Assets | .05-.06 |
| | Temporarily Restricted Net Assets | .07-.08 |
| | Unrestricted Net Assets | .09-.12 |
| | Reclassifications | .13 |
| | Disclosure | .14-.15 |
| | Auditing | .16-.17 |
| 12 | Revenues and Receivables From Exchange Transactions | .01-.06 |
| | Introduction | .01 |
| | Revenues | .02-.03 |
| | Recognition, Measurement, and Display | .04-.06 |
| 13 | Expenses, Gains, and Losses | .01-.66 |
| | Introduction | .01 |
| | Expenses | .02-.04 |
| | Expense Recognition Issues | .05-.15 |
| | Fund-Raising Costs | .06 |
| | Financial Aid and Other Reductions in Amounts Charged for Goods and Services | .07 |
| | Advertising Costs | .08-.10 |
| | Start-Up Costs | .11-.13 |
| | Internal Use Computer Software Costs | .14 |
| | Contributions Made | .15 |

| Chapter | | Paragraph |
|---|---|---|
| 13 | Expenses, Gains, and Losses—continued | |
| | Gains and Losses | .16-.27 |
| | Reporting Costs Related to Sales of Goods and Services | .19-.20 |
| | Reporting the Cost of Special Events and Other Fund-Raising Activities | .21-.26 |
| | Investment Revenues, Expenses, Gains, and Losses | .27 |
| | Functional Reporting of Expenses | .28-.58 |
| | Functional Classifications | .29-.35 |
| | Classification of Expenses Related to More Than One Function | .36 |
| | Direct Identification Versus Allocation Methods | .37-.57 |
| | Expenses of Federated Fund-Raising Organizations | .58 |
| | Income Taxes | .59 |
| | Auditing | .60-.61 |
| | Appendix A—Accounting for Joint Activities | .62 |
| | Appendix B—Illustrations of Applying the Criteria of Purpose, Audience, and Content to Determine Whether a Program or Management and General Activity Has Been Conducted | .63 |
| | Appendix C—Illustrations of Allocation Methods | .64 |
| | Appendix D—Illustrations of Disclosures | .65 |
| | Appendix E—Discussion of Conclusions | .66 |
| 14 | Reports of Independent Auditors | .01-.15 |
| | Reports on Financial Statements | .01-.02 |
| | Reports on Comparative Financial Statements | .03-.05 |
| | Unqualified Opinions | .06 |
| | Modified Reports and Departures From Unqualified Opinions | .07 |
| | Going Concern | .08 |
| | Reporting on Supplementary Information | .09-.10 |
| | Bases of Accounting Other Than GAAP | .11-.12 |
| | Reporting on Prescribed Forms | .13-.14 |
| | Reports Required by *Government Auditing Standards*, the Single Audit Act Amendments of 1996, and OMB Circular A-133 | .15 |
| 15 | Tax Considerations | .01-.23 |
| | Introduction | .01-.03 |
| | Basis of Exemption | .04-.15 |
| | Federal and State Filing Requirements | .16 |
| | Public Charities and Private Foundations | .17 |
| | Unrelated Business Income | .18-.20 |
| | Auditing | .21-.23 |

| Chapter | | Paragraph |
|---|---|---|
| 16 | Fund Accounting | .01-.20 |
| | Introduction | .01 |
| | Fund Accounting and External Financial Reporting | .02-.03 |
| | Unrestricted Current (or Unrestricted Operating or General) Funds | .04-.05 |
| | Restricted Current (or Restricted Operating or Specific-Purpose) Funds | .06-.07 |
| | Plant (or Land, Building, and Equipment) Funds | .08-.10 |
| | Loan Funds | .11-.12 |
| | Endowment Funds | .13-.16 |
| | Annuity and Life-Income (Split-Interest) Funds | .17-.18 |
| | Agency (Or Custodian) Funds | .19 |
| | Summary | .20 |

Appendix

A Background Information and Basis for Conclusions

B Statement of Position 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards*

C Statement of Position 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*

D Statement of Position 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*

E Information Sources

F References to AICPA Technical Practice Aids

G Comparison of Key Provisions of the Risk Assessment Standards to Previous Standards

H Schedule of Changes Made to the Text From the Previous Edition

Glossary

# Chapter 1

# *Introduction*

## Scope

**1.01** This Audit and Accounting Guide (guide) covers organizations that meet the definition of a not-for-profit organization included in appendix D of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 116, *Accounting for Contributions Received and Contributions Made*. That definition is as follows:

> An entity that possesses the following characteristics that distinguish it from a business enterprise: (*a*) contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return, (*b*) operating purposes other than to provide goods or services at a profit, and (*c*) absence of ownership interests like those of business enterprises. Not-for-profit organizations have those characteristics in varying degrees ([FASB Statement of Financial Accounting] Concepts Statement No. 4, paragraph 6). Organizations that clearly fall outside this definition include all investor-owned enterprises and entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance companies, credit unions, farm and rural electric cooperatives, and employee benefit plans (Concepts Statement No. 4, paragraph 7).

As noted in the previous definition, not-for-profit organizations have characteristics (*a*), (*b*), and (*c*) in varying degrees. An organization could meet the definition of a not-for-profit organization without possessing characteristic (*a*), (*b*), or (*c*). For example, some not-for-profit organizations, such as those that receive all their revenue from exchange transactions, receive no contributions.

**1.02** The term *not-for-profit organizations* encompasses all entities defined as not-for-profit organizations by FASB Statement No. 116 and AICPA Statement of Position (SOP) 74-8, *Financial Accounting and Reporting by Colleges and Universities*, and SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, which are superseded by this guide. Accordingly, this guide applies to nongovernmental not-for-profit organizations of the following kinds:[1]

- Cemetery organizations
- Civic and community organizations
- Colleges and universities
- Elementary and secondary schools
- Federated fund-raising organizations

---

[1] This list does not necessarily include all organizations that meet the definition of a not-for-profit organization in Financial Accounting Standards Board (FASB) Statement No. 116, *Accounting for Contributions Received and Contributions Made*. This guide applies to all organizations that meet the definition, regardless of whether they are included in this list.

- Fraternal organizations
- Labor unions
- Libraries
- Museums
- Other cultural organizations
- Performing arts organizations
- Political parties
- Political action committees
- Private and community foundations
- Professional associations
- Public broadcasting stations
- Religious organizations
- Research and scientific organizations
- Social and country clubs
- Trade associations
- Voluntary health and welfare organizations
- Zoological and botanical societies

**1.03** Paragraph 1.02 provides that this guide applies to certain nongovernmental not-for-profit organizations. Nongovernmental organizations are all organizations other than governmental organizations. Public corporations[2] and bodies corporate and politic are governmental organizations. Other organizations are governmental organizations if they have one or more of the following characteristics:

*a.* 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

*b.* The potential for unilateral dissolution by a government with the net assets reverting to a government

*c.* The power to enact and enforce a tax levy

Furthermore, organizations are presumed to be governmental if they have the ability to issue directly (rather than through a state or municipal authority) debt that pays interest exempt from federal taxation. However, organizations possessing only that ability (to issue tax-exempt debt) and none of the other governmental characteristics may rebut the presumption that they are governmental if their determination is supported by compelling, relevant evidence.

---

[2] *Black's Law Dictionary* defines a public corporation as: An artificial person (for example, [a] municipality or a governmental corporation) created for the administration of public affairs. Unlike a private corporation it has no protection against legislative acts altering or even repealing its charter. Instrumentalities created by [the] state, formed and owned by it in [the] public interest, supported in whole or part by public funds, and governed by managers deriving their authority from [the] state. Sharon Realty Co. v. Westlake, Ohio Com. Pl., 188 N.E.2d 318, 323, 25 O.O.2d 322. A public corporation is an instrumentality of the state, founded and owned in the public interest, supported by public funds and governed by those deriving their authority from the state. York County Fair Ass'n v. South Carolina Tax Commission, 249 S.C. 337, 154 S.E.2d 361, 362.

**1.04** Not-for-profit organizations that are providers of health care services[3] are not covered by this guide and should follow the AICPA Audit and Accounting Guide *Health Care Organizations*.

## GAAP Hierarchy for Not-for-Profit Organizations[GPH, COD]

**1.05** AU section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles (AICPA, *Professional Standards*, vol. 1), states that the guidance provided by FASB statements and interpretations, opinions of the Accounting Principles Board (APB), and Accounting Research Bulletins (ARB) shall be considered established accounting principles pursuant to Rule 203 of the AICPA Code of Professional Conduct. (Appendix G [paragraph 1.30] of this chapter discusses AU section 411 and the hierarchy of sources of generally accepted accounting principles [GAAP].)

**1.06** Not-for-profit organizations should follow the guidance in effective provisions of ARBs, APB opinions, and FASB statements and interpretations unless the specific pronouncement explicitly exempts not-for-profit organizations or their subject matter precludes such applicability. (As noted in paragraphs 1.11–.12 of this guide, not-for-profit organizations should follow the guidance in FASB Statement No. 116, No. 117, *Financial Statements of Not-for-Profit Organizations*, No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, and No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*,

---

[3] Providers of health care services that meet the definition of a voluntary health and welfare organization in FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, should follow this guide.

[GPH] On April 28, 2005, FASB issued an exposure draft of a proposed FASB statement, *The Hierarchy of Generally Accepted Accounting Principles*, objectives of which include moving responsibility for the generally accepted accounting principles (GAAP) hierarchy for nongovernmental entities from the AICPA Statement on Auditing Standard (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles (AICPA, *Professional Standards*, vol. 1, AU sec. 411), to FASB literature. Additionally, the proposed statement expands the sources of category (a) to include accounting principles that are issued after being subject to FASB's due process (including, but not limited to FASB Staff Positions (FSP) and FASB Statement 133 implementation issues, which are currently not addressed in SAS No. 69).

Among other matters, the proposed FASB statement would not carry forward the Rule 203 exception from paragraph 7 of SAS No. 69 (paragraph .07 of AU section 411). Accordingly, the proposed FASB statement states that an enterprise shall not represent that its financial statements are presented in accordance with GAAP if its selection of accounting principles departs from the GAAP hierarchy set forth in this statement and that departure has a material impact on its financial statements.

In response to the proposed FASB statement, in May 2005, the AICPA issued an exposure draft of a proposed SAS, *Amendment to Statement on Auditing Standards No. 69 for Nongovernmental Entities*, which deletes the GAAP hierarchy for nongovernmental entities from SAS No. 69 (AU section 411). The final FASB statement and SAS on GAAP hierarchy will be issued concurrently and will have a uniform effective date. Readers should be alert to the issuance of the final standards.

[COD] On January 15, 2008, FASB launched the one-year verification phase of the *FASB Accounting Standards Codification*™ (Codification). During the verification period, constituents are encouraged to use the online Codification Research System free of charge to research accounting issues and provide feedback on whether the Codification content accurately reflects existing U.S. GAAP for nongovernmental entities. Users are advised that the Codification content is not yet approved as authoritative and, therefore, they must verify research results using their existing resources for the currently effective literature. After addressing the issues raised during the constituent feedback process, FASB is expected to formally approve the Codification as the single source of authoritative U.S. GAAP, other than guidance issued by the Securities and Exchange Commission (SEC). Upon approval by FASB, all accounting standards (other than the SEC guidance) used to populate the Codification will be superseded. At that time, with the exception of any SEC or grandfathered guidance, all other accounting literature not included in the Codification will become nonauthoritative.

and this guide in applying the guidance in pronouncements listed in appendixes C–D [paragraphs 1.26–.27] of this chapter.)

**1.07** The appendixes [paragraphs 1.24–.30] of this chapter are aids to the implementation of the guidance in this chapter.

**1.08** Pronouncements issued by FASB subsequent to this guide's effective date apply to not-for-profit organizations unless those pronouncements explicitly exempt not-for-profit organizations or their subject matter precludes such applicability.[4]

**1.09** Not-for-profit organizations may follow and are not prohibited from following the guidance in effective provisions of the APB opinions and FASB statements and interpretations listed in appendix A [paragraph 1.24] of this chapter, which specifically exempt not-for-profit organizations from their application, unless FASB Statement Nos. 116–117 or this guide provide different guidance. (However, the guidance included in the effective provisions of pronouncements listed in appendix A [paragraph 1.24] applies to all for-profit entities owned, whether owned all or in part, by not-for-profit entities.) The discussion in paragraphs 1.11–.17 of this guide should be considered in determining the hierarchy of such guidance and of guidance issued by the AICPA.

**1.10** Certain financial reporting guidance listed in appendix B [paragraph 1.25] of this chapter, such as that concerning common stock and convertible debt, generally does not apply to the kinds of entities covered by this guide, because such entities do not enter into the kinds of transactions covered by that guidance. (However, the guidance included in the effective provisions of pronouncements included in appendix B [paragraph 1.25] applies to all for-profit entities owned, whether owned all or in part, by not-for-profit entities. Also, not-for-profit organizations should follow the effective provisions of pronouncements in appendix B [paragraph 1.25] if they enter into the kinds of transactions covered by that guidance.)

**1.11** Other pronouncements, which are listed in appendix C [paragraph 1.26] of this chapter (ARB No. 51, *Consolidated Financial Statements*,[NIS] and

---

[4] The guidance in paragraphs 1.05-.17 of this guide addresses only the pronouncements listed in paragraph 1.06. However, not-for-profit organizations are also subject to other pronouncements included in categories (b)–(d) of paragraph .05 of AU section 411 and should apply AICPA Audit and Accounting Guides, Statements of Position (SOP), and Practice Bulletins and FASB Technical Bulletins and the consensus positions of FASB Emerging Issues Task Force (EITF) that apply to them. (Appendix G [paragraph 1.30] of this chapter discusses AU section 411 and the GAAP hierarchy.)

[NIS] In December 2007, FASB issued FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51*, which establishes accounting and reporting standards for the noncontrolling interest in a subsidiary (sometimes called minority interests) and for the deconsolidation of a subsidiary. Neither FASB Statement No. 160 nor its amendments to ARB No. 51, *Consolidated Financial Statements*, APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, and No. 29, *Accounting for Nonmonetary Transactions*, FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, No. 89, *Financial Reporting and Changing Prices*, No. 128, *Earnings per Share*, No. 130, *Reporting Comprehensive Income*, and No. 142, *Goodwill and Other Intangible Assets*, FASB Interpretation No. 37, *Accounting for Translation Adjustments upon Sale of Part of an Investment in a Foreign Entity—an interpretation of FASB Statement No. 52*, and No. 46(R), *Consolidation of Variable Interest Entities (revised December 2003)—an interpretation of ARB No. 51*, AICPA Accounting Interpretation No. 1, AICPA SOP 04-2, *Accounting for Real Estate Time-Sharing Transactions* (AICPA, *Technical Practice Aids*, ACC sec. 10,910), and to several EITF issues, apply to not-for-profit organizations. Not-for-profit organizations should continue to apply the guidance in Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, before the amendments made by FASB Statement No. 160, SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations* (AICPA, *Technical Practice Aids*, ACC sec. 10,610), and other applicable standards, until FASB issues interpretative guidance. FASB Statement No. 160 is effective for fiscal years beginning on or after December 15, 2006. Earlier adoption is prohibited.

APB Opinion No. 29, *Accounting for Nonmonetary Transactions*),[MAA,NIS,BCR] do not exempt not-for-profit organizations from their scope, but the transactions

---

[MAA] On October 9, 2006, FASB issued an exposure draft of a proposed FASB statement, *Not-for-Profit Organizations: Mergers and Acquisitions*, which would eliminate the use of the pooling-of-interests method of accounting by not-for-profit organizations and would require that they apply the acquisition method to any merger or acquisition. The acquisition method would require a not-for-profit organization to identify the acquirer, recognize the identifiable assets acquired and liabilities assumed that compose the business or nonprofit activity acquired at their fair values as of the acquisition date (with certain exceptions), and recognize either goodwill or the contribution inherent in the transaction. The proposed FASB statement would amend APB Opinion No. 16, *Business Combinations*, and No. 29 and FASB Statement Nos. 116 and 117. Concurrently, FASB also issued an exposure draft of a proposed FASB statement, *Not-for-Profit Organizations: Goodwill and Other Intangible Assets Acquired in a Merger or Acquisition*, which would amend FASB Statement No. 142 to provide guidance to not-for-profit organizations for testing goodwill for impairment and applying FASB Statement No. 142's provisions (as amended) to identified intangible assets recognized as the result of a merger or acquisition. Readers should be alert to the issuance of final standards.

[NIS] See footnote NIS in paragraph 1.11

[BCR] In December 2007, FASB issued FASB Statement No. 141 (revised 2007), *Business Combinations*, which replaces FASB Statement No. 141, *Business Combinations*. Like its predecessor, FASB Statement No. 141(R) is not applicable to combinations between not-for-profit organizations or the acquisition of a for-profit business by a not-for-profit organization. The nullifications or amendments to other standards made by FASB Statement No. 141(R) also are not applicable to not-for-profit organizations. Thus, not-for-profit organizations should continue to apply FASB Statement No. 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions—an amendment of APB Opinion No. 17, an interpretation of APB Opinions 16 and 17, and an amendment of FASB Interpretation No. 9*, and No. 147, *Acquisitions of Certain Financial Institutions—an amendment of FASB Statements No. 72 and 144 and FASB Interpretation No. 9*, and FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method—an interpretation of FASB Statement No. 2*, and No. 9, *Applying APB Opinions No. 16 and 17 When a Savings and Loan Association or a Similar Institution is Acquired in a Business Combination Accounted for by the Purchase Method—an interpretation of APB Opinions No. 16 and 17*, as indicated in paragraphs 1.24–.28 of this guide. Not-for-profit organizations also should continue to apply the following standards as indicated in paragraphs 1.24–.28 of this guide without regard to the amendments made by FASB Statement No. 141(R): ARB No. 43, *Restatement and Revision of Accounting Research Bulletins*, APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*, No. 18, *The Equity Method of Accounting for Investments in Common Stock*, No. 28, *Interim Financial Reporting*, No. 29, *Accounting for Nonmonetary Transactions*, and No. 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*, FASB Statement No. 2, *Accounting for Research and Development Costs*, No. 5, *Accounting for Contingencies*, No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, No. 45, *Accounting for Franchise Fee Revenue*, No. 52, *Foreign Currency Translation*, No. 60, No. 68, *Research and Development Arrangements*, No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*, No. 87, *Employers' Accounting for Pensions*, No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, No. 109, *Accounting for Income Taxes*, No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts—an amendment of FASB Statements 60, 97, and 113 and Interpretation No. 40*, No. 123(R), *Share-Based Payment*, No. 133, *Accounting for Derivative Instruments and Hedging Activities*, No. 142, No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, and No. 154, *Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3*, and FASB Interpretation No. 21, *Accounting for Leases in a Business Combination—an interpretation of FASB Statement No. 13*, No. 26, *Accounting for Purchase of a Leased Asset by the Lessee during the Term of the Lease—an interpretation of FASB Statement No. 13*, No. 46(R), and No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*. In addition, the amendments made by FASB Statement No. 141(R) to FASB Technical Bulletin 84-1, *Accounting for Stock Issued to Acquire the Results of a Research and Development Arrangement*, SOP 78-9, *Accounting for Investments in Real Estate Ventures* (AICPA, *Technical Practice Aids*, ACC sec. 10,240), SOP 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code* (AICPA, *Technical Practice Aids*, ACC sec. 10,460), SOP 93-6, *Employers' Accounting for Employee Stock Ownership Plans* (AICPA, *Technical Practice Aids*, ACC sec. 10,580), SOP 96-1, *Environmental Remediation Liabilities* (AICPA, *Technical Practice Aids*, ACC sec. 10,680), SOP 00-3, *Accounting by*

*(continued)*

they contemplate also are covered by FASB Statement No. 116 and this guide. FASB Statement Nos. 116, 117, 124, and 136 and this guide provide guidance for applying the pronouncements to circumstances unique to not-for-profit organizations and not contemplated by the pronouncements and therefore should be followed to apply the guidance in those pronouncements to not-for-profit organizations. (However, the guidance included in the effective provisions of pronouncements included in appendix C [paragraph 1.26] should be followed by all for-profit entities owned, whether owned all or in part, by not-for-profit entities.)

**1.12** Some pronouncements (listed in appendix D [paragraph 1.27] of this chapter), which may include guidance concerning the recognition and measurement of assets, liabilities, revenues, expenses, gains and losses, and financial statement display, state that their provisions apply only to entities operating in certain industries. Such entities generally are business enterprises. An example of such guidance is FASB Statement No. 63, *Financial Reporting by Broadcasters*. However, some not-for-profit organizations conduct activities[5] in some of those industries and should apply the guidance in the pronouncements concerning the recognition and measurement of assets, liabilities, revenues, expenses, and gains and losses to the transactions unique to those industries. However, such not-for-profit organizations should follow the financial statement display guidance in FASB Statement No. 117 and this guide, even though it may conflict with display that would result from applying the guidance in the pronouncements listed in appendix D [paragraph 1.27].

**1.13** Financial reporting pronouncements that have not been superseded and are not included in appendixes A–D [paragraphs 1.24–.27] of this chapter are listed in appendix E [paragraph 1.28] of this chapter. Not-for-profit organizations should follow the effective provisions of the pronouncements listed in appendix E [paragraph 1.28].[6]

**1.14** Certain other pronouncements, although they do not exempt not-for-profit organizations and do cover transactions conducted by not-for-profit organizations, include some provisions whose application by not-for-profit

---

*(footnote continued)*

*Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts* (AICPA, *Technical Practice Aids*, ACC sec. 10,810), SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others* (AICPA, *Technical Practice Aids*, ACC sec. 10,850), SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* (AICPA, *Technical Practice Aids*, ACC sec. 10,880), and SOP 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts* (AICPA, *Technical Practice Aids*, ACC sec. 10,920), and AICPA Practice Bulletin No. 4, *Accounting for Foreign Debt/Equity Swaps* (AICPA, *Technical Practice Aids*, PB sec. 12,040), Practice Bulletin No. 6, *Amortization of Discounts on Certain Acquired Loans* (AICPA, *Technical Practice Aids*, PB sec. 12,060), and Practice Bulletin No. 14, *Accounting and Reporting by Limited Liability Companies and Limited Liability Partnerships* (AICPA, *Technical Practice Aids*, PB sec. 12,140), do not apply to not-for-profit organizations, nor do the changes made by Statement No. 141(R) to FASB Technical Bulletin 85-5, *Issues Relating to Accounting for Business Combinations*, FSP FAS No. 141-1 and 142-1, *Interaction of FASB Statements No. 141 and No. 142 and EITF Issue No. 04-2*, and Practice Bulletin No. 11, *Accounting for Preconfirmation Contingencies in Fresh-Start Reporting* (AICPA, *Technical Practice Aids*, PB sec. 12,110), many EITF Issue consensuses, and several responses in the FASB Staff Q&A on FASB Statement No. 109.

[5] Such activities may be conducted by (*a*) for-profit entities owned and consolidated by not-for-profit organizations, (*b*) divisions of not-for-profit organizations, or (*c*) entire not-for-profit organizations, such as those operating as not-for-profit broadcasters.

[6] See footnote 4.

organizations may be unclear. Nevertheless, not-for-profit organizations are required to follow the effective provisions of those pronouncements. These provisions and their applicability are discussed below.

## APB Opinion No. 16, *Business Combinations*[*], [MAA]

**1.15** Because the conditions for applying the pooling of interests method of accounting for a business combination generally include an exchange of common stock of the combining entities, not-for-profit organizations generally would not meet the conditions for applying that method. The AICPA Accounting Standards Executive Committee (AcSEC) believes that circumstances exist under which reporting on the combination of two or more not-for-profit organizations (or that of a not-for-profit organization with a formerly for-profit entity) by the pooling of interests method better reflects the substance of the transaction than reporting by the purchase method. Therefore, not-for-profit organizations are, under certain circumstances, permitted to report by the pooling of interests method, even though they generally do not issue common stock. Such circumstances include the combination of two or more entities to form a new entity without the exchange of consideration.

**1.16** An example of acceptable practice, in some circumstances, for reporting business combinations by not-for-profit organizations if there has been no exchange of consideration is to report the (*a*) assets, (*b*) liabilities, and (*c*) 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 Opinion No. 16, *Business Combinations*.

## Provisions of Certain Pronouncements Concerning Financial Statement Display

**1.17** The following pronouncements include provisions specifying the financial statement display of certain financial statement elements or items such as gains and losses, extraordinary items, translation adjustments, income tax expense, and prepaid or deferred income taxes:

- APB Opinion No. 9, *Reporting the Results of Operations*
- APB Opinion No. 26, *Early Extinguishment of Debt*, as amended

---

[*] In June 2001, FASB issued FASB Statement No. 141 which supersedes several pronouncements including APB Opinion No. 16. In December 2007, FASB issued FASB Statement No. 141(R), which replaces FASB Statement No. 141. However, neither FASB Statement No. 141 nor its replacement, FASB Statement No. 141(R), applies to combinations of two or more not-for-profit organizations or the acquisition of a for-profit business entity by a not-for-profit organization. Thus, GAAP does not change for those types of combinations. Not-for-profit organizations should continue to follow the guidance in this guide and in APB Opinion No. 16 as amended by pronouncements prior to the issuance of FASB Statement No. 141, as well as the guidance in the other pronouncements superseded by FASB Statement Nos. 141 and 141(R). Pronouncements that were amended by FASB Statement Nos. 141 and 141(R) should be applied as though Statement Nos. 141 and 141(R) had not amended them. In addition, in applying the guidance included in APB Opinion No. 16, not-for-profit organizations should continue to apply the amendments to that Opinion that were included in FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, even though FASB Statement No. 121 was superseded by FASB Statement No. 144. (FASB Statement No. 144 did not carry forward the amendments to APB Opinion No. 16 because APB Opinion No. 16 had been superseded.) For additional guidance, refer to footnotes BCR and NIS in this chapter.

[MAA] See footnote MAA in paragraph 1.11.

- APB Opinion No. 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*, as amended[BCR]

- FASB Statement No. 52, *Foreign Currency Translation*, as amended[DDI,BCR]

- FASB Statement No. 109, *Accounting for Income Taxes*, as amended[TAX,NPE,BCR]

None of the preceding pronouncements considers the net asset reporting model included in FASB Statement No. 117 and this guide. Therefore, preparers of financial statements of not-for-profit organizations should consider the reporting objectives of these APB Opinions and FASB statements when exercising judgment about how to best display elements, such as in which net asset class.

## Fund Accounting and Net Asset Classes

**1.18** Fund accounting is a technique used by some not-for-profit organizations for purposes of internal recordkeeping and managerial control and to help ensure that the use of resources is in accordance with stipulations imposed by donors and other resource providers and with self-imposed limitations designated by those charged with governance, hereafter referred to as governing board. Under fund accounting, resources are classified into funds associated with specific activities and objectives. Prior to implementing FASB Statement

---

[BCR] See footnote BCR in paragraph 1.11.

[DDI] On December 8, 2006, FASB issued an exposure draft of a proposed FASB statement, *Disclosures about Derivative Instruments and Hedging Activities*, an amendment of FASB Statement No. 133, which amends and expands the disclosure requirements for derivative instruments. The proposed statement would also amend FASB Statement No. 52 and No. 107, *Disclosures about Fair Value of Financial Instruments*. Readers should be alert to the issuance of a final standard.

[TAX] In June 2006, FASB issued FASB Interpretation No. 48, an interpretation of FASB Statement No. 109. The interpretation limits the recognition of uncertain tax positions to only those positions that are more likely than not to be sustained on audit based solely on the technical merits of the position. The interpretation is effective for fiscal years beginning after December 15, 2006. However, FSP FIN 48-2 defers the effective date of that interpretation to fiscal years beginning after December 15, 2007, for certain nonpublic enterprises as defined by paragraph 289 of FASB Statement No. 109, including nonpublic not-for-profit organizations. Earlier application is permitted. Not-for-profit organizations that have already adopted the provisions of FASB Interpretation No. 48 are not eligible for the deferral.

[NPE] In October 2006, FASB issued FSP FAS 126-1, *Applicability of Certain Disclosure and Interim Reporting Requirements for Obligors for Conduit Debt Securities*, which clarifies the definition of a *public entity* in certain accounting standards to include entities that are conduit bond obligors for conduit debt securities that are traded in a public market. The FSP amends APB Opinion No. 28, *Interim Financial Reporting*, and FASB Statement No. 69, *Disclosures about Oil and Gas Producing Activities—an amendment of FASB Statements 19, 25, 33, and 39*, No. 109, No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities—an amendment to FASB Statement No. 107*, No. 131, *Disclosures about Segments of an Enterprise and Related Information*, No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits—an amendment of FASB Statements No. 87, 88, and 106*, and No. 141. It is effective for fiscal periods beginning after December 15, 2006. An entity may elect to retrospectively apply the guidance to all prior periods.

No. 117, some not-for-profit organizations used fund accounting for financial reporting in conformity with applicable AICPA Industry Audit Guides and Audit and Accounting Guides.

**1.19** *Montgomery's Auditing* notes that "as used in nonprofit accounting, a fund is an accounting entity with a self-balancing set of accounts for recording assets, liabilities, the fund balance, and changes in the fund balance. Separate accounts are maintained for each fund to ensure that the limitations and restrictions on the use of resources are observed. Though the fund concept involves separate accounting records, it does not entail the physical segregation of resources. Fund accounting is basically a mechanism to assist in exercising control over the purpose of particular resources and amounts of those resources available for use."[7] Fund accounting is discussed further in chapter 16, "Fund Accounting," of this guide.

**1.20** Paragraph 18, footnote 5, of FASB Statement No. 117 states that "this Statement does not use the terms *fund balance* or *changes in fund balances* because in current practice those terms are commonly used to refer to individual groups of assets and related liabilities rather than to an entity's net assets or changes in net assets taken as a whole...." As discussed in chapter 3, "Basic Financial Statements," of this guide, FASB Statement No. 117 requires that the amounts for each of three classes of net assets (permanently restricted, temporarily restricted, and unrestricted) be displayed in a statement of financial position and that the amounts of change in each of those classes of net assets be displayed in a statement of activities.

**1.21** Therefore, under FASB Statement No. 117, reporting by individual funds or fund groups is not required. FASB Statement No. 117, however, does not preclude providing disaggregated information by individual funds or fund groups, as long as the required aggregated amounts for each of the three classes of net assets are displayed as indicated previously. Paragraph 50 of the statement specifically notes that "...how an organization maintains its internal accounting and recordkeeping systems is a matter outside the purview of the FASB."

**1.22** Some not-for-profit organizations may continue to use fund accounting for purposes other than reporting in conformity with GAAP, and some may provide disaggregated information in the financial statements beyond the minimum requirements of FASB Statement No. 117. A particular fund balance may fall completely into one of the three net asset classes or may be allocated to more than one net asset class, in conformity with the requirements of FASB Statement No. 117 and as discussed in chapter 16 of this guide.

**1.23** The accounting and auditing issues concerning each particular asset, liability, or class of net assets (financial statement elements) are not a function of the element's internal classification or financial statement subclassification. Accordingly, this guide is organized by financial statement elements and not by type of fund or groups of funds. Chapter 16 of this guide contains a discussion of the relationship of an organization's fund balances to its net asset classes.

---

[7] Vincent M. O'Reilly, Murray B. Hirsch, Philip L. Defliese, and Henry R. Jaenicke, *Montgomery's Auditing*, 11th ed. (New York: John Wiley & Sons, 1990), 791.

1.24

# Appendix A—Financial Reporting Pronouncements That Specifically Exempt Not-for-Profit Organizations From Their Application

| *Pronouncement* | *Other References, if Any*[8] | *Status of Other References* |
|---|---|---|
| APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, as amended[NIS,BCR] | SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations* (AICPA, *Technical Practice Aids*, ACC sec. 10,610)[OMN] (chapter 8, appendix B of this guide) | This guide provides no guidance for the equity method of accounting for common stock. However, it does provide guidance for accounting for investments in common stock. |
| FASB Statement No. 89, *Financial Reporting and Changing Prices*, as amended[NIS] | None | None |
| FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, as amended[FMV, FVO] | FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*; chapter 8 of this guide | Currently effective |
| FASB Statement No. 128, *Earnings per Share*, as amended[EPS,NIS] | None | None |
| FASB Statement No. 130, *Reporting Comprehensive Income*, as amended[DBP,NIS] | FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations* | Currently effective |
| FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*, as amended[NPE] | None | None |
| FASB Statement No. 141, *Business Combinations*, as amended[FMV,NPE] | Paragraphs 1.15–.16 of this guide | Currently effective |
| FASB Statement No. 141 (revised 2007), *Business Combinations*[BCR] | Paragraphs 1.15–.16 of this guide | Currently effective |
| FASB Statement No. 160, *Non-controlling Interests in Consolidated Financial Statements—an amendment of ARB No. 51* | Paragraphs 1.15–.16 of this guide AICPA SOP No. 94-3[OMN] (chapter 8, appendix B of this guide) | Currently effective |

*(continued)*

## Financial Reporting Pronouncements That Specifically Exempt Not-for-Profit Organizations From Their Application—continued

| *Pronouncement* | *Other References, if Any* | *Status of Other References* |
|---|---|---|
| FASB Interpretation No. 18, *Accounting for Income Taxes in Interim Periods*, as amended | None | None |
| FASB Interpretation No. 35, *Criteria for Applying the Equity Method of Accounting for Investments in Common Stock* | See APB Opinion No. 18[BCR] | See APB Opinion No. 18[BCR] |
| FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (revised December 2003), as amended[NIS,BCR] | None | None |

[8]References in this column are provided as a guide to other sources of information about the topic covered by the listed pronouncement.

[NIS]See footnote NIS in paragraph 1.11.

[BCR]See footnote BCR in paragraph 1.11.

[OMN]On September 27, 2007, FASB issued an exposure draft, *Proposed FSP SOP 94-3-a and AAG-HCO-a, Omnibus Changes to Consolidation and Equity Method Guidance for Not-for-Profit Organizations*, which would make several changes to the guidance on consolidation and the equity method of accounting in SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*. Readers should be alert to the issuance of a final standard.

[FMV]In September 2006, FASB issued FASB Statement No. 157, *Fair Value Measurements*, which provides guidance for how to measure the fair value of financial and nonfinancial assets and liabilities. It replaces the more general guidance for determining fair value currently found in many existing FASB standards, including APB Opinions No. 21, *Interest on Receivables and Payables*, No. 28, and No. 29; FASB Statement No. 13, *Accounting for Leases*, No. 15, No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, No. 60, No. 63, *Financial Reporting by Broadcasters*, No. 65, *Accounting for Certain Mortgage Banking Activities*, No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, No. 87, No. 106, No. 107, *Disclosures about Fair Value of Financial Instruments*, No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, No. 116, No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, No. 133, No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities-a replacement of FASB Statement No. 125*, No. 141, No. 142, No. 143, *Accounting for Asset Retirement Obligations*, No. 144, No. 146, No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, and No. 156, *Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*; FASB Interpretation No. 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*; and various FASB Statement No. 133 implementation issues. FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year. However, FSP FAS 157-2, *Effective Date of FASB Statement No. 157*, delays the effective date of FASB Statement No. 157 until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for fair value measurements of all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually).

## Financial Reporting Pronouncements That Specifically Exempt Not-for-Profit Organizations From Their Application—continued

[FVO] In February 2007, FASB issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*, which permits an organization to irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and financial liabilities on a contract-by-contract basis, with changes in fair value recognized in the statement of activities as those changes occur. The statement amends APB No. 21 and FASB Statement No. 57, *Related Party Disclosures*, No. 95, *Statement of Cash Flows*, No. 102, *Statement of Cash Flows-Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale—an amendment of FASB Statement No. 95*, No. 115, No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, and No. 133. FASB Statement No. 159 is effective as of the beginning of an organization's first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the organization also elects to apply the provisions of FASB Statement No. 157.

[EPS] On September 30, 2005, FASB issued a revised exposure draft of a proposed FASB statement, *Earnings Per Share,* that would amend FASB Statement No. 128 to change the computational guidance for computing earnings per share. Readers should be alert to the issuance of the final standard.

[DBP] In September 2006, FASB issued FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, an amendment of FASB Statement No. 87, No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, and No. 132(R), *Employers' Disclosures about Pensions and Other Postretirement Benefits—an amendment of FASB Statements No. 87, 88, and 106*. The statement requires employers to recognize the overfunded or underfunded positions of defined benefit postretirement plans (other than a multiemployer plan), including pension plans, in their statement of financial position. It also requires that employers measure plan assets and obligations as of the date of their financial statements. The statement amends FASB Statement No. 87, No. 88, No. 106, No. 130, No. 132(R), ARB No. 43, and APB Opinion No. 28. The requirement to recognize the funded status of a defined benefit postretirement plan and the related disclosure requirements was effective for not-for-profit organizations as of the end of the fiscal year ending after June 15, 2007. The requirement to measure plan assets and benefit obligations as of the date of the employer's fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008. Earlier application is encouraged.

[NPE] See footnote NPE in paragraph 1.17.

1.25

## Appendix B—Financial Reporting Pronouncements That, by the Nature of Their Subject Matter, Generally Do Not Apply to Not-for-Profit Organizations

The following box lists effective date information for pronouncements in this appendix and for pronouncements that amend or supersede the pronouncements included in this appendix.

Pronouncements that were not effective when this edition of the guide was issued:

- FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51*, does not apply to not-for-profit organizations, nor do its amendments to other standards including those identified within this appendix by the symbol[NIS]. Not-for-profit organizations should continue to apply the guidance in ARB No. 51 before the amendments made by FASB Statement No. 160, the guidance in SOP 94-3 and other applicable standards, until FASB issues interpretative guidance.
- FASB Statement No. 141(R), *Business Combinations*, is not applicable to combinations between not-for-profit organizations or the acquisition of a for-profit business by a not-for-profit organization, nor are its amendments to other standards, including those identified within this appendix by the symbol[BCR].
- FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, an amendment of FASB Statement No. 87, *Employers' Accounting for Pensions*, No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, and No. 132(R), *Employers' Disclosures about Pensions and Other Postretirement Benefits—an amendment of FASB Statements No. 87, 88, and 106*, has multiple effective dates. The requirement to recognize the funded status of a defined benefit postretirement plan and the related disclosure requirements was effective for not-for-profit organizations as of the end of the fiscal year ending after June 15, 2007. The requirement to measure plan assets and benefit obligations as of the date of the employer's fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008. Earlier application is encouraged. The statement requires employers to recognize the overfunded or underfunded positions of defined benefit postretirement plans (other than a multiemployer plan), including pension plans, in their statement of financial position. It also requires that employers measure plan assets and obligations as of the date of their financial statements. The statement amends several FASB standards, including those identified within this appendix by the symbol[DBP].

[NIS] See footnote NIS in paragraph 1.11.

[BCR] See footnote BCR in paragraph 1.11.

[DBP] See footnote DBP in paragraph 1.24.

- FASB Statement No. 157, *Fair Value Measurements*, is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year. However, FSP FAS 157-2, *Effective Date of FASB Statement No. 157*, delays the effective date of FASB Statement No. 157 until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for fair value measurements of all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). FASB Statement No. 157 provides guidance for how to measure the fair value of financial and nonfinancial assets and liabilities. It replaces the more general guidance for determining fair value currently found in many existing FASB standards, including those identified within this appendix with the symbol[FMV].
- FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, is effective for financial instruments entered into or modified after May 31, 2003. However, the effective date of the provisions regarding mandatorily redeemable financial instruments of nonpublic entities and mandatorily redeemable noncontrolling interests were deferred, in certain cases indefinitely, by FSP FAS 150-3, *Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests Under FASB Statement No. 150*, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. FASB Statement No. 150 amends FASB Statement No. 128, *Earnings per Share*, and No. 133, *Accounting for Derivative Instruments and Hedging Activities*.
- FSP FAS 126-1, *Applicability of Certain Disclosure and Interim Reporting Requirements for Obligors for Conduit Debt Securities*, is effective for fiscal periods beginning after December 15, 2006. An entity may elect to retrospectively apply the guidance to all prior periods. The FSP amends several FASB standards, including those identified within this appendix by the symbol[NPE].

- APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued With Stock Purchase Warrants*[BCR]
- APB Opinion No. 28, *Interim Financial Reporting*, as amended[DBP, NPE, FSP,BCR]
- FASB Statement No. 84, *Induced Conversions of Convertible Debt*

[FMV] See footnote FMV in paragraph 1.24.

[NPE] See footnote NPE in paragraph 1.17.

[BCR] See footnote BCR in paragraph 1.11.

[DBP] See footnote DBP in paragraph 1.24.

[FSP] On October 25, 2006, FASB issued FSP FAS 126-1, which makes the disclosure requirements of APB Opinion No. 28 applicable to not-for-profit organizations that meet the definition of a public entity in footnote 1 in paragraph 6 of that opinion. The FSP is applied prospectively for fiscal periods beginning after December 15, 2006.

- FASB Statement No. 123(R), *Share-Based Payment*, as amended[BCR]
- FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity,* as amended[9,FMV,BCR]

---

[BCR] See footnote BCR in paragraph 1.11.

[9] FASB Statement No. 150 generally is not applicable to not-for-profit organizations. However, as explained in paragraphs 11.10–.13, some country clubs and social clubs have member interests that fall within the scope of that FASB statement.

[FMV] See footnote FMV in paragraph 1.24.

1.26

# Appendix C—Financial Reporting Pronouncements Whose Application to Not-for-Profit Organizations Is Subject to Additional FASB or AICPA Guidance

The following box lists effective date information for pronouncements in this appendix and for pronouncements that amend or supersede the pronouncements included in this appendix.

Pronouncements that were not effective when this edition of the guide was issued:

- FASB Statement No. 160 does not apply to not-for-profit organizations, nor do its amendments to other standards including those identified within this appendix by the symbol[NIS]. Not-for-profit organizations should continue to apply the guidance in ARB No. 51 before the amendments made by FASB Statement No. 160, the guidance in SOP 94-3 and other applicable standards, until FASB issues interpretative guidance.
- FASB Statement No. 141(R) is not applicable to combinations between not-for-profit organizations or the acquisition of a for-profit business by a not-for-profit organization, nor are its amendments to other standards, including those identified within this appendix by the symbol[BCR].
- FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*, is effective as of the beginning of an organization's first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the organization also elects to apply the provisions of FASB Statement No. 157. The statement permits an organization to irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and financial liabilities on a contract-by-contract basis, with changes in fair value recognized in the statement of activities as those changes occur. The statement amends several FASB standards, including those identified within this appendix by the symbol[FVO].
- FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year. However, FSP FAS 157-2 delays the effective date of FASB Statement No. 157 until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for fair value measurements of all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). FASB Statement No. 157 provides guidance

[NIS] See footnote NIS in paragraph 1.11.

[BCR] See footnote BCR in paragraph 1.11.

[FVO] See footnote FVO in paragraph 1.24.

for how to measure the fair value of financial and nonfinancial assets and liabilities. It replaces the more general guidance for determining fair value currently found in many existing FASB standards, including those identified within this appendix by the symbol [FMV].

| *Pronouncement* | *Additional Guidance* |
|---|---|
| ARB No. 51, *Consolidated Financial Statements*, as amended[NIS] | SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations* |
| APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, as amended[FMV,MAA, NIS, BCR] | FASB Statement No. 116 and chapter 5 of this guide provide accounting guidance for contributions |
| FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, as amended | See ARB No. 51 |
| FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, as amended[FMV,MAA] | This guide<br>FASB Statement No. 136 |
| FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, as amended[MAA] | This guide |
| FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations,* as amended[FMV,FVO] | This guide |
| FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, as amended[FMV] | This guide |
| FASB Statement No. 153, *Exchanges of Nonmonetary Assets* | FASB Statement No. 116 and chapter 5 of this guide provide accounting guidance for contributions |
| FASB Interpretation No. 30, *Accounting for Involuntary Conversions of Nonmonetary Assets to Monetary Assets*, as amended | See APB Opinion No. 29[BCR] |

[FMV] See footnote FMV in paragraph 1.24.

[NIS] See footnote NIS in paragraph 1.11.

[MAA] See footnote MAA in paragraph 1.11.

[BCR] See footnote BCR in paragraph 1.11.

[FVO] See footnote FVO in paragraph 1.24.

1.27

# Appendix D—Financial Reporting Pronouncements Pertaining to Specialized Industry Practices of Business Enterprises

The following box lists effective date information for pronouncements in this appendix and for pronouncements that amend or supersede the pronouncements included in this appendix.

Pronouncements that were not effective when this edition of the guide was issued:

- FASB Statement No. 160 does not apply to not-for-profit organizations, nor do its amendments to other standards including those identified within this appendix by the symbol[NIS]. Not-for-profit organizations should continue to apply the guidance in ARB No. 51, *Consolidated Financial Statements*, before the amendments made by FASB Statement No. 160, the guidance in SOP 94-3 and other applicable standards, until FASB issues interpretative guidance.
- FASB Statement No. 141(R) is not applicable to combinations between not-for-profit organizations or the acquisition of a for-profit business by a not-for-profit organization, nor are its amendments to other standards, including those identified within this appendix by the symbol[BCR].
- FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year. However, FSP FAS 157-2 delays the effective date of FASB Statement No. 157 until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for fair value measurements of all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). FASB Statement No. 157 provides guidance for how to measure the fair value of financial and nonfinancial assets and liabilities. It replaces the more general guidance for determining fair value currently found in many existing FASB standards, including those identified within this appendix with the symbol[FMV].
- FASB Statement No. 142, *Goodwill and Other Intangible Assets*, is effective for intangible assets acquired in transactions other than combinations, for example, the purchase or gift of patent or royalty rights from the holder of the patent or copyright. However, the provisions of FASB Statement No. 141, *Business Combinations*, FASB Statement No. 141 (revised 2007), *Business Combinations*, and FASB Statement No. 142 should not be applied to goodwill and intangible assets arising from a combination between two or more not-for-profit organizations or acquired in the

---

[NIS] See footnote NIS in paragraph 1.11.

[BCR] See footnote BCR in paragraph 1.11.

[FMV] See footnote FMV in paragraph 1.24.

acquisition of a for-profit business entity by a not-for-profit organization until FASB completes its project on those types of combinations and acquisitions. Thus, the guidance in APB Opinion No. 16 and No. 17, *Intangible Assets*, remains in effect for such assets. In addition, when applying APB Opinion Nos. 16 and 17, not-for-profit organizations should continue to apply the amendments to those Opinions found in other literature even though that other literature may have been superseded by FASB Statement No. 141, No. 141(R), No. 142, and No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. For example, when applying APB Opinion No. 17, not-for-profit organizations should continue to apply the amendments to that Opinion found in FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, even though that statement was superseded by Statement No. 144. On October 9, 2006, FASB issued two exposure drafts to provide guidance to not-for-profit organizations. The proposed FASB statement, *Not-for-Profit Organizations: Mergers and Acquisitions*, would amend APB Opinion Nos. 16 and 29 and FASB Statement Nos. 116 and 117. The proposed FASB statement, *Not-for-Profit Organizations: Goodwill and Other Intangible Assets Acquired in a Merger or Acquisition*, would amend FASB Statement No. 142. Readers should be alert to the issuance of a final standard.

- FSP FAS 126-1 is effective for fiscal periods beginning after December 15, 2006. An entity may elect to retrospectively apply the guidance to all prior periods. The FSP amends several FASB standards, including those identified within this appendix by the symbol[NPE].

This appendix includes pronouncements that apply only to entities operating in certain industries, generally business enterprises. However, some not-for-profit organizations conduct activities in some of those industries and should apply the guidance concerning recognition and measurement of assets, liabilities, revenues, expenses, and gains and losses in those pronouncements to the transactions unique to those industries. In addition, those not-for-profit organizations should follow the financial statement display guidance in FASB Statement No. 117, and this guide, although it may conflict with display that would result from applying the guidance in the pronouncements included in this appendix.

- APB Opinion No. 12, *Omnibus Opinion—1967* (guidance under the heading "Capital Changes")
- APB Opinion No. 13, *Amending Paragraph 6 of APB Opinion No. 9, Application to Commercial Banks*
- FASB Statement No. 7, *Accounting and Reporting by Development Stage Enterprises*, as amended
- FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, as amended[FMV]

[NPE] See footnote NPE in paragraph 1.17.

[FMV] See footnote FMV in paragraph 1.24.

- FASB Statement No. 25, *Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies (an amendment of FASB Statement No. 19)*, as amended
- FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, as amended[FMV]
- FASB Statement No. 45, *Accounting for Franchise Fee Revenue*[BCR]
- FASB Statement No. 50, *Financial Reporting in the Record and Music Industry*
- FASB Statement No. 51, *Financial Reporting by Cable Television Companies*, as amended
- FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, as amended[FMV, NIS, BCR, FGI]
- FASB Statement No. 61, *Accounting for Title Plant*, as amended
- FASB Statement No. 63, *Financial Reporting by Broadcasters*, as amended[FMV]
- FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, as amended[FMV]
- FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, as amended[FMV]
- FASB Statement No. 69, *Disclosures about Oil and Gas Producing Activities (an amendment of FASB Statements 19, 25, 33, and 39)*, as amended[NPE]
- FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation*, as amended
- FASB Statement No. 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions (an amendment of APB Opinion No. 17, an interpretation of APB Opinions 16 and 17, and an amendment of FASB Interpretation No. 9)*, as amended[BCR]
- FASB Statement No. 90, *Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs (an amendment of FASB Statement No. 71)*, as amended
- FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases (an amendment of FASB Statements No. 13, 60, and 65 and a rescission of FASB Statement No. 17)*, as amended
- FASB Statement No. 92, *Regulated Enterprises—Accounting for Phase-in Plans (an amendment of FASB Statement No. 71)*

---

[FMV] See footnote FMV in paragraph 1.24.

[BCR] See footnote BCR in paragraph 1.11.

[NIS] See footnote NIS in paragraph 1.11.

[FGI] On April 18, 2007, FASB issued an exposure draft, *Accounting for Financial Guarantee Insurance Contracts—an interpretation of FASB Statement No. 60*, which would clarify how FASB Statement No. 60 applies to financial guarantee insurance (and reinsurance) contracts issued by insurance enterprises. The proposed FASB statement would amend FASB Statement Nos. 60, 107, and 133 and FASB Interpretation No. 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*. Readers should be alert to the issuance of the final standard.

[NPE] See footnote NPE in paragraph 1.17.

- FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, as amended[BCR]
- FASB Statement No. 101, *Regulated Enterprises—Accounting for the Discontinuation of Application of FASB Statement No. 71*, as amended
- FASB Statement No. 110, *Reporting by Defined Benefit Pension Plans of Investment Contracts (an amendment of FASB Statement No. 35)*
- FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, as amended[BCR]
- FASB Statement No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts (an amendment of FASB Statement Nos. 60, 97, and 113 and Interpretation No. 40)*[BCR]
- FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise*, an amendment of FASB Statement No. 65
- FASB Statement No. 139, *Rescission of FASB Statement No. 53 and amendments to FASB Statements No. 63, 89, and 121*
- FASB Statement No. 147, *Acquisitions of Certain Financial Institutions*, an amendment of FASB Statement Nos. 72 and 144 and FASB Interpretation No. 9[BCR]
- FASB Statement No. 152, *Accounting for Real Estate Time-Sharing Transactions*, an amendment of FASB Statement Nos. 66 and 67
- FASB Statement No. 156, *Accounting for Servicing of Financial Assets*, as amended[FMV]
- FASB Interpretation No. 7, *Applying FASB Statement No. 7 in Financial Statements of Established Operating Enterprises*
- FASB Interpretation No. 9, *Applying APB Opinions No. 16 and 17 When a Savings and Loan Association or a Similar Institution Is Acquired in a Business Combination Accounted for by the Purchase Method*, as amended
- FASB Interpretation No. 33, *Applying FASB Statement No. 34 to Oil and Gas Producing Operations Accounted for by the Full Cost Method*
- FASB Interpretation No. 36, *Accounting for Exploratory Wells in Progress at the End of a Period*
- FASB Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises*, as amended

---

[BCR] See footnote BCR in paragraph 1.11.

[FMV] See footnote FMV in paragraph 1.24.

1.28

## Appendix E—Financial Reporting Pronouncements Not Subsequently Superseded and Not Included in Appendixes A–D of This Chapter

The following box lists effective date information for pronouncements in this appendix and for pronouncements that amend or supersede the pronouncements included in this appendix.

Pronouncements that were not effective when this edition of the guide was issued:

- FASB Statement No. 160 does not apply to not-for-profit organizations, nor do its amendments to other standards including those identified within this appendix by the symbol[NIS]. Not-for-profit organizations should continue to apply the guidance in ARB No. 51 before the amendments made by FASB Statement No. 160, the guidance in SOP 94-3 and other applicable standards, until FASB issues interpretative guidance.
- FASB Statement No. 141(R) is not applicable to combinations between not-for-profit organizations or the acquisition of a for-profit business by a not-for-profit organization, nor are its amendments to other standards, including those identified within this appendix by the symbol[BCR].
- FASB Statement No. 159 is effective as of the beginning of an organization's first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the organization also elects to apply the provisions of FASB Statement No. 157. The statement permits an organization to irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and financial liabilities on a contract-by-contract basis, with changes in fair value recognized in the statement of activities as those changes occur. The statement amends several FASB standards, including those identified within this appendix by the symbol[FVO].
- FASB Statement No. 158, an amendment of FASB Statement Nos. 87, 88, 106, and 132(R), has multiple effective dates. The requirement to recognize the funded status of a defined benefit postretirement plan and the related disclosure requirements was effective for not-for-profit organizations as of the end of the fiscal year ending after June 15, 2007. The requirement to measure plan assets and benefit obligations as of the date of the employer's fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008. Earlier application is encouraged. The statement requires employers to recognize the overfunded or underfunded positions of defined benefit postretirement plans (other than a multiemployer plan), including pension plans, in their statement of financial position. It also requires that employers measure plan assets and obligations as of the date of their financial statements. The statement amends several FASB standards, including those identified within this appendix by the symbol[DBP].

---

[NIS] See footnote NIS in paragraph 1.11.

[BCR] See footnote BCR in paragraph 1.11.

[FVO] See footnote FMV in paragraph 1.24.

[DBP] See footnote DBP in paragraph 1.24.

- FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year. However, FSP FAS 157-2 delays the effective date of FASB Statement No. 157 until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for fair value measurements of all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). FASB Statement No. 157 provides guidance for how to measure the fair value of financial and nonfinancial assets and liabilities. It replaces the more general guidance for determining fair value currently found in many existing FASB standards, including those identified within this appendix by the symbol[FMV].
- FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, an interpretation of FASB Statement No. 109, is effective for fiscal years beginning after December 15, 2006. However, FSP FIN 48-2, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*, defers the effective date of that interpretation to fiscal years beginning after December 15, 2007, for certain nonpublic enterprises as defined by paragraph 289 of FASB Statement No. 109 including nonpublic not-for-profit organizations. Earlier application is permitted. Not-for-profit organizations that have already adopted the provisions of FASB Interpretation No. 48 are not eligible for the deferral. The interpretation limits the recognition of uncertain tax positions to only those positions that are more likely than not to be sustained on audit based solely on the technical merits of the position. The interpretation amends several FASB standards, including those identified within this appendix by the symbol[TAX].
- FASB Statement No. 150 is effective for financial instruments entered into or modified after May 31, 2003. However, the effective date of the provisions regarding mandatorily redeemable financial instruments of nonpublic entities and mandatorily redeemable noncontrolling interests were deferred, in certain cases indefinitely, by FSP FAS 150-3. FASB Statement No. 150 amends FASB Statement Nos. 128 and 133.
- FSP FAS 126-1 is effective for fiscal periods beginning after December 15, 2006. An entity may elect to retrospectively apply the guidance to all prior periods. The FSP amends several FASB standards, including those identified within this appendix by the symbol[NPE].
- FASB Statement No. 142 is effective for intangible assets acquired in transactions other than combinations, for example, the purchase or gift of patent or royalty rights from the holder of the patent or copyright. However, the provisions of FASB Statement No. 141, FASB Statement No. 141(R), and FASB Statement No. 142 should not be applied to goodwill

---

[FMV] See footnote FMV in paragraph 1.24.

[TAX] See footnote TAX in paragraph 1.17.

[NPE] See footnote NPE in paragraph 1.17.

and intangible assets arising from a combination between two or more not-for-profit organizations or acquired in the acquisition of a for-profit business entity by a not-for-profit organization until FASB completes its project on those types of combinations and acquisitions. Thus, the guidance in APB Opinion Nos. 16 and 17 remains in effect for such assets. In addition, when applying APB Opinion Nos. 16 and 17, not-for-profit organizations should continue to apply the amendments to those Opinions found in other literature even though that other literature may have been superseded by FASB Statement Nos. 141, 141(R), 142, and 144. For example, when applying APB Opinion No. 17, not-for-profit organizations should continue to apply the amendments to that Opinion found in FASB Statement No. 121, even though that statement was superseded by FASB Statement No. 144. On October 9, 2006, FASB issued two exposure drafts to provide guidance to not-for-profit organizations. The proposed FASB statement, *Not-for-Profit Organizations: Mergers and Acquisitions*, would amend APB Opinion Nos. 16 and 29 and FASB Statement Nos. 116 and 117. The proposed FASB statement, *Not-for-Profit Organizations: Goodwill and Other Intangible Assets Acquired in a Merger or Acquisition*, would amend FASB Statement No. 142. Readers should be alert to the issuance of final standards.

As stated in paragraph 1.06 of this guide, not-for-profit organizations should follow the guidance in effective provisions of ARBs, APB Opinions, and FASB statements and interpretations, except for specific pronouncements that explicitly exempt not-for-profit organizations and pronouncements for which this guide provides guidance. This appendix includes pronouncements, not subsequently superseded, that (*a*) do not exempt not-for-profit organizations from their application, (*b*) by the nature of their subject matter, apply to the kinds of transactions not-for-profit organizations engage in, (*c*) are subject to no additional FASB or AICPA guidance, and (*d*) do not pertain to specialized industry practices of business enterprises. Not-for-profit organizations should follow the guidance in the effective provisions of the pronouncements included in this appendix.

- ARB No. 43, *Restatement and Revision of Accounting Research Bulletins,* as amended[DBP, BCR]
- ARB No. 45, *Long-Term Construction-Type Contracts*
- ARB No. 46, *Discontinuance of Dating Earned Surplus*
- APB Opinion No. 2, *Accounting for the "Investment Credit,"* as amended
- APB Opinion No. 4 (amending Opinion No. 2), *Accounting for the "Investment Credit"*

[DBP] See footnote DBP in paragraph 1.24.

[BCR] See footnote BCR in paragraph 1.11.

- APB Opinion No. 6, *Status of Accounting Research Bulletins*, as amended
- APB Opinion No. 9, *Reporting the Results of Operations* (paragraph 1.17 of this guide discusses this pronouncement), as amended
- APB Opinion No. 10, *Omnibus Opinion—1966*, as amended
- APB Opinion No. 12, *Omnibus Opinion—1967* (except guidance under the heading, "Capital Changes"), as amended
- APB Opinion No. 16, *Business Combinations* (paragraph 1.15 of this guide discusses this pronouncement), as amended[*, MAA]
- APB Opinion No. 17, *Intangible Assets*, as amended[†, MAA]
- APB Opinion No. 21, *Interest on Receivables and Payables*, as amended[FMV, FVO]
- APB Opinion No. 22, *Disclosure of Accounting Policies*, as amended
- APB Opinion No. 23, *Accounting for Income Taxes—Special Areas*, as amended
- APB Opinion No. 26, *Early Extinguishment of Debt* (paragraph 1.17 of this guide discusses this pronouncement), as amended
- APB Opinion No. 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* (paragraph 1.17 of this guide discusses this pronouncement), as amended[BCR]
- FASB Statement No. 2, *Accounting for Research and Development Costs*, as amended[BCR]
- FASB Statement No. 5, *Accounting for Contingencies*, as amended[TAX, BCR]
- FASB Statement No. 6, *Classification of Short-Term Obligations Expected to Be Refinanced (an amendment of ARB No. 43, Chapter 3A)*

---

[*] See footnote * in heading above paragraph 1.15.

[MAA] See footnote MAA in paragraph 1.11.

[†] This pronouncement remains in effect for not-for-profit organizations until the completion of FASB project on mergers and acquisitions between not-for-profit organizations and the acquisition of a for-profit business entity by a not-for-profit organization. The provisions of FASB Statement No. 142 should not be applied to goodwill and intangible assets arising from a merger or acquisition between two or more not-for-profit organizations or acquired in the acquisition of a for-profit business entity by a not-for-profit organization until FASB completes its project on those types of mergers and acquisitions. Thus, the guidance in APB Opinion No. 17, *Intangible Assets*, remains in effect for such assets. In addition, when applying APB Opinion No. 17, not-for-profit organizations should continue to apply the amendments to that Opinion found in other literature even though that other literature may have been superseded by FASB Statement Nos. 141, 141(R), 142 and 144. For example, when applying APB Opinion No. 17, not-for-profit organizations should continue to apply the amendments to that Opinion found in FASB Statement No. 121 even though that FASB statement was superseded by FASB Statement No. 144. FASB Statement No. 142 is effective for intangible assets acquired in transactions other than combinations, for example, the purchase or gift of patent or royalty rights from the holder of the patent or copyright.

[FMV] See footnote FMV in paragraph 1.24.

[FVO] See footnote FVO in paragraph 1.24.

[BCR] See footnote BCR in paragraph 1.11.

[TAX] See footnote TAX in paragraph 1.17.

- FASB Statement No. 10, *Extension of "Grandfather" Provisions for Business Combinations (an amendment of APB Opinion No. 16)*[*, MAA]
- FASB Statement No. 11, *Accounting for Contingencies—Transition Method (an amendment of FASB Statement No. 5)*
- FASB Statement No. 13, *Accounting for Leases*, as amended[FMV, LST]
- FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, as amended[FMV, BCR]
- FASB Statement No. 16, *Prior Period Adjustments*, as amended*
- FASB Statement No. 22, *Changes in the Provisions of Lease Agreements Resulting from Refundings of Tax-Exempt Debt (an amendment of FASB Statement No. 13)*, as amended
- FASB Statement No. 23, *Inception of the Lease* (an amendment of FASB Statement No. 13)
- FASB Statement No. 27, *Classification of Renewals or Extensions of Existing Sales-Type or Direct Financing Leases (an amendment of FASB Statement No. 13)*
- FASB Statement No. 28, *Accounting for Sales with Leasebacks (an amendment of FASB Statement No. 13)*, as amended
- FASB Statement No. 29, *Determining Contingent Rentals (an amendment of FASB Statement No. 13)*, as amended
- FASB Statement No. 34, *Capitalization of Interest Cost*, as amended
- FASB Statement No. 37, *Balance Sheet Classification of Deferred Income Taxes (an amendment of APB Opinion No. 11)*, as amended
- FASB Statement No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises (an amendment of APB Opinion No. 16)*, as amended[*, MAA]
- FASB Statement No. 42, *Determining Materiality for Capitalization of Interest Cost (an amendment of FASB Statement No. 34)*
- FASB Statement No. 43, *Accounting for Compensated Absences*, as amended
- FASB Statement No. 47, *Disclosure of Long-Term Obligations*

---

[*] See footnote * in heading above paragraph 1.15.

[MAA] See footnote MAA in paragraph 1.11.

[FMV] See footnote FMV in paragraph 1.24.

[LST] On November 28, 2007, FASB issued an exposure draft, *Proposed FSP FAS 157-a—Application of FASB Statement No. 157 to FASB Statement No. 13 and Its Related Interpretive Accounting Pronouncements That Address Leasing Transactions*, which would provide a scope exception from FASB Statement No. 157 for accounting pronouncements that require fair value measurements for leasing transactions. This proposed FSP would amend FASB Statement Nos. 13 and 157. Readers should be alert to the issuance of the final standard.

[BCR] See footnote BCR in paragraph 1.11.

- FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*
- FASB Statement No. 49, *Accounting for Product Financing Arrangements,* as amended
- FASB Statement No. 52, *Foreign Currency Translation* (paragraph 1.17 of this guide discusses this pronouncement), as amended [DDI, BCR]
- FASB Statement No. 57, *Related Party Disclosures*, as amended[FVO]
- FASB Statement No. 58, *Capitalization of Interest in Financial Statements That Include Investments Accounted for by the Equity Method (an amendment of FASB Statement No. 34)*
- FASB Statement No. 62, *Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants (an amendment of FASB Statement No. 34)*
- FASB Statement No. 66, *Accounting for Sales of Real Estate*, as amended
- FASB Statement No. 68, *Research and Development Arrangements*, as amended[BCR]
- FASB Statement No. 78, *Classification of Obligations That Are Callable by the Creditor (an amendment of ARB No. 43, Chapter 3A)*
- FASB Statement No. 79, *Elimination of Certain Disclosures for Business Combinations by Nonpublic Enterprises (an amendment of APB Opinion No. 16)*[*, MAA]
- FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*[BCR]
- FASB Statement No. 87, *Employers' Accounting for Pensions*, as amended [FMV, DBP, BCR]
- FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, as amended[DBP]
- FASB Statement No. 93, *Recognition of Depreciation by Not-for-Profit Organizations*, as amended
- FASB Statement No. 95, *Statement of Cash Flows*, as amended[FVO]
- FASB Statement No. 98, *Accounting for Leases*:
  - *Sale-Leaseback Transactions Involving Real Estate*
  - *Sales-Type Leases of Real Estate*
  - *Definition of the Lease Term*

---

[DDI] See footnote DDI in paragraph 1.17.

[BCR] See footnote BCR in paragraph 1.11.

[FVO] See footnote FVO in paragraph 1.24.

[*] See footnote * in heading above paragraph 1.15.

[MAA] See footnote MAA in paragraph 1.11.

[FMV] See footnote FMV in paragraph 1.24.

[DBP] See footnote DBP in paragraph 1.24.

— *Initial Direct Costs of Direct Financing Leases*

*(an amendment of FASB Statements No. 13, 66, and 91 and a rescission of FASB Statement No. 26 and Technical Bulletin No. 79-11)*

- FASB Statement No. 99, *Deferral of the Effective Date of Recognition of Depreciation by Not-for-Profit Organizations (an amendment of FASB Statement No. 93)*
- FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale (an amendment of FASB Statement No. 95)*, as amended[FVO]
- FASB Statement No. 104, *Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions (an amendment of FASB Statement No. 95)*
- FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, as amended[FMV, DBP, BCR]
- FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, as amended[FMV, DDI, FGI]
- FASB Statement No. 109, *Accounting for Income Taxes* (paragraph 1.17 of this guide discusses this pronouncement), as amended[TAX, NPE, BCR]
- FASB Statement No. 111, *Rescission of FASB Statement No. 32 and Technical Corrections*
- FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits (an amendment of FASB Statement Nos. 5 and 43)*, as amended
- FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan (an amendment of FASB Statement Nos. 5 and 15)*, as amended
- FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures (an amendment of FASB Statement No. 114)*
- FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, as amended (superseded by FASB Statement No. 144, but amendments to APB Opinion No. 16 still applicable as discussed in fn * to paragraph 1.15)

---

[FVO] See footnote FVO in paragraph 1.24.

[FMV] See footnote FMV in paragraph 1.24.

[DBP] See footnote DBP in paragraph 1.24.

[BCR] See footnote BCR in paragraph 1.11.

[DDI] See footnote DDI in paragraph 1.17.

[FGI] See footnote FGI in paragraph 1.27.

[TAX] See footnote TAX in paragraph 1.17.

[NPE] See footnote NPE in paragraph 1.17.

- FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities*, as amended[NPE]
- FASB Statement No. 129, *Disclosure of Information about Capital Structure*
- FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits*, as amended (revised December 2003)[DBP,NPE]
- FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended[FMV, FVO, DDI, BCR, FGI]
- FASB Statement No. 135, *Rescission of FASB Statement No. 75 and Technical Corrections*, as amended
- FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133*
- FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*
- FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, as amended[SPE, FMV]
- FASB Statement No. 142, *Goodwill and Other Intangible Assets,* as amended[FMV, MAA, NIS, BCR, IAL]
- FASB Statement No. 143, *Accounting for Asset Retirement Obligations,* as amended[FMV]
- FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* as amended[FMV,BCR]
- FASB Statement No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*

---

[NPE] See footnote NPE in paragraph 1.17.

[DBP] See footnote DBP in paragraph 1.24.

[FMV] See footnote FMV in paragraph 1.24.

[FVO] See footnote FVO in paragraph 1.24.

[DDI] See footnote DDI in paragraph 1.17.

[BCR] See footnote BCR in paragraph 1.11.

[FGI] See footnote FGI in paragraph 1.27.

[SPE] On August 11, 2005, FASB released a revised exposure draft of a proposed FASB statement, *Transfers of Financial Assets*, which replaces the June 10, 2003, exposure draft, *Qualifying Special-Purpose Entities and Isolation of Transferred Assets*. The proposed FASB statement would amend FASB Statement No. 140 to revise or clarify the derecognition requirements for financial assets and the initial measurement of interests related to transferred financial assets that are held by a transferor. Readers should be alert to the issuance of the final standard.

[MAA] See footnote MAA in paragraph 1.11.

[NIS] See footnote NIS in paragraph 1.11.

[IAL] On November 26, 2007, FASB issued an exposure draft, *Proposed FSP FAS 142-f—Determination of the Useful Life of Intangible Assets*, which would amend the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset. This proposed FSP would amend FASB Statement No. 142. Readers should be alert to the issuance of the final standard.

- FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, as amended[FMV, BCR]
- FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*
- FASB Statement No. 151, *Inventory Costs—an amendment of ARB No. 43, Chapter 4*
- FASB Statement No. 154, *Accounting Changes and Error Corrections*[BCR]
- FASB Statement No. 155, *Accounting for Certain Hybrid Instruments*
- FASB Statement No. 157, *Fair Value Measurements*[FMV,LST]
- FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*
- FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*
- FASB Interpretation No. 1, *Accounting Changes Related to the Cost of Inventory*
- FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method*[BCR]
- FASB Interpretation No. 6, *Applicability of FASB Statement No. 2 to Computer Software*, as amended
- FASB Interpretation No. 8, *Classification of a Short-Term Obligation Repaid Prior to Being Replaced by a Long-Term Security*
- FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*
- FASB Interpretation No. 19, *Lessee Guarantee of the Residual Value of Leased Property*
- FASB Interpretation No. 21, *Accounting for Leases in a Business Combination,* as amended[BCR]
- FASB Interpretation No. 23, *Leases of Certain Property Owned by a Governmental Unit or Authority*
- FASB Interpretation No. 24, *Leases Involving Only Part of a Building*
- FASB Interpretation No. 26, *Accounting for Purchase of a Leased Asset by the Lessee during the Term of the Lease*[BCR]

---

[FMV] See footnote FMV in paragraph 1.24.

[BCR] See footnote BCR in paragraph 1.11.

[LST] See footnote LST in paragraph 1.28.

- FASB Interpretation No. 27, *Accounting for a Loss on a Sublease*, as amended
- FASB Interpretation No. 37, *Accounting for Translation Adjustments upon Sale of Part of an Investment in a Foreign Entity*[NIS]
- FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*, as amended
- FASB Interpretation No. 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*
- FASB Interpretation No. 43, *Real Estate Sales*, as amended
- FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, as amended[FMV,FGI]
- FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*
- FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*[BCR]

[NIS] See footnote NIS in paragraph 1.11.

[FMV] See footnote FMV in paragraph 1.24.

[FGI] See footnote FGI in paragraph 1.27.

[BCR] See footnote BCR in paragraph 1.11.

1.29

# Appendix F—All Financial Reporting Pronouncements, Cross-Referenced by Appendix

The following box lists effective date information for pronouncements in this appendix and for pronouncements that amend or supersede the pronouncements included in this appendix.

Pronouncements that were not effective when this edition of the guide was issued:

- FASB Statement No. 160 does not apply to not-for-profit organizations, nor do its amendments to ARB No. 51, APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, and No. 29, FASB Statement Nos. 60, 89, 128, 130, and 142, FASB Interpretation Nos. 37 and 46(R), AICPA Accounting Interpretation No. 1, AICPA SOP 04-2, and several EITF issues. Not-for-profit organizations should continue to apply the guidance in ARB No. 51 before the amendments made by FASB Statement No. 160, the guidance in SOP 94-3, and other applicable standards, until FASB issues interpretative guidance.
- FASB Statement No. 141(R) is not applicable to combinations between not-for-profit organizations or the acquisition of a for-profit business by a not-for-profit organization, nor are its amendments to ARB No. 43, *Restatement and Revision of Accounting Research Bulletins*; APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*; No. 18, *The Equity Method of Accounting for Investments in Common Stock*, No. 28, *Interim Financial Reporting*; No. 30; FASB Statement No. 2, *Accounting for Research and Development Costs*; No. 5, *Accounting for Contingencies*; No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*; No. 45, *Accounting for Franchise Fee Revenue*; No. 52, *Foreign Currency Translation*; No. 60 *Accounting and Reporting by Insurance Enterprises*; No. 68, *Research and Development Arrangements*; No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*; No. 87; No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*; No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*; No. 109; No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*; No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts—an amendment of FASB Statements 60, 97, and 113 and Interpretation No. 40*; No. 123(R); No. 133; No. 142; No. 144; No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*; No. 150; and No. 154, *Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3*; FASB Interpretation No. 21, *Accounting for Leases in a Business Combination—an interpretation of FASB Statement No. 13*; No. 26, *Accounting for Purchase of a Leased Asset by the Lessee during the Term of the Lease—an interpretation of FASB Statement No. 13*; No. 46(R), *Consolidation of Variable Interest Entities (revised December 2003)—an interpretation of ARB No. 51*; and No. 48; FASB Technical Bulletin 84-1, *Accounting for Stock Issued to Acquire the Results of a Research*

*and Development Arrangement*; AICPA SOP 78-9, *Accounting for Investments in Real Estate Ventures* (AICPA, *Technical Practice Aids*, ACC sec. 10,240); SOP 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code* (AICPA, *Technical Practice Aids*, ACC sec. 10,460); SOP 93-6, *Employers' Accounting for Employee Stock Ownership Plans* (AICPA, *Technical Practice Aids*, ACC sec. 10,580); SOP 96-1, *Environmental Remediation Liabilities* (AICPA, *Technical Practice Aids*, ACC sec. 10,680); SOP 00-3, *Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts* (AICPA, *Technical Practice Aids*, ACC sec. 10,810); SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others* (AICPA, *Technical Practice Aids*, ACC sec. 10,850); SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* (AICPA, *Technical Practice Aids*, ACC sec. 10,880); and SOP 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts* (AICPA, *Technical Practice Aids*, ACC sec. 10,920); and AICPA Practice Bulletin No. 4, *Accounting for Foreign Debt/Equity Swaps* (AICPA, *Technical Practice Aids*, PB sec. 12,040); Practice Bulletin No. 6, *Amortization of Discounts on Certain Acquired Loans* (AICPA, *Technical Practice Aids*, PB sec. 12,060); and Practice Bulletin No. 14, *Accounting and Reporting by Limited Liability Companies and Limited Liability Partnerships* (AICPA, *Technical Practice Aids*, PB sec. 12,140). The pronouncements superseded by FASB Statement No. 141(R), including those identified within this appendix by the symbol[BCR], remain in effect for not-for-profit organizations, and not-for-profit organizations should continue to apply them as indicated in paragraphs 1.24–.28 of this guide.

- FASB Statement No. 159 is effective as of the beginning of an organization's first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the organization also elects to apply the provisions of FASB Statement No. 157. The statement permits an organization to irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and financial liabilities on a contract-by-contract basis, with changes in fair value recognized in the statement of activities as those changes occur. The statement amends APB No. 21, *Interest on Receivables and Payables*, and FASB Statement Nos. 57, 95, 102, 115, 124, and 133.
- FASB Statement No. 158 an amendment of FASB Statement Nos. 87, 88, 106, and 132(R), has multiple effective dates. The requirement to recognize the funded status of a defined benefit postretirement plan and the related disclosure requirements was effective for not-for-profit organizations as of the end of the fiscal year ending after June 15, 2007. The requirement to measure plan assets and benefit obligations as of the date of the employer's fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008. Earlier application is encouraged. The statement requires employers to recognize the overfunded

---

[BCR] See footnote BCR in paragraph 1.11.

or underfunded positions of defined benefit postretirement plans (other than a multiemployer plan), including pension plans, in their statement of financial position. It also requires that employers measure plan assets and obligations as of the date of their financial statements. The statement amends FASB Statement Nos. 87, 88, 106, 130, 132(R), ARB No. 43, and APB Opinion No. 28.

- FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year. However, FSP FAS 157-2 delays the effective date of FASB Statement No. 157 until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for fair value measurements of all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). FASB Statement No. 157 provides guidance for how to measure the fair value of financial and nonfinancial assets and liabilities. It replaces the more general guidance for determining fair value currently found in many existing FASB standards, including APB Opinion Nos. 21, 28, and 29, FASB Statement Nos. 13, 15, 19, 35, 60, 63, 65, 67, 87, 106, 107, 115, 116, 124, 133, 136, 140, 141, 142, 143, 144, 146, 150, and 156, FASB Interpretation No. 45, and various FASB Statement No. 133 implementation issues.
- FASB Interpretation No. 48, an interpretation of FASB Statement No. 109, is effective for fiscal years beginning after December 15, 2006. However, FSP FIN 48-2 defers the effective date of that interpretation to fiscal years beginning after December 15, 2007, for certain nonpublic enterprises as defined by paragraph 289 of FASB Statement No. 109, *Accounting for Income Taxes*, including nonpublic not-for-profit organizations. Earlier application is permitted. Not-for-profit organizations that have already adopted the provisions of FASB Interpretation No. 48 are not eligible for the deferral. The interpretation limits the recognition of uncertain tax positions to only those positions that are probably of being sustained on audit based solely on the technical merits of the position. The interpretation amends FASB Statement Nos. 5 and 109.
- FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, is effective for financial instruments entered into or modified after May 31, 2003. However, the effective date of the provisions regarding mandatorily redeemable financial instruments of nonpublic entities and mandatorily redeemable noncontrolling interests were deferred, in certain cases indefinitely, by FSP 150-3. FASB Statement No. 150 amends FASB Statement Nos. 128 and 133.
- FASB Statement No. 142 is effective for intangible assets acquired in transactions other than combinations, for example, the purchase or gift of patent or royalty rights from the holder of the patent or copyright. However, the provisions of FASB Statement No. 141, No. 141(R), and No. 142 should not be applied to goodwill and intangible assets arising

from a combination between two or more not-for-profit organizations or acquired in the acquisition of a for-profit business entity by a not-for-profit organization until FASB completes its project on those types of combinations and acquisitions. Thus, the guidance in APB Opinion Nos. 16 and 17 remains in effect for such assets. In addition, when applying APB Opinion Nos. 16 and 17, not-for-profit organizations should continue to apply the amendments to those Opinions found in other literature even though that other literature may have been superseded by FASB Statement Nos. 141, 141(R), 142, and 144. For example, when applying APB Opinion No. 17, not-for-profit organizations should continue to apply the amendments to that Opinion found in FASB Statement No. 121, even though that statement was superseded by FASB Statement No. 144. On October 9, 2006, FASB issued two exposure drafts to provide guidance to not-for-profit organizations. The proposed FASB statement, *Not-for-Profit Organizations: Mergers and Acquisitions*, would amend APB Opinion Nos. 16 and 29 and FASB Statement Nos. 116 and 117. The proposed FASB statement, *Not-for-Profit Organizations: Goodwill and Other Intangible Assets Acquired in a Merger or Acquisition*, which would amend FASB Statement No. 142. Readers should be alert to the issuance of final standards.

| *Pronouncement* | *Appendix* |
|---|---|
| ARB Nos. 1–42 | Superseded |
| ARB No. 43 | E |
| ARB Nos. 44 and 44 (Revised) | Superseded |
| ARB No. 45 | E |
| ARB No. 46 | E |
| ARB Nos. 47–50 | Superseded |
| ARB No. 51 | C |
| APB Opinion No. 1 | Superseded |
| APB Opinion No. 2 | E |
| APB Opinion No. 3 | Superseded |
| APB Opinion No. 4 | E |
| APB Opinion No. 5 | Superseded |
| APB Opinion No. 6 | E |
| APB Opinion Nos. 7–8 | Superseded |
| APB Opinion No. 9 | E |
| APB Opinion No. 10 | E |
| APB Opinion No. 11 | Superseded |
| APB Opinion No. 12 | D, E |
| APB Opinion No. 13 | D |
| APB Opinion No. 14 | B |
| APB Opinion No. 15 | Superseded |
| APB Opinion No. 16 | E* |

*(continued)*

* See footnote * in heading above paragraph 1.15.

| *Pronouncement* | *Appendix* |
|---|---|
| APB Opinion No. 17 | E[†] |
| APB Opinion No. 18 | A |
| APB Opinion Nos. 19–20 | Superseded |
| APB Opinion No. 21 | E |
| APB Opinion No. 22 | E |
| APB Opinion No. 23 | E |
| APB Opinion Nos. 24–25 | Superseded |
| APB Opinion No. 26 | E |
| APB Opinion No. 27 | Superseded |
| APB Opinion No. 28 | B |
| APB Opinion No. 29 | C |
| APB Opinion No. 30 | E |
| APB Opinion No. 31 | Superseded |
| FASB Statement No. 1 | Superseded |
| FASB Statement No. 2 | E |
| FASB Statement Nos. 3–4 | Superseded |
| FASB Statement No. 5 | E |
| FASB Statement No. 6 | E |
| FASB Statement No. 7 | D |
| FASB Statement Nos. 8–9 | Superseded |
| FASB Statement No. 10 | E[*] |
| FASB Statement No. 11 | E |
| FASB Statement No. 12 | Superseded |
| FASB Statement No. 13 | E |
| FASB Statement No. 14 | Superseded |
| FASB Statement No. 15 | E |
| FASB Statement No. 16 | E |
| FASB Statement No. 17–18 | Superseded |
| FASB Statement No. 19 | D |
| FASB Statement No. 20–21 | Superseded |
| FASB Statement No. 22 | E |
| FASB Statement No. 23 | E |
| FASB Statement No. 24 | Superseded |
| FASB Statement No. 25 | D |
| FASB Statement No. 26 | Superseded |
| FASB Statement No. 27 | E |
| FASB Statement No. 28 | E |
| FASB Statement No. 29 | E |
| FASB Statement Nos. 30–33 | Superseded |
| FASB Statement No. 34 | E |

[†] See footnote † in paragraph 1.28.

[*] See footnote * in heading above paragraph 1.15.

| *Pronouncement* | *Appendix* |
| --- | --- |
| FASB Statement No. 35 | D |
| FASB Statement No. 36 | Superseded |
| FASB Statement No. 37 | E |
| FASB Statement No. 38 | E* |
| FASB Statement Nos. 39–41 | Superseded |
| FASB Statement No. 42 | E |
| FASB Statement No. 43 | E |
| FASB Statement No. 44 | Superseded |
| FASB Statement No. 45 | D |
| FASB Statement No. 46 | Superseded |
| FASB Statement No. 47 | E |
| FASB Statement No. 48 | E |
| FASB Statement No. 49 | E |
| FASB Statement No. 50 | D |
| FASB Statement No. 51 | D |
| FASB Statement No. 52 | E |
| FASB Statement Nos. 53–56 | Superseded |
| FASB Statement No. 57 | E |
| FASB Statement No. 58 | E |
| FASB Statement No. 59 | Superseded |
| FASB Statement No. 60 | D |
| FASB Statement No. 61 | D |
| FASB Statement No. 62 | E |
| FASB Statement No. 63 | D |
| FASB Statement No. 64 | Superseded |
| FASB Statement No. 65 | D |
| FASB Statement No. 66 | E |
| FASB Statement No. 67 | D |
| FASB Statement No. 68 | E |
| FASB Statement No. 69 | D |
| FASB Statement No. 70 | Superseded |
| FASB Statement No. 71 | D |
| FASB Statement No. 72 | D [BCR] |
| FASB Statement Nos. 73–77 | Superseded |
| FASB Statement No. 78 | E |
| FASB Statement No. 79 | E* |
| FASB Statement Nos. 80–83 | Superseded |
| FASB Statement No. 84 | B |
| FASB Statement No. 85 | Superseded |
| FASB Statement No. 86 | E |

*(continued)*

* See footnote * in heading above paragraph 1.15.

[BCR] See footnote BCR in paragraph 1.11.

| *Pronouncement* | *Appendix* |
|---|---|
| FASB Statement No. 87 | E |
| FASB Statement No. 88 | E |
| FASB Statement No. 89 | A |
| FASB Statement No. 90 | D |
| FASB Statement No. 91 | D |
| FASB Statement No. 92 | D |
| FASB Statement No. 93 | E |
| FASB Statement No. 94 | C |
| FASB Statement No. 95 | E |
| FASB Statement No. 96 | Superseded |
| FASB Statement No. 97 | D |
| FASB Statement No. 98 | E |
| FASB Statement No. 99 | E |
| FASB Statement No. 100 | Superseded |
| FASB Statement No. 101 | D |
| FASB Statement No. 102 | E |
| FASB Statement No. 103 | Superseded |
| FASB Statement No. 104 | E |
| FASB Statement No. 105 | Superseded |
| FASB Statement No. 106 | E |
| FASB Statement No. 107 | E |
| FASB Statement No. 108 | Superseded |
| FASB Statement No. 109 | E |
| FASB Statement No. 110 | D |
| FASB Statement No. 111 | E |
| FASB Statement No. 112 | E |
| FASB Statement No. 113 | D |
| FASB Statement No. 114 | E |
| FASB Statement No. 115 | A |
| FASB Statement No. 116 | C |
| FASB Statement No. 117 | C |
| FASB Statement No. 118 | E |
| FASB Statement No. 119 | Superseded |
| FASB Statement No. 120 | D |
| FASB Statement No. 121 | E, Superseded |
| FASB Statement No. 122 | Superseded |
| FASB Statement No. 123(R) | B |
| FASB Statement No. 124 | C |
| FASB Statement No. 125 | Superseded |
| FASB Statement No. 126 | E |
| FASB Statement No. 127 | Superseded |
| FASB Statement No. 128 | A |
| FASB Statement No. 129 | E |
| FASB Statement No. 130 | A |

| *Pronouncement* | *Appendix* |
|---|---|
| FASB Statement No. 131 | A |
| FASB Statement No. 132(R) | E |
| FASB Statement No. 133 | E |
| FASB Statement No. 134 | D |
| FASB Statement No. 135 | E |
| FASB Statement No. 136 | C |
| FASB Statement No. 137 | E |
| FASB Statement No. 138 | E |
| FASB Statement No. 139 | D |
| FASB Statement No. 140 | E |
| FASB Statement No. 141 (to be superseded) | A [BCR] |
| FASB Statement No. 141 (revised 2007) | A |
| FASB Statement No. 142 | E |
| FASB Statement No. 143 | E |
| FASB Statement No. 144 | E |
| FASB Statement No. 145 | E |
| FASB Statement No. 146 | E |
| FASB Statement No. 147 | D[BCR] |
| FASB Statement No. 148 | Superseded |
| FASB Statement No. 149 | E |
| FASB Statement No. 150 | B |
| FASB Statement No. 151 | E |
| FASB Statement No. 152 | D |
| FASB Statement No. 153 | C |
| FASB Statement No. 154 | E |
| FASB Statement No. 155 | E |
| FASB Statement No. 156 | D |
| FASB Statement No. 157 | E |
| FASB Statement No. 158 | E |
| FASB Statement No. 159 | E |
| FASB Statement No. 160 | A |
| FASB Interpretation No. 1 | E |
| FASB Interpretation Nos. 2–3 | Superseded |
| FASB Interpretation No. 4 | E[BCR] |
| FASB Interpretation No. 5 | Superseded |
| FASB Interpretation No. 6 | E |
| FASB Interpretation No. 7 | D |
| FASB Interpretation No. 8 | E |
| FASB Interpretation No. 9 | D[BCR] |

*(continued)*

[BCR] See footnote BCR in paragraph 1.11.

| *Pronouncement* | *Appendix* |
|---|---|
| FASB Interpretation Nos. 10–13 | Superseded |
| FASB Interpretation No. 14 | E |
| FASB Interpretation Nos. 15–17 | Superseded |
| FASB Interpretation No. 18 | A |
| FASB Interpretation No. 19 | E |
| FASB Interpretation No. 20 | Superseded |
| FASB Interpretation No. 21 | E |
| FASB Interpretation No. 22 | Superseded |
| FASB Interpretation No. 23 | E |
| FASB Interpretation No. 24 | E |
| FASB Interpretation No. 25 | Superseded |
| FASB Interpretation No. 26 | E |
| FASB Interpretation No. 27 | E |
| FASB Interpretation Nos. 28–29 | Superseded |
| FASB Interpretation No. 30 | C |
| FASB Interpretation Nos. 31–32 | Superseded |
| FASB Interpretation No. 33 | D |
| FASB Interpretation No. 34 | Superseded |
| FASB Interpretation No. 35 | A |
| FASB Interpretation No. 36 | D |
| FASB Interpretation No. 37 | E |
| FASB Interpretation No. 38 | Superseded |
| FASB Interpretation No. 39 | E |
| FASB Interpretation No. 40 | D |
| FASB Interpretation No. 41 | E |
| FASB Interpretation No. 42 | Superseded |
| FASB Interpretation No. 43 | E |
| FASB Interpretation No. 44 | Superseded |
| FASB Interpretation No. 45 | E |
| FASB Interpretation No. 46(R) | A |
| FASB Interpretation No. 47 | E |
| FASB Interpretation No. 48 | E |

1.30

## Appendix G—The Hierarchy of GAAP[GPH, COD]

AU section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, as amended,[10] establishes the hierarchy of generally accepted accounting principles (GAAP).

For financial statements of entities other than governmental entities, the hierarchy is summarized as follows:

*Category (a).* Rule 203 literature consists of officially established accounting principles, which are FASB statements and interpretations, APB opinions, and ARBs.

*Category (b).* This consists of FASB Technical Bulletins and, if cleared by FASB, AICPA Industry Audit and Accounting Guides, and AICPA SOPs.

*Category (c).* This consists of AICPA AcSEC Practice Bulletins that have been cleared by FASB and consensus positions of FASB EITF.

*Category (d).* This consists of AICPA accounting interpretations and implementation guides (Qs and As) published by FASB staff, and practices that are widely recognized and prevalent either generally or in the industry.

If the accounting treatment of a transaction or event is not specified by Rule 203 literature, the auditor should consider whether the accounting treatment is specified by another source of established accounting principles. If an established accounting principle from one or more sources in category (*b*), (*c*), or (*d*) is relevant to the circumstances, the auditor should be prepared to justify a conclusion that another treatment is generally accepted. If there is a conflict between accounting principles relevant to the circumstances from one or more sources in category (*b*), (*c*), or (*d*), the auditor should follow the treatment specified by the source in the higher category—for example, follow category (*b*) treatment over category (*c*)—or be prepared to justify a conclusion that a treatment specified by a source in the lower category better presents the substance of the transaction in the circumstances.

---

[GPH] See footnote GPH in heading above paragraph 1.05.

[COD] See footnote COD in heading above paragraph 1.05.

[10] Paragraph .14 of AU section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, establishes a hierarchy for federal governmental entities.

# Chapter 2

# General Auditing Considerations[*], [1]

## Overview

**2.01** In accordance with AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1), an independent auditor plans, conducts, and reports the results of an audit in accordance with generally accepted auditing standards (GAAS). Auditing standards provide a measure of audit quality and the objectives to be achieved in an audit. This chapter of the guide provides guidance, primarily on the application of the standards of fieldwork. Specifically, this chapter provides guidance on the risk assessment process and general auditing considerations for not-for-profit organizations.

## Planning and Other Auditing Considerations

**2.02** The objective of an audit of a not-for-profit organization's financial statements is to express an opinion on whether its financial statements present fairly, in all material respects, its financial position, changes in net assets, and its cash flows in conformity with generally accepted accounting principles (GAAP) or other comprehensive bases of accounting (OCBOA). To accomplish that objective, the independent auditor's responsibility is to plan and perform the audit to obtain reasonable assurance (a high, but not absolute, level of assurance) that material misstatements, whether caused by errors or fraud, are detected. This section addresses general planning considerations and other auditing considerations relevant to not-for-profit organizations.

### Audit Planning

**2.03** The first standard of field work states, "The auditor must adequately plan the work and must properly supervise any assistants." AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1), establishes standards and provides guidance on the considerations and activities applicable to planning and supervision of an audit conducted in accordance with GAAS, including appointment of the independent auditor, preliminary engagement activities, establishing an understanding with the client, preparing a detailed, written audit plan, determining the extent of involvement of professionals with specialized skills, and communicating with those charged with governance and management. Audit planning also involves developing an overall audit strategy for the expected conduct, organization, and staffing of the audit. The nature, timing, and extent of planning vary with the size and complexity of the entity and with the auditor's experience with the entity, understanding of the entity, and its environment, including its internal control.

---

[*] Refer to the preface of this guide for important information about the references to the professional standards from Statements on Auditing Standards (SAS) to AU sections.

[1] Not-for-profit organizations are not issuers subject to oversight by the Public Company Accounting Oversight Board (PCAOB). Thus, auditing standards issued by the PCAOB do not apply to audits of not-for-profit organizations. The Auditing Standards Board (ASB) sets auditing and assurance standards for nonissuers.

**2.04** Paragraph .03 of AU section 311 states that the auditor must plan the audit so that it is responsive to the assessment of the risks of material misstatement based on the auditor's understanding of the entity and its environment, including its internal control. Planning is not a discrete phase of the audit, but rather an iterative process that begins with engagement acceptance and continues throughout the audit as the auditor performs audit procedures and accumulates sufficient appropriate audit evidence to support the audit opinion.

## Using the Work of a Specialist

**2.05** Organization management or the auditor may engage a specialist to provide special skill or knowledge about complex or subjective matters that are potentially material to the financial statements. Auditors of not-for-profit organizations, for example, may need to use the work of a specialist with respect to the valuation of contributed assets, particularly contributed collection items that the organization capitalizes. AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), provides guidance to an auditor who uses the work of a specialist.

## Scope of Services

**2.06** The scope of services rendered by independent auditors depends on the kinds of reports to be issued as a result of the engagement. AU section 311 states the auditor should establish an understanding with the not-for-profit organization regarding the services to be performed for each engagement. This understanding should be documented through a written communication with the not-for-profit organization in the form of an engagement letter. The understanding generally includes the objectives of the engagement, management's responsibilities, the auditor's responsibilities, and limitations of the engagement. AU section 311 also identifies specific matters that would generally be included in the understanding with the client and other contractual matters an auditor might wish to include in the understanding. So that the understanding does not misinterpret the need and expectations of the not-for-profit organization, the scope of the understanding should, where applicable, address all relevant contractual, legal, and regulatory requirements. For example, the auditor may be engaged to issue reports that meet requirements found in *Government Auditing Standards* as amended (often called the Yellow Book) issued by the Comptroller General of the United States.[2] Also, the auditor may be engaged to perform tests and issue reports required by the Single Audit Act Amendments of 1996 and United States Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.[3]

---

[2] In practice, the standards included in *Government Auditing Standards* (2003 revision, as amended) are sometimes referred to as generally accepted government auditing standards (GAGAS). Government auditing standards includes standards for performance audits as well as standards for financial audits. The references to government auditing standards in this Audit and Accounting Guide (guide) pertain only to the standards for financial audits. On February 1, 2007, the Comptroller General of the United States issued the 2007 revision of *Government Auditing Standards*, which supercedes the 2003 revision. The effective date for the 2007 revision of *Government Auditing Standards* is for financial audits and attestation engagements for periods beginning on or after January 1, 2008, and performance audits beginning on or after January 1, 2008. Early implementation is permissible and encouraged.

[3] United States Office of Management and Budget (OMB) Circular A-133 includes requirements that the auditor perform tests and report on compliance with the cost principles and matching or cost-sharing requirements set forth in various other government regulations, such as OMB Circulars A-21, *Cost Principles for Colleges and Universities*; A-110, *Uniform Administrative Requirements*

*(continued)*

The auditor may also be engaged to prepare special reports on various financial data prepared by the organization, such as those related to bond indentures and other debt instruments and annual state information returns required by state attorneys general. AU section 380, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1), states that the auditor should communicate to those charged with governance of the organization the auditor's responsibilities under GAAS and an overview of the planned scope and timing of the audit.[†]

**2.07** Paragraphs .21–.23 of AU section 801, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1), provide guidance on the auditor's responsibilities when he or she becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement. AU section 801 provides that in that situation "the auditor should communicate to management and the audit committee, or to others with equivalent authority and responsibility, that an audit in accordance with GAAS may not satisfy the relevant legal, regulatory, or contractual requirements." AU section 801 also notes that "the auditor should consider how the client's actions in response to such communication relate to other aspects of the audit, including the potential effect on the financial statements and on the auditor's report on those financial statements. Specifically, the auditor should consider management's actions (such as not arranging for an audit that meets the applicable requirements) in relation to the guidance in AU section 317, *Illegal Acts by Clients* [AICPA, *Professional Standards*, vol. 1])."

## Independence

**2.08** Paragraph .11 of AU section 311 states at the beginning of an audit engagement, in addition to performing procedures regarding the continuance of the client relationship and the specific audit engagement, auditors should evaluate their compliance with ethical requirements, including independence. Members of the AICPA who are engaged to audit the financial statements of not-for-profit organizations in accordance with GAAS are required to be independent. In making judgments about whether they are independent, members should be guided by Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2), of the AICPA Code of Professional Conduct, its interpretations, and the ethics rulings under it. While a number of ethics interpretations specifically address matters of independence as it relates to not-for-profit organizations, members should use paragraph .01 of ET section 100, *Conceptual Framework for AICPA Independence Standards* (AICPA, *Professional Standards*, vol. 2), when making decisions on independence matters that are not explicitly addressed by the AICPA Code of Professional Conduct.

---

*(footnote continued)*

*for Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Nonprofit Organizations*; and A-122, *Cost Principles for Nonprofit Organizations*. OMB Circular A-133 was revised to incorporate state and local governments and to comply with other requirements of the Single Audit Act Amendments of 1996.

[†] SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, AU sec. 380), which supersedes SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), is effective for audits of financial statements for periods beginning on or after December 15, 2006. The SAS uses the term *those charged with governance* to refer to those with responsibility for overseeing the strategic direction of the organization and obligations related to the accountability of the organization, including overseeing the organization's financial reporting process.

**2.09** Ethics Interpretation No. 101-3, "Performance of Nonattest Services," under Rule 101 (AICPA, *Professional Standards*, vol. 2) (revised July 31, 2007), states that a member who performs attest services (audits, examinations, reviews, compilations, and agreed-upon procedures services) should not perform management functions or make management decisions for an attest client. (However, the member may provide advice, research materials, and recommendations to assist the client's management in performing its functions and making decisions.) If a member is engaged to perform nonattest services, the client must agree to perform the following functions in connection with the engagement:

- Make all management decisions and perform all management functions
- Designate a competent employee, preferably within senior management, to oversee the services
- Evaluate the adequacy and results of the services performed
- Accept responsibility for the results of the services

**2.10** The member should be satisfied that the client will be able to meet all of these criteria and make an informed judgment on the results of the member's nonattest services. Assessing the competency of the client's designated employee is a matter of professional judgment. A Q&A issued by the Professional Ethics Executive Committee on January 27, 2005, provides guidance in assessing the client's competency. The member should be satisfied that the employee understands the services to be performed sufficiently to oversee them. In cases where the client is unable or unwilling to assume these responsibilities (for example, the client does not have an individual with the necessary competence to oversee the nonattest services provided or is unwilling to perform such functions due to lack of time or desire), the member's provision of nonattest services would impair independence. Before performing nonattest services, the member should establish and document in writing the client's acceptance of its responsibilities, as well as the objectives of the nonattest engagement, services to be performed, member's responsibilities, and any limitations of the engagement. Code of Professional Conduct section 101 provides examples of nonattest services and whether performance of those services would impair independence.

## Audit Risk

**2.11** AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), states that audit risk is a function of the risk that the financial statements prepared by management are materially misstated and the risk that the auditor will not detect such material misstatement. The auditor should consider audit risk in relation to the relevant assertions related to individual account balances, classes of transactions, and disclosures and at the overall financial statement level.

**2.12** At the account balance, class of transactions, relevant assertion, or disclosure level, audit risk consists of (*a*) the risks of material misstatement (consisting of inherent risk and control risk) and (*b*) the detection risk. Paragraph .23 of AU section 312 states that auditors should assess the risks of material misstatement at the relevant assertion level as a basis to design and perform further audit procedures (tests of controls or substantive procedures).

It is not acceptable to simply deem risk to be "at the maximum." This assessment may be in qualitative terms such as high, medium, and low, or in quantitative terms such as percentages.

**2.13** In considering audit risk at the overall financial statement level, the auditor should consider risks of material misstatement that relate pervasively to the financial statements taken as a whole and potentially affect many relevant assertions. Risks of this nature often relate to the entity's control environment and are not necessarily identifiable with specific relevant assertions at the class of transactions, account balance, or disclosure level. Such risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud, for example, through management override of internal control.

## Planning Materiality

**2.14** The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of users of financial statements. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations.

**2.15** In accordance with paragraph .27 of AU section 312, the auditor should determine a materiality level for the financial statements taken as a whole when establishing the overall audit strategy for the audit. The auditor often may apply a percentage to a chosen benchmark as a step in determining materiality for the financial statements taken as a whole.

**2.16** Expenditures of not-for-profit organizations are often tightly controlled and based on the concept of a balanced budget with relatively small or zero *operating* margins. Examples of appropriate benchmarks include total net assets, various net asset classes, changes in net assets, changes in each class of net assets, total revenues, revenues of each net asset class, total expenses, total unrestricted contributions, total program expenses, or the effect on important measures, such as the ratio of program expenses to total expenses and the ratio of fund-raising expenses to contributions.

**2.17** In an audit of compliance with requirements governing major federal award programs in accordance with OMB Circular A-133, materiality should be considered in terms of each major program. For example, materiality could be considered in relation to the separate assets, revenues, or expenditures of each program that is being reported on.

### *Tolerable Misstatement*

**2.18** The initial determination of materiality is made for the financial statement taken as a whole. However, the auditor should allow for the possibility that some misstatements of lesser amounts than the materiality levels could, in the aggregate, result in a material misstatement of the financial statements. To do so, the auditor should determine one or more levels of tolerable misstatement. Paragraph .34 of AU section 312 defines *tolerable misstatement* (or *tolerable error*) as the maximum error in a population (for example, the class of transactions or account balance) that the auditor is willing to accept. Such levels of tolerable misstatement are normally lower than the materiality levels.

## Qualitative Aspects of Materiality

**2.19** As indicated previously, judgments about materiality include both quantitative and qualitative information. As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements. For example, it was revealed that an officer of a not-for-profit organization had been improperly spending the organization's money to support a lavish personal lifestyle. Although the amount of the improper spending was only a small fraction of 1 percent of the charity's annual budget, the wide publicity surrounding the officer's behavior led to an estimated 10 percent decrease in public contributions for several years and severely affected the charity's ability to fund its programs. Further, as discussed in paragraph 3.50 of this guide, noncompliance with donor-imposed restrictions (even of an otherwise immaterial amount) could be material if there is a reasonable possibility that the noncompliance could lead to a material loss of revenue or could cause an entity to be unable to continue as a going concern.

**2.20** Qualitative considerations also influence the auditor in reaching a conclusion about whether misstatements are material. Paragraph .60 of AU section 312 provides qualitative factors that the auditor may consider relevant in determining whether misstatements are material.

## Related-Party Transactions

**2.21** Obtaining knowledge of the client's organization and operations should include performing the procedures in AU section 334, *Related Parties* (AICPA, *Professional Standards*, vol. 1), to determine the existence of related-party relationships and transactions with such parties and to examine those transactions. The definition of related parties in Financial Accounting Standards Board (FASB) Statement No. 57, *Related Party Disclosures*, includes an organization's management and members of management's immediate family, as well as affiliated entities. Accordingly, transactions with brother-sister organizations and certain national and local affiliates as well as entities whose officers or directors are members of the not-for-profit organization's governing board may have to be disclosed under FASB Statement No. 57.

**2.22** AU section 334 provides guidance on, among other matters, procedures that the auditor should consider to identify related party relationships and transactions and to obtain satisfaction about the related financial statement reporting and disclosure. Obtaining that information will be enhanced if the organization has a policy that requires an annual written disclosure by governing board members of the details of their transactions and other business involvements with the organization, as well as disclosure of their other board memberships. Some states require that these kinds of disclosures be made on the annual reporting form filed by the organization.

**2.23** Some states have exhibited a heightened concern about whether the governing board members of not-for-profit organizations are meeting their stewardship responsibilities, particularly if there are potential conflicts between the governing board members' financial interests and their duties as governing board members. Responses by an organization to that concern might include increased sensitivity when it enters into business relationships with governing board members and might include developing appropriate controls for addressing potential conflicts of interests that could arise in related-party transactions

and for ensuring that such transactions are disclosed to and approved by the governing board.

## Errors and Fraud

**2.24** The auditor has a 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.[4] AU section 312 establishes standards and provides guidance on the auditor's consideration of the risk that the financial statements are materially misstated by error or fraud. AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), establishes standards and provides guidance to auditors in fulfilling their responsibility, as it relates to fraud, in an audit of financial statements conducted in accordance with GAAS. AU section 316 describes fraud and its characteristics; discusses the importance of exercising professional skepticism; requires the engagement personnel to discuss how and where the organization's financial statements might be susceptible to material misstatement due to fraud; requires the auditor to gather information necessary to identify risks of material misstatement due to fraud, to use the information gathered to identify risks that may result in a material misstatement due to fraud, and to evaluate the organization's programs and controls that address the identified risks; provides guidance on how the auditor responds to the results of the assessment; provides guidance on the evaluation of audit evidence as it relates to the risk of material misstatement due to fraud; describes related documentation requirements; and provides guidance regarding the auditor's communication about fraud to management, the audit committee, and others. As described in paragraph .33 of AU section 316, risk factors that relate to misstatements arising from fraudulent financial reporting and misappropriation of assets may be grouped into three categories based on the conditions generally present when fraud exists: incentive or pressure, or both, opportunity, and attitude or rationalization, or both. Additional information about the implementation of AU section 316 is provided in appendix A (paragraph 2.79) to this chapter.

## Illegal Acts

**2.25** AU section 317 prescribes the nature and extent of the consideration the auditor should give to the possibility of illegal acts by a client. It also provides guidance on the auditor's responsibilities when a possible illegal act is detected, including the responsibility to be assured that the audit committee or its equivalent is adequately informed about illegal acts that come to the auditor's attention.

**2.26** AU section 317 notes that illegal acts vary considerably in their relation to the financial statements. Some laws and regulations—such as sections of the tax law that affect tax provisions and accruals because of unrelated business income and government regulations that affect the amount of revenue accrued under government contracts—may have a direct and material effect on the determination of financial statement amounts. The auditor's responsibility

---

[4] The auditor's consideration of illegal acts and responsibility for detecting misstatements resulting from illegal acts is defined in AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1). For those illegal acts that are defined in that section as having a direct and material effect on the determination of financial statement amounts, the auditor's responsibility to detect misstatements resulting from such illegal acts is the same as that for errors or fraud.

to detect misstatements resulting from direct-effect illegal acts is the same as for errors and fraud (see footnote 4). Accordingly, management generally should identify federal, state, and local laws and regulations that may have a direct and material effect on the determination of financial statement amounts. The auditor should make inquiries of management concerning the client's compliance with laws and regulations.

**2.27** Not-for-profit organizations frequently receive financial assistance—such as grants, loans, loan guarantees, and interest-rate subsidies—from federal, state, and local governmental entities. By accepting such assistance, organizations often become subject to laws and regulations that may have a direct and material effect on the determination of amounts in their financial statements. Such laws and regulations may specifically address (*a*) the types of goods or services that organizations may purchase with the assistance, (*b*) the eligibility of those to whom organizations may provide benefits, (*c*) amounts organizations must contribute from their own resources toward projects for which financial assistance is provided, and (*d*) principles and standards for determining the direct and indirect costs that are allowable as charges to governmental financial assistance programs.

**2.28** Other laws and regulations relate more to an organization's operating aspects than to its financial and accounting aspects, and violations of these laws and regulations have only an indirect effect on the financial statements. (The indirect effect is usually limited to the need to disclose a contingent liability under FASB Statement No. 5, *Accounting for Contingencies*, because of the allegation or determination of illegality and the possibility of fines, penalties, or damages.) Such laws and regulations may concern securities trading, occupational safety and health, food and drug administration, environmental protection, equal employment opportunities, or antitrust violations. An example particular to the not-for-profit environment might be the requirement that an organization inform contributors of the portion of their contributions that is tax deductible; the failure to do so could subject the organization to financial penalties. Normally, an audit in accordance with GAAS does not include audit procedures specifically designed to detect illegal acts. AU section 317 specifies the auditor's responsibilities when he or she becomes aware of possible illegal acts as defined in that section.

## Compliance Auditing Under Government Auditing Standards

**2.29** Not-for-profit organizations that receive government financial assistance may be required to have audits in accordance with government auditing standards, as specified in the Yellow Book.[5] Government auditing standards pertain to auditors' professional qualifications, the quality of the work performed, and the characteristics of the reports issued. In performing an audit in accordance with the Yellow Book, the auditor assumes reporting responsibilities beyond those required by GAAS. The auditor must report on compliance with laws and regulations, violations of which may affect financial statement amounts, and on the organization's internal control over financial reporting.[6]

---

[5] Though government auditing standards primarily apply to federal financial assistance, some states have adopted government auditing standards.

[6] Auditors reports on compliance are restricted-use reports under the provisions of AU section 532, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1). Paragraph 14.15 provides further information about restricted-use reports.

## Single Audits and Related Considerations

**2.30** OMB Circular A-133 also prescribes audit requirements for not-for-profit organizations receiving federal awards.[7] The audit requirements of Circular A-133 vary with the amount of federal awards an organization receives.[8]

**2.31** For audits performed in accordance with OMB Circular A-133, the auditor has responsibilities specified in the circular that go beyond GAAS. In such audits, the auditor must perform additional procedures to test and report on compliance with specified laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on major federal award programs (as defined in the circular). Other requirements of OMB Circular A-133 include reports on the financial statements, on the supplementary schedule of expenditures of federal awards, and on internal control relevant to major federal award programs.

**2.32** AU section 801 and AICPA Audit Guide *Government Auditing Standards and Circular A-133 Audits* provide guidance on testing and reporting on compliance with laws and regulations in engagements performed under GAAS, the Yellow Book, and OMB Circular A-133. They provide auditors of not-for-profit organizations with a basic understanding of the work they should do and the reports they should issue under the Yellow Book and OMB Circular A-133. (Auditors may be asked to report on either (*a*) an organization's compliance with specified requirements of state and local laws, regulations, contracts, and grants or (*b*) the effectiveness of the organization's internal control over compliance with specified requirements. Guidance for engagements related to an entity's compliance with (or management's written assertion about) specified state or local laws, regulations, rules, or contracts not involving governmental financial assistance is provided in chapter 6, "Compliance Attestation" of Statement on Standards for Attestation Engagements (SSAE) No. 10 (AICPA, *Professional Standards*, vol. 1, AT sec. 601), as amended.

## Processing of Transactions by Service Organizations

**2.33** In addition to transactions, such as discretionary investment management services and payroll, for which for-profit organizations might use service organizations, not-for-profit organizations may also use such organizations to process transactions, such as student financial aid payments and receipt of contributions, that are unique to that industry. AU section 324,[9] *Service*

---

[7] A single audit is an audit of an entity's financial statements and of compliance with federal regulations relating to federal financial assistance, such as the audits required by Single Audit Act of 1984, as amended by the Single Audit Act Amendments of 1996, and OMB Circular A-133. Program-specific audits may be conducted in accordance with specific government audit guides, such as the U.S. Department of Education's Audit Guide titled *Compliance Audit (Attestation Engagements) of Federal Student Financial Assistance Programs at Participating Institutions.*

[8] OMB Circular A-133 requires not-for-profit organizations that expend $500,000 or more in federal awards in a year to have an audit in accordance with the Circular. (Generally, organizations that expend $500,000 or more, but under only one program, have the option of having a program-specific audit or a single audit in accordance with OMB Circular A-133.) Organizations that expend less than $500,000 must maintain records and make them available for review, if requested, but they are exempt from OMB Circular A-133 audit requirements.

[9] The AICPA Audit Guide titled *Service Organizations: Applying SAS No. 70, as Amended* includes illustrative control objectives as well as three new interpretations that address the responsibilities of service organizations and service auditors with respect to forward-looking information, subsequent events, and the risk of projecting evaluations of controls to future periods. The guide also clarifies that the use of a service auditor's report should be restricted to existing customers and is not meant for potential customers.

*Organizations* (AICPA, *Professional Standards*, vol. 1), provides requirements and guidance for auditing the financial statements of an entity that uses a service organization to provide services that are part of the entity's information system for accounting or financial reporting.

## Use of Assertions in Obtaining Audit Evidence

**2.34** Paragraphs .14–.19 of AU section 326, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1), discuss the use of assertions in obtaining audit evidence. In representing that the financial statements are fairly presented in accordance with GAAP, management implicitly or explicitly makes assertions regarding the recognition, measurement, and disclosure of information in the financial statements and related disclosures. Assertions used by the auditor fall into the following categories:

| **Categories of Assertions** | | | |
|---|---|---|---|
| | *Description of Assertions* | | |
| | *Classes of Transactions and Events During the Period* | *Account Balances at the End of the Period* | *Presentation and Disclosure* |
| Occurrence/ Existence | Transactions and events that have been recorded have occurred and pertain to the entity. | Assets and liabilities exist. | Disclosed events and transactions have occurred. |
| Rights and Obligations | — | The entity holds or controls the rights to assets, and liabilities are the obligations of the entity. | Disclosed events and transactions pertain to the entity. |
| Completeness | All transactions and events that should have been recorded have been recorded. | All assets, liabilities, and restricted net assets that should have been recorded have been recorded. | All disclosures that should have been included in the financial statements have been included. |
| Accuracy/ Valuation and Allocation | Amounts and other data relating to recorded transactions and events have been recorded appropriately. | Assets, liabilities, and restricted net assets are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are recorded appropriately. | Financial and other information is disclosed fairly and at appropriate amounts. |
| Cut-off | Transactions and events have been recorded in the correct accounting period. | — | — |

| Categories of Assertions—continued | | | |
|---|---|---|---|
| | *Description of Assertions* | | |
| | *Classes of Transactions and Events During the Period* | *Account Balances at the End of the Period* | *Presentation and Disclosure* |
| Classification and Understandability | Transactions and events have been recorded in the proper accounts. | — | Financial information is appropriately presented and described and information in disclosures is expressed clearly. |

**2.35** The auditor should use relevant assertions for classes of transactions, account balances, and presentation and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. The auditor should use relevant assertions in assessing risks by considering the different types of potential misstatements that may occur and then designing further audit procedures that are responsive to the assessed risks.

**2.36** The purpose of the use of assertions, specific audit objectives, examples of controls, and examples of auditing procedures in the tables titled "Auditing Considerations," which are presented in the auditing sections of several of the following chapters, is to assist the auditor in linking the auditor's risk assessments and further audit procedures. The tables include only those matters that are unique to not-for-profit organizations. Accordingly, they should not be considered a complete listing of all of the audit objectives, controls, and auditing procedures that the auditor should consider when auditing a not-for-profit organization. In addition, the absence of examples of selected controls related to a particular assertion is intended to indicate that the assertion does not ordinarily lend itself to specific controls that would provide reasonable assurance that the related audit objective has been achieved.

**2.37** There is not necessarily a one-to-one relationship between audit objectives and auditing procedures. Some procedures may relate to more than one objective. On the other hand, a combination of procedures may be necessary to achieve a single objective. The tables are not intended to be all-inclusive or to suggest that specific audit objectives, controls, and auditing procedures should be applied. Some of the audit objectives may not be relevant to a particular organization because of the nature of its operations or the absence of certain types of transactions. The absence of one or more of the illustrative controls would not necessarily indicate a deficiency in internal control.

**2.38** Many of the illustrative controls are premised on the existence of certain essential characteristics of internal control: authorization of transactions, segregation of duties, documentation, supervision and review, and timeliness of controls. To avoid repetition, these characteristics have not been explicitly incorporated in the tables.

## Understanding the Entity, Its Environment, and Its Internal Control

**2.39** AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), establishes standards and provides guidance about implementing the second standard of field work, as follows:

> "The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures."

**2.40** Obtaining an understanding of the entity and its environment, including its internal control, is a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit. Throughout this process, the auditor should also consider the guidance in AU section 316. See appendix A of this chapter for additional guidance pertaining to AU section 316.

This section addresses the unique aspects of not-for-profit organizations that may be helpful in developing the required understanding of the entity, its environment, and its internal control.

### Risk Assessment Procedures

**2.41** As described in AU section 326, audit procedures performed to obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and relevant assertion levels are referred to as *risk assessment procedures*. Paragraph .21 of AU section 326 states that the auditor must perform risk assessment procedures to provide a satisfactory basis for the assessment of risks at the financial statement and relevant assertion levels. Risk assessment procedures by themselves do not provide sufficient appropriate audit evidence on which to base the audit opinion and must be supplemented by further audit procedures in the form of tests of controls, when relevant or necessary, and substantive procedures. In accordance with paragraph .06 of AU section 314, the auditor should perform the following risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control:

*a.* Inquiries of management and others within the entity

*b.* Analytical procedures

*c.* Observation and inspection

See paragraphs .06–.13 of AU section 314 for more guidance on risk assessment procedures.

### Analytical Procedures

**2.42** AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1), provides guidance on the use of analytical procedures. Paragraphs .04 and .06 of AU section 329 specify that the auditor should apply analytical procedures in planning the audit to assist in understanding the entity and its environment and to identify areas that may represent specific risks relevant to the audit. In performing analytical procedures as risk assessment procedures, the auditor should develop expectations about plausible relationships

that are reasonably expected to exist. When comparison of those expectations with recorded amounts or ratios developed from recorded amounts yields unusual or unexpected relationships, the auditor should consider those results in identifying risks of material misstatement. However, when such analytical procedures use data aggregated at a high level (which is often the situation), the results of those analytical procedures provide only a broad initial indication about whether a material misstatement may exist. Accordingly, the auditor should consider the results of such analytical procedures along with other information gathered in identifying the risks of material misstatement.

**2.43** Paragraph .05 of AU section 329 provides examples of sources of information that can be used to develop the necessary expectations for applying analytical procedures. The sources of information that may be unique to not-for-profit organizations are (1) "information regarding the industry in which the client operates" and (2) "relationships of financial information with relevant nonfinancial information." The first of these utilizes industry-wide data for comparisons (such as data on endowment return, contributions, or program, fund-raising, and management and general costs that can be obtained from industry trade and professional associations). The second uses the auditor to formulate relevant relationships that are usually unique to a particular type of not-for-profit organization, such as the relationship that might be expected to exist at a college or university between the number of students registered at standard tuition rates and tuition revenues, the relationship between the number of members in an organization and its dues revenue, and the relationship between stagehand costs and the number of theatrical, dance, orchestral, or similar performances.

## Discussion Among the Audit Team

**2.44** In obtaining an understanding of the entity and its environment, including its internal control, AU section 314 states that there should be discussion among the audit team. In accordance with paragraph .14 of AU section 314, the members of the audit team, including the auditor with final responsibility for the audit, should discuss the susceptibility of the entity's financial statements to material misstatements. This discussion could be held concurrently with the discussion among the audit team that is specified by AU section 316 to discuss the susceptibility of the entity's financial statements to fraud.

## Understanding of the Entity and Its Environment

**2.45** AU section 314 requires auditors to obtain an understanding of the entity and its environment, including its internal control. In accordance with paragraph .04 of AU section 314, the auditor should use professional judgment to determine the extent of the understanding required of the entity and its environment, including its internal control. The auditor's primary consideration is whether the understanding that has been obtained is sufficient (1) to assess risks of material misstatement of the financial statements and (2) to design and perform further audit procedures (tests of controls and substantive tests).

**2.46** The auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

*a.* Industry, regulatory, and other external factors

*b.* Nature of the entity

*c.* Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements

*d.* Measurement and review of the entity's financial performance

*e.* Internal control, which includes the selection and application of accounting policies (see subsequent section for further discussion)

Refer to appendix A of AU section 314 for examples of matters that the auditor may consider in obtaining an understanding of the entity and its environment relating to categories (*a*)–(*d*) previously. Industry characteristics that are particularly relevant to not-for-profit organizations are discussed subsequently.[‡]

## *Industry Characteristics*

**2.47** The operations of not-for-profit organizations differ from those of for-profit entities in several significant ways, and those differences affect the auditor's assessment of the risk of material misstatement. Not-for-profit organizations use their resources to accomplish the purpose or mission for which they exist, not to generate net income. These resources often come from contributions, grants, or appropriations, some of which may be subject to limitations on how the resources may be used.[10] These limitations, which may be imposed by donor restrictions, by contractual terms, or by the organization's governing board, may affect the way in which revenues and net assets are recorded and presented in the financial statements.

**2.48** Not-for-profit organizations are also required to comply with numerous other provisions of statutes, contractual agreements, terms of grants and trust agreements, and similar limitations. As discussed earlier in this chapter, these compliance requirements may have an effect on the financial statements. Finally, though not-for-profit organizations are usually eligible for tax-exempt status under section 501 of the Internal Revenue Code (IRC), income from activities not related to a not-for-profit organization's exempt purpose may be subject to tax and that the organization may own or control for-profit subsidiaries. Taxes on unrelated business income and other tax matters related to the assessment of the risk of material misstatement for a not-for-profit organization are addressed in chapter 15, "Tax Considerations," of this guide.

**2.49** Not-for-profit organizations often have revenue and expenditure transactions that are unique to the industry, and these transactions have attendant implications for assessing the risk of material misstatement. For example, some not-for-profit organizations solicit contributions from various sources, some receive revenues from grants, and some organizations collect dues from members. Fund-raising may take place through telemarketing, direct mail solicitations, door-to-door solicitations, telethons, various kinds of special events, and other activities. Some organizations collect substantial amounts of contributions in the form of currency. Each of these sources of cash flows is associated

---

[‡] In addition to industry characteristics, the auditor's understanding of the entity and its environment also consists of regulatory and other external factors; the nature of the entity; objectives and strategies and related business risks; and measurement and review of the entity's financial performance. Examples of these aspects as they relate to not-for-profit organizations will be incorporated in a future edition of this guide.

[10] As used in this guide, *limitation* refers broadly to any constraints imposed on the use of assets or net assets, restriction refers to donor-imposed limitations, and *designation* refers to governing-board-imposed limitations.

with different kinds of risk. On the expenditure side, some not-for-profit organizations must also comply with restrictions imposed by resource providers. The revenue and expenditure transaction cycles of not-for-profit organizations may also include transactions that are similar to those entered into by for-profit enterprises—for example, buying and selling merchandise, purchasing investments, property and equipment, and other assets; providing services for fees, and earning income from investments. These cycles may include transactions that do not immediately result in revenues and expenses.

**2.50** FASB Statement of Financial Accounting Standards No. 116, *Accounting for Contributions Received and Contributions Made*, requires not-for-profit organizations to recognize agreements for future nonreciprocal transfers of cash, other assets, and services that are unconditional (that is, promises to give). Chapter 5, "Contributions Received and Agency Transactions," of this guide, discusses recognition and measurement principles for the assets and revenues related to such transactions. Applying those principles often involves the use of significant accounting estimates. AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1), provides guidance on obtaining and evaluating sufficient appropriate audit evidence to support those estimates. AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), addresses audit considerations relating to the measurement and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements.

**2.51** Not-for-profit organizations also have unique reporting requirements under GAAP. For example, they must report their expenses by function, such as major classes of program services and supporting activities, in conformity with FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*. They are also subject to specific disclosure requirements under FASB Statement No. 116, such as disclosures about promises to give, contributed services, and collections.

**2.52** Each of these kinds of transactions and reporting requirements increases the risk of material misstatement. Not-for-profit organizations usually have controls designed to achieve control objectives related to these transactions.

**2.53** Many not-for-profit organizations face financial and operating pressures that are similar to those faced by for-profit enterprises. Not-for-profit organizations may also face pressures that are unique to institutions that seek revenues in the form of contributions and grants, transactions that often depend on the state of the economy. These pressures generate operating, financial, and accounting responses by management, and such responses may increase the risk of material misstatement, which the auditor should assess and, when necessary, respond to by performing appropriate further audit procedures. The following are examples:

- Certain donors may tie contribution allocation formulas to the organization's actual or budgeted revenues, leading management to attempt to manage revenues to achieve the largest allocation possible.
- A sluggish economy may reduce contributions and the collection of promises to give that were made in prior years. The reduced receipts may lead the organization to pursue a more aggressive investment strategy involving complex financial instruments.

Accounting for these instruments may represent significant risks. As part of performing his or her risk assessment procedures, the auditor should understand the substance of these instruments and determine that they are reported in conformity with GAAP.

- Adverse demographics may lead an organization that charges fees for its services to pursue a more aggressive marketing strategy in its quest for constituents; this could decrease the collectibility of its receivables.
- Shortfalls in unrestricted contributions may induce an organization to use restricted contributions for purposes that violate donor restrictions.
- Acceptance by an organization of federal research and other grants carries with it an obligation to comply with federal regulations when the organization administers those grants. Such regulations include those governing overhead and other costs charged to these grants. The terms of the grants may induce organizations to charge unallowable costs to the grants, possibly resulting in liabilities for fines and repayment of any unallowable costs.
- An attempt to appear as efficient as possible may increase the likelihood of misstatement of the allocation of costs between program services and supporting activities. (Because some financial statement users view program expenses more favorably than supporting services, some not-for-profit organizations have incentive to report costs as program rather than supporting services.)

## Understanding of Internal Control

**2.54** AU section 314 states that the auditor should obtain an understanding of the five components of internal control sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. The auditor should obtain a sufficient understanding by performing risk assessment procedures to

*a.* evaluate the design of controls relevant to an audit of financial statements and

*b.* determine whether they have been implemented.

**2.55** The auditor should use such knowledge to:

- identify types of potential misstatements;
- consider factors that affect the risks of material misstatement; and
- design tests of controls, when applicable, and substantive procedures.

**2.56** Obtaining an understanding of the internal controls is distinct from testing the operating effectiveness of internal controls. The objective of obtaining an understanding of internal control is to evaluate the design of controls and determine whether they have been implemented for the purpose of assessing the risks of material misstatement. In contrast, the objective of testing the operating effectiveness of internal controls is to determine whether the controls, as designed, prevent or detect a material misstatement.

**2.57** Paragraph .41 of AU section 314 defines internal control as "a process—effected by those charged with governance, management, and other personnel—designed to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations." Internal control consists of five interrelated components:

*a.* The control environment

*b.* Risk assessment

*c.* Information and communication systems

*d.* Control activities

*e.* Monitoring

Refer to paragraphs .40–.101 of AU section 314 for a detailed discussion of the internal control components. Those paragraphs recognize the definition and description of internal control contained in *Internal Control—Integrated Framework, published by the Committee of Sponsoring Organizations of the Treadway Commission* (COSO Report).

**2.58** Certain characteristics of internal control, particularly in the control environment, may be unique to not-for-profit organizations. Paragraph .70 of AU section 314 states that auditors should obtain sufficient knowledge of the control environment to understand the attitudes, awareness, and actions of those charged with governance concerning the entity's internal control and its importance in achieving reliable financial reporting. In understanding the control environment, the auditor should concentrate on the implementation of controls because controls may be established but not acted upon. The following are examples of characteristics of a not-for-profit organization's control environment that the auditor may consider in obtaining an understanding of that environment:

- The role of management and the governing board
- The frequency of governing board meetings
- The qualifications of management and governing board members
- The governing board members' involvement in the organization's operations
- The organizational structure

**2.59** The other four components of internal control of not-for-profit organizations may also include characteristics that would not ordinarily exist in for-profit entities. The auditor should obtain sufficient knowledge of the other four components to understand how

- restricted contributions are identified, evaluated, and accepted;
- promises to give are valued and recorded;
- contributed goods, services, utilities, facilities, and the use of long-lived assets are valued and recorded;
- compliance with donor restrictions and board designations is monitored;
- reporting requirements imposed by donors, contractors, and regulators are met;

- conformity with accounting presentation and disclosure principles, including those related to functional and natural expense reporting and allocation of joint costs, is achieved; and
- new programs are identified and accounted for.

## Risk Assessment and the Design of Further Audit Procedures

**2.60** As discussed previously, risk assessment procedures allow the auditor to gather the information necessary to obtain an understanding of the entity and its environment, including its internal control. This knowledge provides a basis for assessing the risks of material misstatement of the financial statements. These risk assessments are then used to design further audit procedures, such as tests of controls, substantive tests, or both. This section provides guidance on assessing the risk of material misstatement and how to design further audit procedures that effectively respond to those risks.

### Assessing the Risks of Material Misstatement

**2.61** Paragraph .102 of AU section 314 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures. For this purpose, the auditor should

*a.* identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and considering the classes of transactions, account balances, and disclosures in the financial statements;

*b.* relate the identified risks to what can go wrong at the relevant assertion level;

*c.* consider whether the risks are of a magnitude that could result in a material misstatement of the financial statements; and

*d.* consider the likelihood that the risks could result in a material misstatement of the financial statements.

**2.62** The auditor should use information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, as audit evidence to support the risk assessment. The auditor should use the assessment of the risk of material misstatement at the relevant assertion level as the basis to determine the nature, timing, and extent of further audit procedures to be performed.

#### *Identification of Significant Risks*

**2.63** As part of the assessment of the risks of material misstatement, the auditor should determine which of the risks identified are, in the auditor's judgment, risks that require special audit consideration (such risks are defined as *significant risks*). In considering the nature of the risks, the auditor should consider a number of matters, including whether the risk is related to recent significant economic, accounting, or other developments; whether the risk involves significant transactions with related parties; whether the risk involves significant nonroutine transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual; the degree

of subjectivity in the measurement of financial information; the complexity of the transactions; and whether the risk is a risk of fraud. Examples of risks of material misstatements due to fraud can be found in paragraphs A-6–A-8 in appendix A of paragraph 2.79. One or more significant risks normally arise on most audits. In exercising this judgment, the auditor should consider inherent risk to determine whether the nature of the risk, the likely magnitude of the potential misstatement including the possibility that the risk may give rise to multiple misstatements, and the likelihood of the risk occurring are such that they require special audit consideration. Refer to paragraphs .45 and .53 of AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1), for further audit procedures pertaining to significant risks.

## Designing and Performing Further Audit Procedures

**2.64** AU section 318 provides guidance about implementing the third standard of field work, as follows:

> "The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit."

**2.65** To reduce audit risk to an acceptably low level, the auditor (1) should determine overall responses to address the assessed risks of material misstatement at the financial statement level and (2) should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the relevant assertion level. The purpose is to provide a clear linkage between the nature, timing, and extent of the auditor's further audit procedures and the assessed risks. The overall responses and the nature, timing, and extent of the further audit procedures to be performed are matters for the professional judgment of the auditor and should be based on the auditor's assessment of the risk of material misstatement.

### *Overall Responses*

**2.66** The auditor's overall responses to address the assessed risks of material misstatement at the financial statement level may include emphasizing to the audit team the need to maintain professional skepticism in gathering and evaluating audit evidence, assigning more experienced staff or those with specialized skills or using specialists, providing more supervision, or incorporating additional elements of unpredictability in the selection of further audit procedures to be performed. Additionally, the auditor may make general changes to the nature, timing, or extent of further audit procedures as an overall response, for example, performing substantive procedures at period end instead of at an interim date.

### *Further Audit Procedures*

**2.67** Further audit procedures provide important audit evidence to support an audit opinion. These procedures consist of tests of controls and substantive tests. The nature, timing, and extent of the further audit procedures to be performed by the auditor should be based on the auditor's assessment of risk of material misstatement at the relevant assertion level.

**2.68** In some cases, an auditor may determine that performing only substantive procedures is appropriate. However, the auditor often will determine

that a combined audit approach using both tests of the operating effectiveness of controls and substantive procedures is an effective audit approach.

**2.69** The auditor should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level.

**2.70** Regardless of the audit approach selected, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure.

**2.71** The auditor's substantive procedures should include the following audit procedures related to the financial statement reporting process:

- Agreeing the financial statements, including their accompanying notes, to the underlying accounting records
- Examining material journal entries and other adjustments made during the course of preparing the financial statements. The nature and extent of the auditor's examination of journal entries and other adjustments depend on the nature and complexity of the entity's financial reporting system and the associated risks of material misstatement

## Evaluating Misstatements

**2.72** Based on the results of the audit procedures performed, the auditor may identify misstatements in accounts or notes to the financial statements. Paragraph .42 of AU section 312 states that auditors must accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are trivial, and communicate them to the appropriate level of management. AU section 312 further states that auditors must consider the effects, both individually and in the aggregate, of misstatements (known and likely) that are not corrected by the entity. This consideration includes, among other things, the effect of misstatements related to prior periods.

**2.73** For detailed guidance on evaluating audit findings and audit evidence, refer to AU section 312 and AU section 326, respectively.

## Completing the Audit

**2.74** The procedures involved in completing the audit include the following:

- Performing analytical procedures in the overall review stage
- Evaluating whether the financial statements are free of material misstatements. Procedures include the following:
  *a)* Evaluating uncorrected misstatements and the concluding whether the accumulated misstatements cause the financial statements to be materially misstated (AU section 312)
  *b)* Evaluating whether the accumulated results of audit procedures and other observations affect the assessment of

the risks of material misstatement due to fraud made earlier in the audit (AU section 316)

*c)* Considering the effect of undetected misstatements

*d)* Considering the possibility of management's bias

- Obtaining legal letters
- Reviewing for subsequent events
- Obtaining written management representations
- Evaluating whether there is a substantial doubt about the organization's ability to continue as a going concern for a reasonable period of time
- Preparing the auditor's reports
- Communicating, in writing, to management and those charged with governance, significant deficiencies and material weaknesses identified in the audit (AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* [AICPA, *Professional Standards*, vol. 1])
- Communicating the auditor's views about qualitative aspects of the organization's significant accounting policies; significant difficulties encountered during the audit; uncorrected misstatements (other than those the auditor believes are trivial); disagreements with management; material, corrected misstatements; representations that the auditor is requesting of management; management's consultations with other accountants; significant issues discussed with management; and other significant findings or issues that the auditor believes are significant and relevant to those charged with governance (AU section 380)[||]

This section of the guide discusses aspects of these procedures that are unique to not-for-profit organizations.

## Management Representations

**2.75** AU section 333, *Management Representations* (AICPA, *Professional Standards*, vol. 1), sets forth requirements that the auditor obtain written representations from management as a part of an audit of financial statements performed in accordance with GAAS and provides guidance concerning the representations to be obtained. Written representations from management should be obtained for all financial statements and periods covered by the auditor's report. The specific written representations to be obtained depend on the circumstances of the engagement and the nature and basis of the presentation of the financial statements. Paragraph .06 of AU section 333 lists matters ordinarily included in management's representation letter. Paragraph .06*g* of AU section 333 states that the representation letter should include an acknowledgment by management that it has considered the financial statement misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented, and has concluded that any uncorrected misstatements

[||] SAS No. 114, which supersedes SAS No. 61, is effective for audits of financial statements for periods beginning on or after December 15, 2006. The SAS uses the term *those charged with governance* to refer to those with responsibility for overseeing the strategic direction of the organization and obligations related to the accountability of the organization, including overseeing the organization's financial reporting process.

are immaterial, both individually and in the aggregate to the financial statements taken as a whole. Also, a summary of the uncorrected misstatements should be included in or attached to the representation letter. Additional representations specific to not-for-profit organizations that may be obtained include the following:

- Compliance with contractual agreements, grants, and donor restrictions
- Maintenance of an appropriate composition of assets in amounts needed to comply with all donor restrictions
- Taxation and tax-exempt status
- Reasonableness of bases for allocation of functional expenses
- Inclusion in the financial statements of all assets and liabilities under the entity's control
- Adequacy of internal control over the receipt and recording of contributions
- Propriety of reclassifications between net asset classes
- The governing board's interpretation concerning whether laws place restrictions on net appreciation of donor-restricted endowments
- Appropriateness of the methods and significant assumptions used by management to determine fair value, their consistency in application, and the completeness and adequacy of fair value information for financial statement measurement and disclosure purposes

**2.76** Paragraph .07 of AU section 801 notes that an auditor who has been engaged to audit an organization that receives government funds that make it subject to government-imposed compliance testing and reporting requirements of the Yellow Book might consider obtaining written representations from management concerning the completeness of management's identification of laws and regulations that have a direct and material effect on the determination of financial statement amounts.

## Going-Concern Considerations

**2.77** AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1), provides guidance to the auditor in meeting the responsibility to evaluate whether there is substantial doubt about the client's ability to continue as a going concern for a reasonable period of time not to exceed one year beyond the date of the balance sheet. AU section 341 gives examples of conditions and events that might indicate that there could be substantial doubt about the entity's continued existence. Additional examples of such conditions and events that are particularly applicable to not-for-profit organizations include the following:

- Insufficient unrestricted revenues to provide supporting services to activities funded by restricted contributions
- A high ratio of fund-raising expenses to contributions received or a low ratio of program expenses to total expenses
- Insufficient resources to meet donor's restrictions (This may result from the use of restricted net assets for purposes that do not satisfy the donor's restrictions, sometimes referred to as interfund borrowing.)

- Activities that could jeopardize the organization's tax-exempt status and thus endanger current contribution levels
- Concerns expressed by governmental authorities regarding alleged violations of state laws governing an organization's maintenance or preservation of certain assets, such as collection items
- A loss of key governing board members or volunteers
- External events that could affect donors' motivations to continue to contribute
- Decreases in revenues contributed by repeat donors
- A loss of major funding sources

**2.78** Paragraph .18 of AU section 341 states that if, after considering the identified conditions and events in the aggregate, the auditor believes there is substantial doubt about the ability of the entity to continue as a going concern for a reasonable period of time, he or she should follow the guidance in paragraphs .07–.16 of AU section 341. In connection with that guidance, the auditor should document all of the following:

*a.* The conditions or events that led him or her to believe that there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.

*b.* The elements of management's plans that the auditor considered to be particularly significant to overcoming the adverse effects of the conditions or events.

*c.* The auditing procedures performed and evidence obtained to evaluate the significant elements of management's plans.

*d.* The auditor's conclusion as to whether substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains or is alleviated. If substantial doubt remains, the auditor also should document the possible effects of the conditions or events on the financial statements and the adequacy of the related disclosures. If substantial doubt is alleviated, the auditor also should document the conclusion as to the need for disclosure of the principal conditions and events that initially caused him or her to believe there was substantial doubt.

*e.* The auditor's conclusion as to whether he or she should include an explanatory paragraph in the audit report. If disclosures with respect to an entity's ability to continue as a going concern are inadequate, the auditor also should document the conclusion as to whether to express a qualified or adverse opinion for the resultant departure from GAAP.

2.79

# Appendix A—Consideration of Fraud in a Financial Statement Audit

**A-1** AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), is the primary source of authoritative guidance about an auditor's responsibilities concerning the consideration of fraud in a financial statement audit. AU section 316 establishes standards and provides guidance to auditors in fulfilling their 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 as stated in paragraph .02 of AU section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1).

**A-2** There are two types of misstatements relevant to the auditor's consideration of fraud in a financial statement audit:

- Misstatements arising from fraudulent financial reporting.
- Misstatements arising from misappropriation of assets.

**A-3** Three conditions generally are present when fraud occurs. First, management or other employees have an *incentive* or are under *pressure,* which provides a reason to commit fraud. Second, circumstances exist—for example, the absence of controls, ineffective controls, or the ability of management to override controls—that provide an *opportunity* for a fraud to be perpetrated. Third, those involved are able to *rationalize* committing a fraudulent act.

## The Importance of Exercising Professional Skepticism

**A-4** Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred.

## Discussion Among Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud[1]

**A-5** Members of the audit team should discuss the potential for material misstatement due to fraud in accordance with the requirements of paragraphs .14–.18 of AU section 316. The discussion among the audit team members about the susceptibility of the entity's financial statements to material misstatement due to fraud should include a consideration of the known external and internal factors affecting the entity that might (*a*) create incentives or pressures, or

[1] The brainstorming session to discuss the entity's susceptibility to material misstatements due to fraud could be held concurrently with the brainstorming session required under AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), to discuss the potential of the risk of material misstatement.

both, for management and others to commit fraud, (*b*) provide the opportunity for fraud to be perpetrated, and (*c*) indicate a culture or environment that enables management to rationalize committing fraud. Communication among the audit team members about the risks of material misstatement due to fraud also should continue throughout the audit.

**A-6** When brainstorming about the incentives and pressures for management and others to commit fraud, the audit team members may want to discuss whether any of the following exist:

- Incentive to minimize reported fundraising and management and general expenses, and maximize reported program expenses, to make the organization appear worthy of contributions, especially if some potential resource providers have stated or implied limits in these areas (for example, the resource provider will not fund organizations with more than 25 percent overhead), or if the organization desires to be in compliance with standards of the charitable organization rating agencies, such as those mentioned in appendix E of this guide
- Incentive to defer fundraising expenses to future periods if the related contributions will not be received until those future periods
- Incentive to make the organization look poor (but not *too* poor) to induce contributors to contribute
- Incentive to mischaracterize the relationship with related parties (for example, affiliated chapters, fundraising organizations, foundations, guilds, trusts, funds, student clubs, and auxiliaries) to avoid consolidating those entities or reporting the assets held by them for the organization's benefit if the organization wants to appear poorer
- Incentive to achieve certain fundraising goals, especially to meet terms of matching gifts
- Incentive to misstate financial information if contributions are conditioned on achieving certain financial performance goals
- Incentive to report that donor gifts (or restricted income from donor endowments) have been used in accordance with donor restrictions when, in fact, that is not the case (This incentive may be particularly strong if there is a deficit change in unrestricted net assets.)
- Incentive to "borrow" from restricted funds to cover a current unrestricted deficit
- Incentive to mischaracterize revenue so as not to fail the IRS public support test
- Incentive to recognize intentions to give as contributions made in order to reduce the private foundation excise tax on the net investment income, avoid the excise tax for failure to distribute income, or both
- Incentive to misallocate expenses to avoid exceeding IRS limits on allowable lobbying

- Incentive to inappropriately minimize unrelated business income taxes, such as by over-allocating costs against taxable unrelated business income
- Incentive to mischaracterize overhead expenses as direct program expenses when grantors limit the amount of their grants that may be used for overhead (sometimes such limits are zero)
- Incentive to avoid surplus funds in grants that require that surplus funds be returned to the grantor

**A-7** When brainstorming about the opportunities for fraud to be perpetrated, the audit team members may want to discuss whether the following exist:

- Domination of management by a single person (such as an executive director) or small group without compensating controls, for example, a charismatic executive combined with a reluctance of employees or those charged with governance to disagree with him or her
- Limited number of staff involved in the accounting functions, if the result is inadequate internal control over assets that increases the susceptibility of misappropriation of those assets
- The attitude among management of, "We're a charity, no one would steal from us!" with an attendant lack of appreciation for the importance of strong internal controls
- Unjustified trust in employees or volunteers because "we know they are committed to the cause"
- Key management functions and controls are in the hands of volunteers not subject to normal levels of supervision
- Management lacks the necessary background, experience, or commitment to fulfill their duties
- A hands-off governing board or one with insufficient financial expertise to oversee the financial reporting process and internal controls
- Special events or fundraising methods result in large amounts of cash on hand or processed, for example, church plate collections, and door-to-door and other off-premises fundraising
- Revenue (including contributions) received in the form of coins or currency, or both, or in the form of checks personally handed to organization staff and volunteers
- Inadequate investigation of past-due promises to give, especially conditional promises, which are not recognized in the financial statements
- Numerous restricted grants received under the control of a single individual or a small group of individuals, which could lead to allocating expenses to an inappropriate grant account when grant limits are reached on the appropriate one
- Programs are supported by mixed types of grants (fixed price, units of service, cost reimbursement) that could motivate charging inappropriate expenses against certain grants or charging multiple grants for the same expenditure

- Fixed assets not subject to existing general ledger controls because they are not recorded, for example, fixed assets legally owned by a grantor or collection items that the organization has chosen not to capitalize
- Grant programs for which the recipients are individuals (for example, food, clothing, or other assets are distributed) or scholarships, fellowships, or other financial assistance is paid out
- Research projects where payments to test subjects are made in cash, especially if lists of payments are not prepared so as to preserve the confidentiality of the subjects' identities
- A complex organizational structure (often including several entities under common control), especially if there are numerous inter-organization transactions

**A-8** When brainstorming about a culture or environment that enables management to rationalize committing fraud, the audit team members may want to discuss whether any of the following exist:

- An organization culture that lets concern for provision of program services completely override sound internal controls
- Misguided attempts to preserve the organization's program services no matter what the cost or risk, for example, by not remitting payroll withholdings
- An employee's attitude that because his or her compensation is lower than what the employee perceives could be earned in the for-profit sector, special perquisites are justified (such as rights to take donated noncash items for personal use)
- An employee who has access to assets subject to misappropriation is dissatisfied, perhaps because of long work hours or inability to get resources assigned to the employee's projects
- Governing board members have personally guaranteed debt of the organization and the organization is experiencing a deteriorating financial condition

**A-9** The preceding lists highlight incentives or pressures, or both, opportunities, and cultures or environments that are unique to or more common in the not-for-profit industry than in other industries. Additionally, the exhibit of AU section 316 provides examples of fraud risk factors that the audit team members might consider.

## Obtaining the Information Needed to Identify the Risks of Material Misstatement Due to Fraud

**A-10** AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), establishes standards and provides guidance about how the auditor obtains an understanding of the entity and its environment, including its internal control for the purpose of assessing the risks of material misstatement. In performing that work, information may come to the auditor's attention that should be considered in identifying risks of material misstatement due to fraud. As part of this work, the auditor should perform the following procedures to obtain information that is used (as described in paragraphs .35–.42 of AU section 316) to identify the risks of material misstatement due to fraud:

*a.* Make inquiries of management and others within the entity to obtain their views about the risks of fraud and how they are addressed (see paragraphs .20–.27 of AU section 316)

*b.* Consider any unusual or unexpected relationships that have been identified in performing analytical procedures in planning the audit (see paragraphs .28–.30 of AU section 316)

*c.* Consider whether one or more fraud risk factors exist (see paragraphs .31–.33 of AU section 316, the appendix to AU section 316, and paragraphs A-5–A-9 of this appendix)

*d.* Consider other information that may be helpful in the identification of risks of material misstatement due to fraud (see paragraph .34 of AU section 316)

**A-11** In planning the audit, the auditor also should perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that may indicate a material misstatement due to fraudulent financial reporting. For example, in the not-for-profit industry, the following unusual or unexpected relationships may indicate a material misstatement due to fraud.

- Changes in contribution revenue as compared to a prior period are not as expected, considering changes in the surrounding circumstances (state of the economy, changed fundraising efforts, known major gifts or grants, or both)
- Revenue does not change in the direction or magnitude, or both, that is expected based on observed changes in related expenses (for example, revenue and expenses of a clinic)
- Earned revenue is inconsistent with known levels of services provided
- A significant amount of expenditures on cost-reimbursement grants are recognized at the tail end of the grant period
- Investment return overall, or for an individual fund, is not reasonable

**A-12** ***Considering Fraud Risk Factors.*** As indicated in item *c* previously, the auditor may identify events or conditions that indicate incentives or pressures, or both, to perpetrate fraud, opportunities to carry out the fraud, or attitudes or rationalizations, or both, to justify a fraudulent action. Such events or conditions are referred to as "fraud risk factors." Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances where fraud exists.

**A-13** AU section 316 provides fraud risk factor examples that have been written to apply to most enterprises. The section about brainstorming sessions that are conducted by the audit team members (paragraphs A-5–A-9 of this appendix) contains a list of fraud risk factors specific to the not-for-profit industry. Remember that fraud risk factors are only one of several sources of information an auditor considers when identifying and assessing risk of material misstatement due to fraud.

### *Identifying Risks That May Result in a Material Misstatement Due to Fraud*[2]

**A-14** In identifying risks of material misstatement due to fraud, it is helpful for the auditor to consider the information that has been gathered in accordance with the requirements of paragraphs .19–.34 of AU section 316. The auditor's identification of fraud risks may be influenced by characteristics such as the size, complexity, and ownership attributes of the entity. In addition, the auditor should evaluate whether identified risks of material misstatement due to fraud can be related to specific financial-statement account balances or classes of transactions and related assertions, or whether they relate more pervasively to the financial statements as a whole. Certain accounts, classes of transactions, and assertions that have high inherent risk because they involve a high degree of management judgment and subjectivity also may present risks of material misstatement due to fraud because they are susceptible to manipulation by management.

**A-15** Recognition of the following items might involve a high degree of management judgment and subjectivity:

*a. Contributions Receivable and Revenue*

- Measurement of noncash contributions in the absence of publicly available market quotations
- Whether the allowance for uncollectible pledges is appropriate (This involves a higher degree of subjectivity than normal trade or loans receivable, due to the voluntary nature of the underlying transaction.)
- Whether a donor communication is an expression of an intention to give or a promise to give
- Whether promises to give are conditional or unconditional
- Whether donor stipulations are conditions or restrictions
- Whether a donor-imposed condition on a promise to give has been substantially met
- Whether donated services require specialized skills
- Whether the organization would typically have had to purchase services if they were not provided by donation
- Whether assets received that must be passed on to another entity meet the criteria in FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others,* for recognition as contribution revenue by the reporting (recipient) organization (That is, is there variance power; are the organizations financially interrelated; is a transfer revocable; and so forth?)

---

[2] AU section 314 requires the auditor to identify and assess the risk of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances and disclosures. See paragraph .102 of AU section 314.

*b. Revenues Other Than Contributions*

- Whether revenue transactions (for example, membership dues, grants, contracts) are contributions or exchange transactions (or whether they have a contribution element)
- Whether a revenue source results from an activity that is subject to tax as an unrelated business

*c. Contributions Payable and Expense*

- Whether a communication with another not-for-profit organization is an expression of an intention to give or a promise to give
- Whether promises to give are conditional or unconditional
- Whether stipulations are conditions or restrictions
- Whether a condition on a promise to give to another organization has been met, especially if the donor organization's monitoring system is inadequate

*d. Expenses, in General*

- Allocation of costs of joint activities, both as to whether the criteria in AICPA Statement of Position (SOP) 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising* (AICPA, *Technical Practice Aids*, ACC sec. 10,730), are met and whether the allocation bases and methods chosen are appropriate
- Allocation of expenses among functional categories, especially if that allocation is made at year end based on percentages
- Whether an expenditure satisfies a restriction on net assets

*e. Other Items*

- Whether an organization maintains its collection in a manner that qualifies for nonrecognition, especially if they have occasionally sold collection items in the past without purchasing new items for the collection
- Recoverability of assets with possibly limited future use (for example, sets and costumes owned by a theater)
- Whether a related not-for-profit organization meets the criteria for consolidation or for financially interrelated organizations accounted for under the equity method in FASB Statement No. 136, especially if one organization has significant influence over the other but not a majority voting interest in the governing board of the other

## A Presumption That Improper Revenue Recognition Is a Fraud Risk

**A-16** Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of

revenues (for example, through improperly shifting revenues to a later period). Therefore, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition (see paragraph .41 of AU section 316).

**A-17** Revenue may be improperly recognized due to fraudulent financial reporting if

- revenue is improperly classified among the three net asset classes, restrictions are released before they are met, or restrictions are not released even though they are met;
- conditional promises to give are recognized as unconditional, or vice versa;
- intentions to give are recognized as promises to give, or promises to give are not recognized because it is asserted that they are intentions to give;
- unconditional grants that are in substance contributions are recognized as exchange transactions, or vice versa;
- membership dues that are in substance contributions are recognized as exchange transactions, or vice versa;
- improper periods for amortization of income from membership dues, tuition, and season ticket sales are used;
- agency transactions are recognized as contribution revenue and program expense, particularly if the reported fair value of noncash items changes without cause between receipt and disbursement;
- works of art, historical treasures, and similar items are not recognized but should be because the collection does not meet the criteria for nonrecognition;
- in-kind contributions are selectively recognized to maximize the reported ratio of program expenses to total expenses (that is, the organization makes every attempt to recognize and maximize the fair value of contributions of items for program purposes, but ignores or minimizes the estimated fair value of items used for management and general or fundraising purposes);
- discount rates used in measuring promises to give or split-interest gifts are inappropriate;
- revenue is recognized for services that were not delivered; and
- sliding scales used to charge service recipients are not appropriately applied.

### *A Consideration of the Risk of Management Override of Controls*

**A-18** Even if specific risks of material misstatement due to fraud are not identified by the auditor, there is a possibility that management override of controls could occur, and accordingly, the auditor should address that risk (see paragraph .57 of AU section 316) apart from any conclusions regarding the existence of more specifically identifiable risks. Specifically, the procedures described in paragraphs .58–.67 of AU section 316 should be performed to further address the risk of management override of controls. These procedures include (1) examining journal entries and other adjustments for evidence of possible

material misstatement due to fraud, (2) reviewing accounting estimates for biases that could result in material misstatement due to fraud, and (3) evaluating the business rationale for significant unusual transactions.

### *Key Estimates*

**A-19** Fraudulent financial reporting is often accomplished through the intentional misstatement of accounting estimates. Estimates by management are common in the following areas:

- Measurement of noncash contributions other than marketable securities and especially of unusual noncash assets
- Allowance for uncollectible promises to give
- Present value calculations for unconditional promises to give and split-interest agreements
- Methods and factors used in allocating the costs of joint activities
- Allocation of expenses to functional categories
- Future cash flows related to assets that are possibly impaired

**A-20** Review and evaluation of the financial results reported by the organization or its individual operating units also may detect fraudulent financial reporting. Unusual fluctuations in results of a particular reporting unit, or the lack of expected fluctuations, may indicate potential manipulation by management. Examples of key ratios or trends to evaluate include the following:

- Percentage of revenue by major source, particularly if compared over a series of years or between similar individual operating units
- Percentage of expenses in each of the major programs and in management and general and fundraising categories, particularly if compared over a series of years or between similar individual operating units
- Fundraising expenses as a percentage of contribution revenue
- Investment income as a percentage of investment assets
- Comparisons of budget to actual for revenues and expenses
- Per capita calculations such as payroll expense per employee, average fee per service recipient, average gift shop sales per person admitted, and average contribution per person solicited, particularly if the denominator (head count) can be determined independent of the accounting function
- Comparison of the amount of gifts received in the accounting records and the development records

### *Assessing the Identified Risks After Taking Into Account an Evaluation of the Entity's Programs and Controls That Address the Risks*

**A-21** Paragraphs .43–.45 of AU section 316 provide requirements and guidance for the evaluation of entity programs and controls and assessing identified risks of material misstatement due to fraud.

**A-22** The exhibit to AU section 316 discusses examples of programs and controls an entity may implement to prevent, deter, and detect fraud. It includes sections on creating a culture of honesty and high ethics, evaluating antifraud processes and controls, and developing an appropriate oversight process. Some example recommendations from the exhibit to AU section 316 are included in the following two paragraphs.

**A-23** The organization should attract individuals to serve on the governing board who are financially literate and who have an understanding of GAAP and audits of financial statements prepared under those principles. It is also helpful if some members of the governing board have experience in the preparation or the auditing, or both, of financial statements of a not-for-profit organization of similar size, scope and complexity, an appreciation of what is necessary to maintain a good internal control environment and experience in internal governance and procedures of audit committees. (Additional desirable characteristics of board members are discussed in the exhibit to AU section 316.) Members of the governing board should set the "tone at the top" for ethical behavior within the organization, including making sure that transactions do not result in private inurement or violate the IRS Intermediate Sanctions. (Intermediate sanctions are designed to protect donors and charities from insider dealing and excessive compensation for executives.)

**A-24** Management also participates in setting the tone for ethical behavior. It also should create a positive workplace environment, hire and promote appropriate employees, provide training upon hiring and periodically thereafter, hold all employees accountable to act within the entity's code of conduct, investigate all suspected incidents of fraud, and discipline for actual violations.

**A-25** In addition, management has primary responsibility for establishing and monitoring all aspects of the entity's fraud risk-assessment and prevention activities. Among the processes that management should design and monitor are those that

- satisfy management that substantially all contributions intended for the organization have been received, recorded, and deposited;
- satisfy management that services are provided only to authorized persons and properly billed (members have paid dues, patients have paid proper fees, beneficiaries meet eligibility criteria, only ticketholders are admitted to events);
- satisfy management that expenses are being properly allocated to functions and to individual funds or grants;
- monitor and explain budget variances, including by fund or grant; and
- ensure that related party transactions and relationships have a valid business purpose and are conducted in a manner that does not result in private inurement.

**A-26** The auditor should consider whether such programs and controls mitigate the identified risks of material misstatement due to fraud or whether specific control deficiencies exacerbate the risks. After the auditor has evaluated

whether the entity's programs and controls have been suitably designed and placed in operation, the auditor should assess these risks taking into account that evaluation. This assessment should be considered when developing the auditor's response to the identified risks of material misstatement due to fraud.

### *Responding to the Results of the Assessment*[3]

**A-27** Paragraphs .46–.67 of AU section 316 provide requirements and guidance about an auditor's response to the results of the assessment of the risks of material misstatement due to fraud. The auditor responds to risks of material misstatement due to fraud in the following three ways:

*a.* A response that has an overall effect on how the audit is conducted—that is, a response involving more general considerations apart from the specific procedures otherwise planned (see paragraph .50 of AU section 316).

*b.* A response to identified risks involving the nature, timing, and extent of the auditing procedures to be performed (see paragraphs .51–.56 of AU section 316). Audit tests that are unique to not-for-profit organizations are included at the ends of chapters 5–11 and 13 of this guide.

*c.* A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls, given the unpredictable ways in which such override could occur (see paragraphs .57–.67 of AU section 316 and paragraph A-18–A-20 previously).

### *Evaluating Audit Evidence*

**A-28** Paragraphs .68–.78 of AU section 316 provide requirements and guidance for evaluating audit evidence. The auditor should evaluate whether analytical procedures that were performed as substantive tests or in the overall review stage of the audit indicate a previously unrecognized risk of material misstatement due to fraud. The auditor also should consider whether responses to inquiries throughout the audit about analytical relationships have been vague or implausible or have produced evidence that is inconsistent with other audit evidence accumulated during the audit.

**A-29** At or near the completion of fieldwork, the auditor should evaluate whether the accumulated results of auditing procedures and other observations affect the assessment of the risks of material misstatement due to fraud made earlier in the audit. As part of this evaluation, the auditor with final responsibility for the audit should ascertain that there has been appropriate communication with the other audit team members throughout the audit regarding information or conditions indicative of risks of material misstatement due to fraud.

---

[3] AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1), requires the auditor to determine overall responses and design and perform further audit procedures to respond to assessed risks of material misstatement at the financial statement and relevant assertion levels in a financial statement audit. See paragraphs .03 and .07 of AU section 318.

### *Responding to Misstatements That May Be the Result of Fraud*

**A-30** When audit test results identify misstatements in the financial statements, the auditor should consider whether such misstatements may be indicative of fraud. See paragraphs .75–.78 of AU section 316 for requirements and guidance about an auditor's response to misstatements that may be the result of fraud. If the auditor believes that misstatements are or may be the result of fraud, but the effect of the misstatements is not material to the financial statements, the auditor nevertheless should evaluate the implications, especially those dealing with the organizational position of the person(s) involved.

**A-31** If the auditor believes that the misstatement is or may be the result of fraud, and either has determined that the effect could be material to the financial statements or has been unable to evaluate whether the effect is material, the auditor should

*a.* attempt to obtain additional audit evidence to determine whether material fraud has occurred or is likely to have occurred, and, if so, its effect on the financial statements and the auditor's report thereon;[4]

*b.* consider the implications for other aspects of the audit (see paragraph .76 of AU section 316);

*c.* discuss the matter and the approach for further investigation with an appropriate level of management that is at least one level above those involved, and with senior management and the audit committee; and[5]

*d.* if appropriate, suggest that the client consult with legal counsel.

**A-32** The auditor's consideration of the risks of material misstatement and the results of audit tests may indicate such a significant risk of material misstatement due to fraud that the auditor should consider withdrawing from the engagement and communicating the reasons for withdrawal to the audit committee or others with equivalent authority and responsibility. The auditor may wish to consult with legal counsel when considering withdrawal from an engagement.

### *Communicating About Possible Fraud to Management, the Audit Committee, and Others*

**A-33** Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. See paragraphs .79–.82 of AU section 316 for further requirements and guidance about communications with management, the audit committee, and others.

---

[4] See AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), for guidance on auditors' reports issued in connection with audits of financial statements.

[5] If the auditor believes senior management may be involved, discussion of the matter directly with the audit committee may be appropriate.

### *Documenting the Auditor's Consideration of Fraud*

**A-34** Paragraph .83 of AU section 316 requires certain items and events to be documented by the auditor. Auditors should comply with those requirements.

### *Practical Guidance*

**A-35** The AICPA practice aid *Fraud Detection in a GAAS Audit* provides a wealth of information and help on complying with the provisions of AU section 316. This practice aid is an other auditing publication as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply Statements on Auditing Standards.

# Chapter 3

# *Basic Financial Statements and General Financial Reporting Matters*

## Introduction

**3.01** Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*, establishes standards for general-purpose external financial statements prepared by not-for-profit organizations. It specifies that a complete set of financial statements should include a statement of financial position, a statement of activities, a statement of cash flows,[1] accompanying notes to the financial statements, and for voluntary health and welfare organizations, a statement of functional expenses.[2] Appendix C of FASB Statement No. 117 includes illustrations of those financial statements.

**3.02** A set of financial statements of a not-for-profit organization should include information required by generally accepted accounting principles (GAAP), except for principles included in authoritative pronouncements that specifically exempt not-for-profit organizations,[3] including information required by applicable specialized accounting and reporting principles and practices, such as those specified in this guide. The requirements of FASB Statement No. 117 are generally no more stringent than the requirements for for-profit organizations; accordingly, although FASB Statement No. 117 does not specify the degree of aggregation and the order of presentation in financial statements of not-for-profit organizations, they should be similar to what is required or permitted for for-profit organizations. Appendix C to FASB Statement No. 117 includes financial statements that illustrate some of the ways in which the requirements of the statement can be met.

## Statement of Financial Position

**3.03** A statement of financial position should focus on the organization as a whole and should report the amounts of its assets, liabilities, and net assets. Assets and liabilities should be aggregated into reasonably homogeneous

---

[1] As discussed in chapter 5, "Contributions Received and Agency Transactions," of this Audit and Accounting Guide (guide), some not-for-profit organizations receive resources in agency transactions. For some of those organizations, receiving resources as agents may be a primary component of their mission. Those organizations should consider presenting the statement of cash flows as the first financial statement presented in their set of financial statements, in order to emphasize the importance of the information presented in that statement.

[2] The terms *statement of financial position*, *statement of activities*, and *statement of functional expenses* indicate the content and purpose of the respective statements and serve as possible titles for those statements. Other appropriately descriptive titles may also be used. For example, a statement reporting financial position could be called a *balance sheet* as well as a *statement of financial position*. Current practice and the statement's purpose suggest, however, that a statement of cash flows only be titled "Statement of Cash Flows."

[3] Chapter 1, "Introduction," of this guide, incorporates Statement of Position (SOP) 94-2, *The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations*, which is superseded by this guide for organizations that are included in the scope of this guide.

groups. Assets need not be disaggregated on the basis of the presence of donor-imposed restrictions on their use; for example, cash available for unrestricted current use need not be reported separately from cash received with donor-imposed restrictions that is also available for current use.[4] However, cash or other assets either (*a*) designated for long-term purposes or (*b*) received with donor-imposed restrictions that limit their use to long-term purposes should not be aggregated on a statement of financial position with cash or other assets that is available for current use. For example, cash that has been received with donor-imposed restrictions limiting its use to the acquisition of long-lived assets should be reported under a separate caption, such as "cash restricted to investment in property and equipment," and displayed near the section of the statement where property and equipment is displayed. The kind of asset should be described in the notes to the financial statements if its nature is not clear from the description on the face of the statement of financial position.

**3.04** Paragraph 12 of FASB Statement No. 117 requires that one or more of the following techniques be used to provide information about the organization's liquidity:

*a.* Sequencing assets according to their nearness of conversion to cash and sequencing liabilities according to the nearness of their maturity and resulting use of cash

*b.* Classifying assets and liabilities as current and noncurrent, as defined by Accounting Research Bulletin (ARB) No. 43, chapter 3A, "Working Capital—Current Assets and Current Liabilities"

*c.* Disclosing in notes to financial statements relevant information about the liquidity or maturity of assets and liabilities, including restrictions on the use of particular assets

Information about the liquidity or maturity of assets and liabilities should be disclosed in a separate note to the financial statements if that information is not apparent from the face of the statements or the other notes.

**3.05** A statement of financial position should report amounts for each of three classes of net assets (permanently restricted net assets, temporarily restricted net assets, and unrestricted net assets) as well as total net assets. The three net asset classes should be based solely on the existence or absence of donor-imposed restrictions. (As discussed in paragraph 3.07, board-designated limitations on the use of unrestricted net assets are permitted to be disclosed.)

**3.06** Permanently restricted net assets result from contributions whose use is limited by donor-imposed stipulations that neither expire by passage of time nor can be fulfilled or otherwise removed by the organization's actions. Temporarily restricted net assets result from contributions whose use is limited by donor-imposed stipulations that either expire by passage of time or can be fulfilled and removed by actions of the organization pursuant to these stipulations. Net assets may be temporarily restricted for various purposes, such as use in future periods or use for specified purposes.

**3.07** In the absence of donor-imposed restrictions, net assets should be classified as unrestricted. Paragraph 16 of FASB Statement No. 117 permits

---

[4] Assets other than cash may also be restricted by donors. For example, land could be restricted to use as a public park. Generally, however, restrictions apply to net assets, not to specific assets.

organizations to disclose self-imposed limitations on the use of unrestricted net assets (such as board-designated endowments) in the notes to the financial statements or on their face, provided that total unrestricted net assets are displayed. Contractual limitations on the use of particular assets (such as cash held on deposit as a compensating balance) should be disclosed either on the face of the statement of financial position or in the notes to the financial statements.

## Statement of Activities

**3.08** A statement of activities should focus on the organization as a whole and should report the amount of the change in net assets for the period, using a descriptive term such as *change in net assets* or *change in equity*. The statement should report the amounts of the changes in permanently restricted net assets, temporarily restricted net assets, unrestricted net assets, and total net assets. Revenues, expenses, and gains and losses should be classified by net asset class.[5] Events that simultaneously increase one net asset class and decrease another (reclassifications) should be reported as separate items. Classification of revenues, expenses, gains and losses, and reclassifications are discussed in greater detail in subsequent chapters of this guide.

**3.09** Paragraph 7 of FASB Statement No. 117 requires the display of an appropriately labeled subtotal within a statement of activities for the change in each class of net assets before the effects of extraordinary items, discontinued operations, or accounting changes.[6] (Paragraph 7 of FASB Statement No. 117 also notes that not-for-profit organizations should apply the appropriate disclosure and display requirements for, among other things, unusual and infrequently occurring events.)

**3.10** The determination of the net asset class in which revenues and gains and losses should be reported should be based solely on the presence or kind of donor-imposed restrictions. In the absence of such restrictions, revenues should be reported as increases in unrestricted net assets. All expenses should be reported as decreases in unrestricted net assets. Gains should be reported as increases and losses as decreases in unrestricted net assets unless their use is temporarily or permanently restricted by explicit donor stipulations or by law. Expirations of donor-imposed restrictions that simultaneously increase one net asset class and decrease another (reclassifications) should be reported as separate items.

**3.11** FASB Statement No. 117 does not specify the way that revenues, expenses, gains and losses, and reclassifications should be sequenced. Paragraph 158 of FASB Statement No. 117 suggests several ways that items constituting those elements could be sequenced: (*a*) revenues and gains, reclassifications, expenses, and losses; (*b*) revenues, expenses, gains, losses, and reclassifications; and (*c*) certain revenues, less directly related expenses, followed by a subtotal, then other revenues, other expenses, gains and losses, and reclassifications. Chapter 13, "Expenses, Gains, and Losses," of this guide, discusses alternative

---

[5] Paragraph 20 of Financial Accounting Standards Board (FASB) Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, requires expenses to be reported as decreases in unrestricted net assets.

[6] FASB Statement No. 154, *Accounting Changes and Error Corrections*, establishes standards for reporting accounting changes.

ways of reporting costs related to sales of goods and services and the direct costs of special events.

**3.12** An organization may, if it wishes, incorporate additional classifications within the statement of activities. For example, it may classify revenues and expenses within a class or classes of net assets as operating and nonoperating, expendable and nonexpendable, recurring and nonrecurring, or in other ways, such as by business segments.

**3.13** Accordingly, an intermediate measure of operations, such as an excess or deficit of operating revenues over expenses, may be reported in a statement of activities, as long as the use of the term *operations* is clear either from the details provided on the face of the statement or from a description contained in a note to the financial statements. If an intermediate measure of operations is reported, it must be in a financial statement that, at a minimum, reports the change in total unrestricted net assets for the period. Paragraphs 25 and 45 of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, and paragraph 18 of FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, place some limitations on an organization's use of an intermediate measure of operations. That measure must include (*a*) any impairment loss recognized for a long-lived asset (or asset group) to be held and used, (*b*) any gain or loss recognized on the sale of a long-lived asset (or disposal group) if that asset (or group) is not a component of the organization, and (*c*) costs associated with an exit or disposal activity that does not involve a discontinued operation.[7]

## Reporting Expenses

**3.14** To help users assess an organization's service efforts, including the costs of its services and how it uses resources, a statement of activities or the notes to the financial statements should report expenses by their functional classification, such as major programs and supporting activities. Voluntary health and welfare organizations[8] are required to report that information, together with information about expenses by their natural classification in a matrix format in a separate financial statement. A natural classification of expenses would include expense categories such as salaries, rent, electricity, interest expense, depreciation, awards and grants to others, and professional fees. To the extent that those expenses are reported by other than their natural classification (such as salaries included in cost of goods sold or facility rental costs of special events reported as direct benefits to donors), they should be reported by their natural classification if information about expenses by their natural classification is presented on the separate financial statement (matrix) containing natural classifications. For example, salaries, wages, and fringe benefits that are included as part of the cost of goods sold on the statement of activities should be included with other salaries, wages, and fringe benefits on the matrix containing natural classifications. FASB Statement No. 117 encourages,

---

[7] Paragraph 8.22 describes reporting investment return in a statement of activities that includes an intermediate measure of operations.

[8] *Voluntary health and welfare organizations* are defined in appendix D of FASB Statement No. 117. That definition includes a provision that "as a group, voluntary health and welfare organizations include those not-for-profit organizations that derive their revenue primarily from voluntary contributions from the general public..." For purposes of this guide, the *general public* excludes governmental entities.

but does not require, other not-for-profit organizations to provide information about expenses by their natural expense classification.

## Statement of Cash Flows

**3.15** FASB Statement No. 117 amends FASB Statement No. 95, *Statement of Cash Flows*, by extending its provisions to not-for-profit organizations. A statement of cash flows provides relevant information about an organization's cash receipts and cash payments during a period; the statement classifies those receipts and payments as resulting from investing, financing, or operating activities. Separate disclosure of noncash investing and financing activities (for example, receiving contributions of buildings, securities, or recognized collection items) is also required.

**3.16** Operating activities are defined in FASB Statement No. 95 as including "all transactions and other events that are not defined as investing or financing activities" (paragraph 21). Cash flows from operating activities are not limited to the cash effects of transactions and other events that are reported on an organization's statement of activities and would include, if applicable, agency transactions.

**3.17** FASB Statement No. 95 permits entities to use either the direct or the indirect method of reporting cash flows from operating activities. The direct method reports major classes of gross cash receipts and gross cash payments from operating activities to arrive at a subtotal of net cash provided by or used in operating activities (net cash flow from operating activities). The direct method also requires a reconciliation of the change in (total) net assets to the net cash flow from operating activities in a separate schedule. The indirect method starts with the change in (total) net assets for the period and reconciles that amount to a subtotal of net cash flow from operating activities.

**3.18** FASB Statement No. 117 expands the description of financing activities in FASB Statement No. 95 to encompass receipts of resources that are donor-restricted for long-term purposes. As discussed in paragraph 3.03 of this guide, cash that is received with donor-imposed restrictions limiting its use to long-term purposes should not be aggregated on a statement of financial position with cash that is available for current use. In order for the statement of cash flows to reconcile beginning and ending cash and cash equivalents, and to report in conformity with FASB Statement No. 95, as revised by FASB Statement No. 117, the receipt of a cash contribution that is restricted for the purchase of equipment should be reported as a cash flow from financing activities (using a caption such as "contributions restricted for purchasing equipment"), and it should be simultaneously reported as a cash outflow from investing activities (using a caption such as "purchase of assets restricted to investment in property and equipment" or, if the equipment was purchased in the same period, "purchase of equipment").[9] An adjustment to reconcile the change in net assets to net cash used or provided by operating activities would also be needed if the contributed asset is not classified as "cash or cash equivalents" on the statement of financial position. If the equipment is purchased in a subsequent period, both the proceeds from the sale of assets restricted to investment in the

---

[9] Paragraphs 3.03 and 3.19 of this guide discuss the classification on a statement of financial position of cash received with donor-imposed restrictions limiting its use to long-term purposes.

equipment and the purchase of the equipment should be reported as cash flows from investing activities.

**3.19** Not all assets of not-for-profit organizations that meet the definition of *cash equivalents* in FASB Statement No. 95 are cash equivalents for purposes of preparing statements of financial position and cash flows. As noted in paragraph 3.03, restrictions can prevent them from being included as cash equivalents even if they otherwise qualify. For example, short-term highly liquid investments are not cash equivalents if they are purchased with resources that have donor-imposed restrictions that limit their use to long-term investment. Further, paragraph 10 of FASB Statement No. 95 states that an organization can, by policy, exclude from cash equivalents items that meet the definition of "cash equivalents." For example, an organization may hold a portion of its endowment portfolio in cash or other instruments with maturities of less than three months and exclude the cash and other instruments from "cash and cash equivalents." Similarly, cash and investments of endowment funds held temporarily until suitable long-term investments are identified may be excluded from cash equivalents. Paragraph 10 of FASB Statement No. 95 requires organizations to disclose their policy for determining which items are treated as cash equivalents.

## Comparative Financial Information

**3.20** Not-for-profit organizations sometimes present comparative information for a prior year or years only in total rather than by net asset class. Such summarized information may not include sufficient detail to constitute a presentation in conformity with GAAP. If the prior year's financial information is summarized and does not include the minimum information required by FASB Statement No. 117 and this guide (for example, if the statement of activities does not present revenues, expenses, gains, and losses by net asset class), the nature of the prior year information should be described by the use of appropriate titles on the face of the financial statements and in a note to the financial statements.[10,11] The use of appropriate titles includes a phrase such as "with summarized financial information for the year ended June 30, 19PY," following the title of the statement or column headings that indicate the summarized nature of the information. Labeling the prior year summarized financial information "for comparative purposes only" without further disclosure in the notes to the financial statements would not constitute the use of an appropriate title.

**3.21** An example of a note to the financial statements[12] that describes the nature of the prior period(s) information would be as follows:

> The financial statements include certain prior year summarized comparative information in total but not by net asset class. Such information does not include sufficient detail to constitute a presentation in conformity with GAAP. Accordingly, such information should be read in conjunction with the organization's financial statements for the year ended June 30, 20PY, from which the summarized information was derived.

---

[10] Chapter 14, "Reports of Independent Auditors," of this guide, discusses auditors' reports on comparative financial information.

[11] Because the note discusses information that does not pertain to the current-period financial statements, the note is not considered to be part of the current-period financial statements.

[12] See footnote 11.

## Reporting of Related Entities and Collaborative Arrangements

**3.22** In September 1994, the AICPA issued Statement of Position (SOP) 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, which is included as appendix B [paragraph 8.36] to chapter 8, "Investments," of this guide. SOP 94-3 amends and makes uniform the previously existing guidance concerning reporting related entities.* Some of the conclusions in SOP 94-3 depend on whether the reporting not-for-profit organization has an economic interest in other organizations. The glossary of SOP 94-3 includes examples of economic interests. In addition to the examples included in the glossary, the following is an example of an economic interest:

> The reporting entity has a right to or a responsibility for the operating results of another entity. Or upon dissolution, the reporting entity is entitled to the net assets, or is responsible for any deficit, of another entity.

**3.23** FASB Emerging Issues Task Force (EITF) Issue No. 07-1, "Accounting for Collaborative Arrangements,"[13] provides display and disclosure guidance for a collaborative arrangement, which is defined in the consensus as a contractual arrangement that involves a joint operating activity that involves two (or more) parties who are both (*a*) active participants in the activity and (*b*) exposed to significant risks and rewards dependent on the commercial success of the activity and that does not involve the formation of a separate legal entity. The consensus includes indicators to help in applying that definition. Further, EITF Issue No. 07-1 states that the equity method of accounting should not be used for a collaborative arrangement. The guidance in the consensus does not apply to arrangements for which the accounting is specifically addressed within the scope of other authoritative accounting literature, such as appendix A to chapter 8 of this guide.

## The Use of Fair Value Measures

**3.24** The use of fair value measures is pervasive in the preparation of financial statements. Among other uses, fair value is used in the following items:

- Measurement of noncash contributions received (discussed in chapter 5 of this guide)
- Measurement of financial assets held as an agent (discussed in chapter 5 of this guide)

---

* On September 27, 2007, FASB issued an exposure draft, *Proposed FSP SOP 94-3-a and AAG-HCO-a, Omnibus Changes to Consolidation and Equity Method Guidance for Not-for-Profit Organizations*, which *would make* several changes to the guidance on consolidation and the equity method of accounting in SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations* (AICPA, *Technical Practice Aids*, ACC sec. 10,610). Readers should be alert to the issuance of a final standard.

[13] FASB Emerging Issues Task Force (EITF) Issue 07-1, "Accounting for Collaborative Arrangements," is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. The guidance should be applied retrospectively to all prior periods presented for all collaborative arrangements existing as of the effective date. EITF consensus opinions are category (c) generally accepted accounting principles (GAAP) as described in AU section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles (AICPA, *Professional Standards*, vol. 1). Including the EITF consensus opinion within this guide, which is category (b) GAAP, does not change its position in the GAAP hierarchy.

- Measurement of a beneficial interest in a trust (discussed in chapters 5 and 6 of this guide)
- Measurement of the contribution portion of a split-interest agreement (discussed in chapter 6 of this guide)
- Measurement of certain investments (discussed in chapter 8 of this guide)
- Measurement of derivative instruments (discussed in chapter 8 of this guide)
- Disclosures about the fair value of financial instruments (discussed in chapter 8 of this guide)
- Measurement of impairment losses for long-lived assets (discussed in chapter 9 of this guide)
- Measurement of asset retirement obligations (discussed in chapter 9 of this guide)
- Measurement of a guarantee obligation (discussed in chapter 10 of this guide)
- Measurement of exit and disposal costs (discussed in chapter 10 of this guide)
- Measurement of an underfunded or overfunded postretirement benefit plan (discussed in chapter 10 of this guide)
- Measurement of nonmonetary transactions in conformity with Accounting Principles Board (APB) Opinion No. 29, *Accounting for Nonmonetary Transactions*
- Measurement of transfers of financial assets in conformity with FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125*
- Measurement of a financial asset or financial liability for which an election is made pursuant to FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*, or FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115* (discussed in paragraphs 3.44–.46)

**3.25** FASB Statement No. 157, *Fair Value Measurements*, issued in September 2006, defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements.[†] The following

[†] FASB Statement No. 157, *Fair Value Measurements*, is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year. However, FSP FAS 157-2, *Effective Date of FASB Statement No. 157*, delays the effective date of FASB Statement No. 157 until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for fair value measurements of all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). However, an entity that has issued interim or annual financial statements reflecting the application of the measurement and disclosure provisions of FASB Statement No. 157 prior to the issuance of FSP FAS 157-2 must continue to apply all of the provisions of FASB Statement No. 157. Examples of items to which the deferral applies include, but are not

*(continued)*

paragraphs summarize FASB Statement No. 157, but are not intended as a substitute for the reading the statement itself.

## Definition of Fair Value

**3.26** Paragraph 5 of FASB Statement No. 157 defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." That definition retains the exchange price notion in earlier definitions of fair value, but clarifies that the exchange price is the price in a hypothetical transaction at the measurement date in the market in which the reporting entity would transact for the asset or liability. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. Paragraph 8 of FASB Statement No. 157 defines the principal market as the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability.

**3.27** Paragraph 12 of FASB Statement No. 157 provides that a fair value measurement of an asset assumes the highest and best use of the asset by market participants, considering the use of the asset that is physically possible, legally permissible, and financially feasible at the measurement date. Highest and best use is determined based on the use of the asset by market participants that would maximize the value of the asset or the group of assets within which the asset would be used, even if the intended use of the asset by the reporting entity is different.

**3.28** Paragraph 13 of FASB Statement No. 157 provides that the highest and best use for an asset is established by one of two valuation premises: value in-use or value in-exchange. The highest and best use of the asset is in-use if the asset would provide maximum value to market participants principally through its use in combination with other assets as a group (as installed or otherwise configured for use). For example, value in-use might be appropriate for certain nonfinancial assets. An asset's value in-use should be based on the price that would be received in a current transaction to sell the asset assuming that the asset would be used with other assets as a group and that those other assets would be available to market participants. The highest and best use of the asset is in-exchange if the asset would provide maximum value to market participants principally on a standalone basis. For example, value in-exchange might be

---

*(footnote continued)*

limited to: contributed nonfinancial assets and nonfinancial liabilities initially measured at fair value but not measured at fair value in subsequent periods, indefinite-lived intangible assets measured at fair value for impairment assessment, nonfinancial long-lived assets (asset groups) measured at fair value for an impairment assessment, asset retirement obligations initially measured at fair value, and nonfinancial liabilities for exit or disposal activities initially measured at fair value. Examples of items to which the deferral would not apply include, but are not limited to: real estate and other nonfinancial investments that are carried at fair value under one of the options in appendix A of chapter 8 of this guide, items within the scope of paragraph 7 of FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115* that are recognized or disclosed at fair value on a recurring basis; financial and nonfinancial derivatives within the scope of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*; items within the scope of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, whether recognized or not; certain servicing assets and servicing liabilities; and loans measured for impairment based on the fair value of collateral, even if the underlying collateral is nonfinancial.

appropriate for a financial asset. An asset's value in-exchange is determined based on the price that would be received in a current transaction to sell the asset standalone.

**3.29** Paragraph 15 of FASB Statement No. 157 provides that a fair value measurement for a liability reflects its nonperformance risk (the risk that the obligation will not be fulfilled). Because nonperformance risk includes the reporting entity's credit risk, the reporting entity should consider the effect of its credit risk (credit standing) on the fair value of the liability in all periods in which the liability is measured at fair value.

**3.30** Paragraph 7 of FASB Statement No. 157 provides that the hypothetical transaction to sell the asset or transfer the liability is considered from the perspective of a market participant that holds the asset or owes the liability. Therefore, the definition of fair value focuses on the price that would be received to sell the asset or paid to transfer the liability (an exit price), not the price that would be paid to acquire the asset or received to assume the liability (an entry price). Conceptually, entry prices and exit prices are different. However, paragraph 17 of FASB Statement No. 157 explains that, in many cases, at initial recognition a transaction price (entry price) will equal the exit price and, therefore, will represent the fair value of the asset or liability.

**3.31** Paragraph 9 of FASB Statement No. 157 provides that the price should not be adjusted for transaction costs. If location is an attribute of the asset or liability (as might be the case for a commodity), the price in the principal (or most advantageous) market used to measure the fair value of the asset or liability should be adjusted for the costs, if any, that would be incurred to transport the asset or liability to (or from) that market.

## Valuation Techniques

**3.32** Paragraphs 18–20 of FASB Statement No. 157 describe the valuation techniques that should be used to measure fair value. Valuation techniques consistent with the market approach, income approach or cost approach, or both, should be used to measure fair value, as follows:

- The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities. Valuation techniques consistent with the market approach include matrix pricing and often use market multiples derived from a set of comparables.
- The income approach uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts. Valuation techniques consistent with the income approach include present value techniques, option-pricing models, and the multiperiod excess earnings method.
- The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost). Fair value is determined based on the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence.

**3.33** Valuation techniques that are appropriate in the circumstances and for which sufficient data are available should be used to measure fair value.

In some cases, a single valuation technique will be appropriate (for example, when valuing an asset or liability using quoted prices in an active market for identical assets or liabilities). In other cases, multiple valuation techniques will be appropriate and the respective indications of fair value should be evaluated and weighted, as appropriate, considering the reasonableness of the range indicated by those results. Examples 4–5 of appendix A of FASB Statement No. 157 illustrate the use of multiple valuation techniques. A fair value measurement is the point within that range that is most representative of fair value in the circumstances.

**3.34** Valuation techniques used to measure fair value should be consistently applied. However, a change in a valuation technique or its application is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. Such a change would be accounted for as a change in accounting estimate in accordance with the provisions of FASB Statement No. 154, *Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3.*

### Present Value Techniques

**3.35** Appendix B of FASB Statement No. 157 provides guidance on present value techniques, thereby incorporating into level A GAAP certain guidance from FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, making certain revisions. Appendix B neither prescribes the use of one specific present value technique nor limits the use of present value techniques to the three techniques discussed therein. It says that a fair value measurement of an asset or liability using present value techniques should capture the following elements from the perspective of market participants as of the measurement date: an estimate of future cash flows, expectations about possible variations in the amount or timing (or both) of the cash flows, the time value of money, the price for bearing the uncertainty inherent in the cash flows (risk premium), other case-specific factors that would be considered by market participants, and in the case of a liability, the nonperformance risk relating to that liability, including the reporting entity's (obligor's) own credit risk.

**3.36** Paragraph B3 of FASB Statement No. 157 provides the general principles that govern any present value technique, as follows:

- Cash flows and discount rates should reflect assumptions that market participants would use in pricing the asset or liability.
- Cash flows and discount rates should consider only factors attributed to the asset (or liability) being measured.
- To avoid double counting or omitting the effects of risk factors, discount rates should reflect assumptions that are consistent with those inherent in the cash flows. For example, a discount rate that reflects expectations about future defaults is appropriate if using the contractual cash flows of a loan, but is not appropriate if the cash flows themselves are adjusted to reflect possible defaults.
- Assumptions about cash flows and discount rates should be internally consistent. For example, nominal cash flows (that include the effects of inflation) should be discounted at a rate that includes the effects of inflation.

- Discount rates should be consistent with the underlying economic factors of the currency in which the cash flows are denominated.

**3.37** Present value techniques differ in how they adjust for risk and in the type of cash flows they use. For example, the discount rate adjustment technique (also called the traditional present value technique) uses a risk-adjusted discount rate and contractual, promised, or most likely cash flows. In contrast, expected present value techniques use the probability-weighted average of all possible cash flows (referred to as expected cash flows). The traditional present value technique and two methods of expected present value techniques are discussed more fully in the appendix B of FASB Statement No. 157.

**3.38** This guide includes guidance about measuring assets (promises to give and beneficial interests in trusts) and liabilities (split-interest obligations) using traditional present value techniques. That guidance is not intended to suggest that the income approach is the only one of the three approaches that is appropriate in the circumstances, nor is it intended to suggest that the traditional present value technique described in the guide is preferred over other present value techniques. Rather, the inclusion of that guidance in the guide merely reflects that prior to the issuance of FASB Statement No. 157, present value techniques were specifically mentioned in FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, and FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, as appropriate for measuring promises to give cash and beneficial interests in trusts, and the guide had been drafted reflecting those standards. In conforming this guide to the standards of FASB Statement No. 157, guidance that previously specified the use of the traditional present value technique was modified to indicate that the technique was a possible technique to consider for fair value measurement. Further, because FASB Statement No. 157 uses the phrase *expected cash flows* in its description of the probability-weighted present value techniques and many standards previously used the phrase *estimated cash flows* when describing the traditional present value technique, the phrases *estimated cash flows*, *expected cash flows*, and *estimated expected cash flows*, which had been used in the guide, were all changed to the phrase *future cash flows* so as not to suggest a particular present value technique.

## The Fair Value Hierarchy

**3.39** FASB Statement No. 157 emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability (referred to in the statement as inputs). Paragraphs 21–31 of FASB Statement No. 157 establish a fair value hierarchy that distinguishes between (1) market participant assumptions developed based on market data obtained from sources independent of the reporting entity (observable inputs) and (2) the reporting entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). Valuation techniques used to measure fair value should maximize the use of observable inputs and minimize the use of unobservable inputs.

**3.40** The fair value hierarchy in FASB Statement No. 157 prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The three levels are:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. An active market is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. A quoted price in an active market provides the most reliable evidence of fair value and should be used to measure fair value whenever available, except as discussed in paragraphs 25–26 of FAS 157.
- Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Adjustments to Level 2 inputs will vary depending on factors specific to the asset or liability. An adjustment that is significant to the fair value measurement in its entirety might render the measurement a Level 3 measurement, depending on the level in the fair value hierarchy within which the inputs used to determine the adjustment fall. Level 2 inputs include the following:

  *a.* Quoted prices for similar assets or liabilities in active markets

  *b.* Quoted prices for identical or similar assets or liabilities in markets that are not active

  *c.* Inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates)

  *d.* Inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs)

- Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs should be used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. Unobservable inputs should reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk). The reporting entity should not ignore information about market participant assumptions that is reasonably available without undue cost and effort.

In some cases, the inputs used to measure fair value might fall in different levels of the fair value hierarchy. The level in the fair value hierarchy within which the fair value measurement in its entirety falls should be determined based on the lowest level input that is significant to the fair value measurement in its entirety.

**3.41** As discussed in paragraph 23 of FASB Statement No. 157, the availability of inputs relevant to the asset or liability and the relative reliability of

the inputs might affect the selection of appropriate valuation techniques. However, the fair value hierarchy prioritizes the inputs to valuation techniques, not the valuation techniques. For example, a fair value measurement using a present value technique might fall within Level 2 or Level 3, depending on the inputs that are significant to the measurement in its entirety and the level in the fair value hierarchy within which those inputs fall.

**3.42** Market participant assumptions should include assumptions about the effect of a restriction on the sale or use of an asset if market participants would consider the effect of the restriction in pricing the asset. Examples 8–9 (paragraphs A29–A30) of Statement No. 157 explain that restrictions that are an attribute of an asset, and, therefore, would transfer to a market participant, are the only restrictions reflected in fair value. Donor restrictions that are specific to the donee are reflected in the classification of net assets, not in the measurement of fair value.

## Disclosures

**3.43** Paragraphs 32–35 of FASB Statement No. 157 expand the disclosures required for assets and liabilities measured at fair value. For assets and liabilities that are measured at fair value on a recurring basis in periods subsequent to initial recognition or that are measured on a nonrecurring basis in periods subsequent to initial recognition, the statement requires the reporting entity to disclose certain information that enables users of its financial statements to assess the inputs used to develop those measurements. For recurring fair value measurements using significant unobservable inputs (Level 3), the reporting entity is required to disclose certain information to help users assess the effect of the measurements on earnings (or changes in net assets) for the period.

## Fair Value Option

**3.44** FASB Statement No. 159 creates a fair value option under which an organization may irrevocably elect fair value as the initial and subsequent measure for many financial instruments and certain other items, with changes in fair value recognized in the statement of activities as those changes occur.[‡] FASB Statement No. 155 similarly permits an elective fair value remeasurement for any hybrid financial instrument that contains an embedded derivative, if that embedded derivative would otherwise have to be separated from its debt host in conformity with FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. An election is made on a instrument-by-instrument basis (with certain exceptions), generally when an instrument is initially recognized in the financial statements.

**3.45** Most financial assets and financial liabilities are eligible to be recognized using the fair value option, as are firm commitments for financial instruments and certain nonfinancial contracts. Specifically excluded from eligibility are investments in other entities that are required to be consolidated, employer's and plan's obligations under postemployment, postretirement plans, and deferred compensation arrangements (or assets representing overfunded positions in those plans), financial assets and liabilities recognized under leases, deposit liabilities of depository institutions, and financial instruments that are,

---

[‡] FASB Statement No. 159 is effective as of the beginning of the first fiscal year that begins after November 15, 2007. Earlier adoption is permitted if certain conditions described in paragraph 30 of the statement are met.

in whole or in part, classified by the issuer as a component of shareholder's equity. Additionally, the election cannot be made for most nonfinancial assets and liabilities or for current or deferred income taxes.

**3.46** FASB Statement No. 159 also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. Organizations should report assets and liabilities that are measured using the fair value option in a manner that separates those reported fair values from the carrying amounts of similar assets and liabilities measured using another measurement attribute. To accomplish that, an organization should either (*a*) report the aggregate carrying amount for both fair value and nonfair value items on a single line, with the fair value amount parenthetically disclosed or (*b*) present separate lines for the fair value carrying amounts and the nonfair value carrying amounts.

## Financial Statement Disclosures Not Considered Elsewhere

**3.47** Financial statement disclosures are generally discussed in this guide in connection with the specific financial statement items to which they pertain. This section discusses disclosures that are unique to not-for-profit organizations and that are not discussed elsewhere in this guide.

### Noncompliance With Donor-Imposed Restrictions[14]

**3.48** A not-for-profit organization may not be in compliance with donor-imposed restrictions, including requirements that it maintain an appropriate composition of assets (usually cash and marketable securities in amounts needed to comply with all donor restrictions). Such noncompliance could result in a material contingent liability, result in a material loss of future revenue, or cause the organization to be unable to continue as a going concern.

**3.49** FASB Statement No. 5, *Accounting for Contingencies*, provides guidance for accruing and disclosing contingent liabilities. AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1), addresses disclosure of illegal acts that could lead to a material loss of revenue. AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1), contains broad guidance on disclosures when there is a substantial doubt about an entity's ability to continue as a going concern.

**3.50** Noncompliance with donor-imposed restrictions should be disclosed if there is a reasonable possibility that a material contingent liability has been incurred at the date of the financial statements or there is at least a reasonable possibility that the noncompliance could lead to a material loss of revenue or

---

[14] As discussed in chapter 11, "Net Assets," of this guide, and throughout other sections of this guide, not-for-profit organizations should report amounts for each of three classes of net assets. Noncompliance with donor-imposed restrictions may result in net assets being reported other than in accordance with donor-imposed restrictions. For example, net assets would be reported other than in accordance with donor-imposed restrictions if restricted net assets were reported as unrestricted net assets. If net assets are reported other than in accordance with donor-imposed restrictions, the financial statements are not presented in conformity with GAAP.

could cause an entity to be unable to continue as a going concern.[15] If the noncompliance results from an organization's failure to maintain an appropriate composition of assets in amounts needed to comply with all donor restrictions, the amounts and circumstances should be disclosed.

## Risks and Uncertainties

**3.51** SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (AICPA, *Technical Practice Aids*, ACC sec. 10,640), requires entities to include in their financial statements information about the following:

- The nature of their operations
- Use of estimates in the preparation of financial statements

In addition, if specified disclosure criteria are met, it requires entities to include in their financial statements disclosures about the following:

- Certain significant estimates
- Current vulnerability due to certain concentrations

The SOP includes examples of disclosures that may be pertinent for not-for-profit organizations.

[15] As discussed in paragraph 10.14, noncompliance with donor-imposed restrictions may require accrual of a liability in conformity with FASB Statement No. 5, *Accounting for Contingencies*.

# Chapter 4

# *Cash and Cash Equivalents*

## Introduction

**4.01** Like for-profit enterprises, not-for-profit organizations (NPOs) hold cash balances to meet payments arising in the ordinary course of operations and payments for unanticipated contingencies. These balances may be held as cash or cash equivalents.

**4.02** Cash includes currency on hand and deposits held by financial institutions that can be added to or withdrawn without limitation, such as demand deposits. Paragraph 8 of Financial Accounting Standards Board (FASB) Statement No. 95, *Statement of Cash Flows*, defines *cash equivalents* as "short-term, highly liquid investments that are both (*a*) readily convertible to known amounts of cash [and] (*b*) so near their maturity that they present insignificant risk of changes in value because of changes in interest rates."[1] NPOs may invest excess cash in cash equivalents (such as treasury bills, commercial paper, and money-market mutual funds) to earn greater returns.

## Financial Statement Presentation

**4.03** A statement of financial position should include a separate line item for "Cash" or "Cash and Cash Equivalents." As noted in paragraph 3.03, cash and cash equivalents received with donor-imposed stipulations restricting the use of the cash contributed to long-term purposes and cash set aside for long-term purposes should not be classified on a statement of financial position with assets that are available for current use.[2]

**4.04** Some limitations may exist on an organization's ability to withdraw or use cash and cash equivalents. These limitations may be imposed by (*a*) creditors and other outside parties (such as limitations on cash held by financial institutions to meet compensating balance requirements, cash and cash equivalents held as collateral on debt obligations, cash received as collateral on loaned securities, and cash held for students, clients, and others under agency agreements); (*b*) donors, who place permanent or temporary restrictions on their cash contributions (such as restricting the contributions to investments in buildings or requiring that the principal be maintained permanently or for a specified

---

[1] Paragraph 8 of FASB Statement No. 95, *Statement of Cash Flows*, indicates that, "generally, only investments with original maturities [footnote reference omitted] of three months or less qualify under that definition."

[2] As noted in paragraph 3.04 of this Audit and Accounting Guide (guide), paragraph 12 of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, requires not-for-profit organizations (NPOs) to do one or more of the following: (*a*) sequence assets based on their nearness to cash, (*b*) classify assets as current and noncurrent, or (*c*) include relevant information about assets' liquidity, including restrictions on the use of particular assets, in notes to the financial statements. Paragraph 156 of Statement No. 117 illustrates this requirement: cash and cash equivalents restricted by donors to investment in fixed assets are not included as "cash or cash equivalents" but as "assets restricted to investment in land, buildings, and equipment"; cash and cash equivalents contributed by donors with stipulations that the contributed assets be invested permanently are reported as "long-term investments."

time period); or (*c*) governing boards, which may designate cash for investment purposes (traditionally known as "funds functioning as endowment" or "quasi endowment").

**4.05** Relevant information about the nature and amount of limitations on the use of cash and cash equivalents should be included on the face of the financial statements or in the notes. Information about the nature and amount of donor-imposed restrictions should also be disclosed in the net asset section of the statement of financial position or in the notes to the financial statements.[3] (Chapter 11, "Net Assets," of this guide discusses accounting for net assets.) Disclosure in the notes to the financial statements should also be made if unusual circumstances (such as special borrowing arrangements, requirements imposed by resource providers that cash be held in separate accounts, and known significant liquidity problems) are present, or if the organization has not maintained appropriate amounts of cash and cash equivalents to comply with donor-imposed restrictions.[4]

---

[3] Paragraph 94 of FASB Statement No. 117 also permits NPOs to disaggregate assets into unrestricted and donor-restricted classes when there are donor restrictions on the use of specific donated assets.

[4] Paragraphs 3.25–.27 of this guide discuss reporting requirements when the organization is not in compliance with donor-imposed restrictions.

# Chapter 5

# *Contributions Received and Agency Transactions*

## Introduction

**5.01** Some not-for-profit organizations receive contributions of cash, other assets, and services from individuals, for-profit organizations, other not-for-profit organizations, and governments. Paragraph 5 of Financial Accounting Standards Board (FASB) Statement No. 116, *Accounting for Contributions Received and Contributions Made*, defines a contribution as

> an unconditional transfer of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner. Other assets include securities, land, buildings, use of facilities or utilities, material and supplies, intangible assets, services, and unconditional promises to give those items in the future.

**5.02** Some inflows of assets are not included in the definition of contributions, as follows:

- Transfers that are exchange transactions, in which both parties receive goods or services of commensurate value
- Transfers in which the organization is acting as an agent, trustee, or intermediary for the donor (that is, the organization has little or no discretion concerning the use of the assets transferred)
- Tax exemptions, tax incentives, and tax abatements

This chapter provides guidance for distinguishing contributions from other kinds of transactions. It also discusses recognition, measurement, and disclosure principles for contribution revenues[1] and related receivables.[2] Chapter 12 of this guide discusses accounting principles for revenues, gains, and receivables from providing services and from other exchange transactions. Chapter 13,

---

[1] The classification of contributions received as revenues or gains depends on whether the transactions are part of the organization's ongoing major or central activities, or are peripheral or incidental to the organization. For purposes of this chapter, the term *contribution revenue* is used to apply to either situation. Chapter 12, "Revenues and Receivables From Exchange Transactions," of this Audit and Accounting Guide (guide), discusses the distinction between ongoing major activities and peripheral or incidental transactions and events.

[2] Unconditional promises to give cash or other financial instruments, such as an ownership interest in an entity, are financial instruments as defined in Financial Accounting Standards Board (FASB) Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and thus requirements for recognition and disclosure of financial instruments apply. For example, disclosures about fair value required by FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, as amended, apply unless the conditions described in FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities—an amendment to FASB Statement No. 107*, are met and the disclosures about measurement attributes used by the organization that are required by FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*, apply if the organization has elected the fair value option for unconditional promises to give cash or certain other financial instruments. FASB Statement No. 159 is effective as of the beginning of the first fiscal year that begins after November 15, 2007. Earlier adoption is permitted if certain conditions described in paragraph 30 of the statement are met.

"Expenses, Gains, and Losses," of this guide, discusses reporting contributions made by not-for-profit organizations.

## Distinguishing Contributions From Other Transactions[3]

**5.03** Contributions are transactions in which one entity, acting other than as an owner, makes an unconditional voluntary transfer to another entity without directly receiving equal value in exchange. Some resource providers may be required to transfer assets or provide services to not-for-profit organizations involuntarily; for example, to settle legal disputes or to pay fines. Those transactions are not contributions. Accounting for contributions is different from accounting for other kinds of voluntary transfers, such as conditional transfers, agency transactions, and exchange transactions. Accounting for transfers with donor-imposed conditions is discussed in paragraphs 5.32–.37 of this guide.

**5.04** To determine the accounting for transactions in which an entity voluntarily transfers assets to a not-for-profit organization, it is first necessary to assess the extent of discretion the not-for-profit organization has over the use of the assets that are received. If it has little or no discretion, the transaction is an agency transaction. If it has discretion over the assets' use, the transaction is a contribution, an exchange, or a combination of the two.

### Agency Transactions

**5.05** Some not-for-profit organizations act as agents, trustees, or intermediaries helping donors to make a contribution to another entity or individual. When acting in that capacity, those not-for-profit organizations do not receive a contribution when they receive the assets, nor do they make a contribution when they disburse the assets to the other entity or individual. Instead, they act as go-betweens, passing the assets from the donor through their organization to the specified entity or individual. Federated fund-raising organizations, community foundations, and institutionally related organizations are examples of not-for-profit organizations that commonly serve as agents, trustees, or intermediaries, but any organization can function in those capacities.

**5.06** FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, clarifies paragraphs 52–54 of FASB Statement No. 116, which noted that not-for-profit organizations act as agents, trustees, or intermediaries (rather than donees) if they have little or no discretion in determining the use of assets transferred to them. FASB Statement No. 136 establishes standards for transactions in which a donor makes a contribution by transferring assets to a recipient organization (a not-for-profit organization or a charitable trust) that accepts the assets from the donor and agrees to use the assets on behalf of the donor or transfers the assets, their investment return, or both to another entity—the beneficiary—named by the donor. (This guide collectively refers to those transactions as agency transactions.) FASB Statement No. 136 also establishes standards for transactions that take place in a similar manner but are

---

[3] Federal rules specify the classification of certain transactions for purposes other than reporting in conformity with generally accepted accounting principles (GAAP), such as contractual reporting requirements. For example, certain transactions should be classified as federal awards received and expended by not-for-profit organizations. The guidance in this guide pertains to financial reporting in conformity with GAAP. Classifications in conformity with GAAP may differ from classifications in accordance with federal rules.

not contributions because the transfers are revocable, repayable, or reciprocal. (Paragraphs 5.18–.21 discuss those standards.) FASB Statement No. 136 does not set standards for recipient organizations that are trustees.[4]

**5.07** In general, if a donor specifies a beneficiary, the recipient organization should not recognize a contribution. (For exceptions, see the discussion of variance power at paragraphs 5.13–.14 and financially interrelated organizations at paragraphs 5.15–.17.) Paragraph 68 of FASB Statement No. 136 states that a donor may specify the beneficiary (*a*) by name, (*b*) by stating that all entities that meet a set of donor-defined criteria are beneficiaries, or (*c*) by actions surrounding the transfer that made clear the identity of the beneficiary. (Paragraphs 69–72 and appendix A of FASB Statement No. 136 provide examples of donor stipulations and discuss whether those stipulations specify a beneficiary.)

**5.08** The following are three examples of circumstances in which donors specify a beneficiary and the recipient organization should not recognize a contribution. (For exceptions, see the discussion of variance power at paragraphs 5.13–.14 and financially interrelated organizations at paragraphs 5.15–.17.) If a donor selects a beneficiary from among a list of potential beneficiaries that have been prequalified or otherwise identified by the recipient not-for-profit organization, the assets received are not contributions to that recipient organization. Similarly, if a grantor specifies eligibility criteria and states that the grant proceeds must be transferred to all who meet those criteria, the recipient not-for-profit organization has not received a contribution even though it may be responsible for determining whether individuals or entities meet those grantor-specified eligibility criteria. Likewise, if a donor responds to a campaign request from an organization that indicates that the proceeds of the campaign will be distributed to a named beneficiary, that recipient organization has not received a contribution.

**5.09** In contrast, if neither the language used by the donor, the representations of the recipient organization, nor the actions surrounding the transfers cause the donor to believe that he or she is directing the gift to a specified beneficiary, then the not-for-profit organization is a donee and should recognize a contribution received. For example, an organization is a donee and should recognize a contribution if it asks the donor to select one or more fields of interest from among a list of community needs prepared by the not-for-profit organization. Similarly, if a donor uses broad generalizations to describe the beneficiaries, such as homeless individuals, the not-for-profit organization has received a contribution because the choice of the beneficiary is within its control. Likewise, if an organization asks its donors to indicate an organization for consideration by its allocation committee, the not-for-profit organization is the donee if that request is conveyed in a manner that leads the donor to conclude that its role is merely to propose possible allocations.

**5.10** The representations made to the donor during the solicitation of a gift are important in determining whether a transaction is an agency transaction. If an organization creates a donor's reasonable expectation that a contribution will be transferred to a beneficiary specified by the donor, the not-for-profit organization is an agent or intermediary. Unless the organization has variance

---

[4] Chapter 6, "Split-Interest Agreements," of this guide, discusses split-interest and similar agreements in which organizations act as trustee for a resource provider and have a beneficial interest in the assets transferred.

power or is financially interrelated to the specified beneficiary, it should not recognize a contribution received even if it has discretion over the timing of the distribution to the specified beneficiary. The ability to choose a payment date does not relieve an entity from its obligation to pay.

**5.11** Cash or other financial assets received in transactions in which a not-for-profit organization is acting as an agent, trustee, or intermediary for a resource provider should be reported as increases in assets and liabilities; distributions to the specified third-party beneficiaries should be reported as decreases in those accounts. As discussed in paragraph 11 of FASB Statement No. 136, both the asset and the liability should be measured at the fair value of the assets received. If the assets received from the donor are donated materials, supplies, or other nonfinancial assets, the recipient organization may choose either to (*a*) report the receipt of the assets as a liability to the beneficiary concurrent with recognition of the assets received or (*b*) not report the transaction at all. The choice is an accounting policy that should be applied consistently from period to period. An organization should consider the need for disclosure in the notes to the financial statements pursuant to Accounting Principles Board (APB) Opinion No. 22, *Disclosure of Accounting Policies*, and FASB Statement No. 136 paragraph 11. Cash received and paid in such transactions should be reported as cash flows from operating activities in a statement of cash flows. If the statement of cash flows is presented using the indirect method, cash received and paid in such transactions is permitted to be reported either gross or net. Additional information about such transactions may be required to be disclosed under FASB Statement No. 57, *Related Party Disclosures*.

**5.12** In general, a specified beneficiary recognizes its rights to the assets held by a recipient organization as either a beneficial interest (an asset) or a receivable. (Paragraphs 5.13–.14 discuss exceptions pertaining to variance power, and paragraphs 5.15–.17 discuss exceptions pertaining to financially interrelated organizations.) (See paragraphs 12 and 15 of FASB Statement No. 136.) If the beneficiary has an unconditional right to receive all or a portion of the specified cash flows from a charitable trust or other identifiable pool of assets, the beneficiary has a beneficial interest. The beneficiary recognizes that beneficial interest as an asset and a contribution received, measuring and subsequently remeasuring it at fair value. (Although FASB Statement No. 136 does not establish standards for the trustee, it does establish standards for the beneficiaries' rights to trust assets.) Present value techniques are one valuation technique for measuring the fair value of the contribution and the beneficial interest; other valuation techniques also are available, as described in FASB Statement No. 157, *Fair Value Measurements*.[5] If present value techniques

---

[5] This guide discusses present value techniques as one possible valuation technique to measure the asset and contribution revenue for beneficial interests in trusts and unconditional promises to give. Paragraphs 3.24–.43 of this guide discuss FASB Statement No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. Appendix B of FASB Statement No. 157 provides standards for using present value techniques when the measurement objective is fair value. FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year or its interim periods. However, FASB Staff Position (FSP) FAS 157-2, *Effective Date of FASB Statement No. 157*, delays the effective date of FASB Statement No. 157 until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for fair value measurements of all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). See footnote † to paragraph 3.25 for more information about the types of assets and liabilities to which the deferral applies.

are used, the contribution revenue and the beneficial interest in trust should be measured as the present value of the future cash inflows over the expected term of the agreement. If the beneficiary has unconditional rights to receive the value of the transferred assets at a future date, the beneficiary has a receivable that should be recognized in accordance with the provisions of FASB Statement No. 116 for unconditional promises to give. (Paragraphs 5.47–.51 and 5.63–.66 discuss recognition of promises to give.) The choice of accounting policies regarding recognition of nonfinancial assets, as discussed in paragraph 5.11, applies only to the agent or intermediary; beneficiaries should recognize their rights to nonfinancial assets held by the recipient organization.

## Variance Power

**5.13** Variance power is the *unilateral power* to redirect the use of the transferred assets to an entity or individual other than the specified beneficiary or beneficiaries. If a *donor explicitly* grants a recipient organization variance power and names an *unaffiliated* beneficiary, the recipient organization is a donee and recognizes contribution revenue. *Explicitly grants* means that the donor should explicitly refer to the recipient organization's ability to exercise variance power in the instrument that transfers the assets. *Unaffiliated* means that the beneficiary is other than the donor or the donor's affiliate as defined in FASB Statement No. 57. *Unilateral power* means that the recipient organization can override the donor's instructions without approval from the donor, the beneficiary, or any other interested party. (See paragraph 12 of FASB Statement No. 136.) Variance power provides the recipient organization with discretion sufficient to recognize a contribution received despite the specification of a beneficiary by the donor. As discussed in paragraph 16 of FASB Statement No. 136, if the recipient organization is explicitly granted variance power, the specified unaffiliated beneficiary should not recognize its potential for future distributions from the assets held by the recipient organization. Those distributions, if they occur, should be recognized as contributions by the specified beneficiary when received or unconditionally promised.

**5.14** A recipient organization that receives variance power should not report a contribution if the resource provider specifies itself or its affiliates as the beneficiary of the transferred assets. Because of their reciprocal nature, those transfers are not contributions received by the recipient organization—even if the resource provider granted the recipient organization variance power at the time of the transfer. (See paragraphs 4 and 17 of FASB Statement No. 136.) (Paragraphs 5.20 and 5.21 discuss transactions in which a resource provider names itself or its affiliate as beneficiary of a transfer of assets to a recipient organization.)

## Financially Interrelated Organizations

**5.15** Paragraph 13 of FASB Statement No. 136 provides that organizations are financially interrelated if the relationship between them has both of the following characteristics: (*a*) one organization has the ability to influence the operating and financial decisions of the other and (*b*) one organization has an ongoing economic interest in the net assets of the other. (Paragraph 5.16 of this guide discusses financially interrelated organizations further.) If a recipient organization and a specified beneficiary are financially interrelated organizations, and the recipient organization is not a trustee, the recipient organization

should recognize the fair value of any assets it receives as a contribution received, rather than as a liability to the beneficiary. For example, a foundation that exists to raise, hold, and invest assets for the specified beneficiary or for a group of affiliates of which the specified beneficiary is a member generally is financially interrelated with the organization or organizations it supports. The foundation should recognize contribution revenue when it receives assets from the donor. (See paragraph 14 of FASB Statement No. 136.) The specified beneficiary should recognize its interest in the net assets of the recipient organization and adjust that interest for its share of the change in net assets of the recipient organization using a method similar to the equity method of accounting for investments in common stock.[6]

**5.16** The ability to influence the operating and financial decisions of the other may be demonstrated in several ways:

*a.* The organizations are affiliates as defined in FASB Statement No. 57,

*b.* One organization has considerable representation on the governing board of the other organization,

*c.* The charter or bylaws of one organization limit its activities to those that are beneficial to the other organization, or

*d.* An agreement between the organizations allows one organization to actively participate in the policymaking processes of the other, such as setting organizational priorities, budgets, and management compensation.

An ongoing economic interest in the net assets of another is a residual right to the other organization's net assets that results from an ongoing relationship. The value of those rights increases or decreases as a result of the investment, fundraising, operating, and other activities of the other organization.

**5.17** Paragraph 104 of FASB Statement No. 136 notes that although most of the relationships described in the definition of economic interest in the glossary of Statement of Position (SOP) 94-3, *Reporting of Related Entities by Not-for-Profit Organizations* (AICPA, *Technical Practice Aids*, ACC sec. 10,610) (paragraph 8.36 of this guide), are potentially ongoing economic interests in the net assets of the other, some are not. Only economic interests that are both ongoing and residual interests in the net assets meet the criterion of paragraph 13(b) of FASB Statement No. 136.

## Similar Transactions That Are Revocable, Repayable or Reciprocal

**5.18** In addition to establishing standards for contributions transferred to beneficiaries via agents, trustees, and intermediaries, FASB Statement No. 136 sets standards for transactions that take place in a similar manner

---

[6] That interest would be eliminated if the beneficiary and the recipient organization were included in consolidated financial statements.

(that is, there is a resource provider, a recipient organization, and a specified beneficiary) but that are not contributions because the terms of the transfer or the relationships between the parties make the transfer revocable, repayable, or reciprocal.

**5.19** Paragraph 17 of FASB Statement No. 136 describes four types of transfers that are not contributions to either the recipient organization or the specified beneficiary. The first three types are:

*a.* The transfer is subject to the resource provider's unilateral right to redirect the use of the transferred assets to another beneficiary

*b.* The transfer is accompanied by the resource provider's conditional promise to give or is otherwise revocable or repayable

*c.* The resource provider controls[7] the recipient organization and specifies an unaffiliated beneficiary

Those transfers are refundable advances and should be reported as a liability of the recipient organization and as an asset of the resource provider until the transferred assets are beyond the control of the resource provider. (See paragraph 92 of FASB Statement No. 136.)

**5.20** The fourth type of transfer described in paragraph 17 of FASB Statement No. 136 is one in which a resource provider specifies itself or its affiliate as beneficiary of a transfer of assets to a recipient organization. Those transfers are reciprocal and thus are not contributions. Examples of those types of transfers are (*a*) a not-for-profit organization transfers assets to a community foundation to establish an endowment for the benefit of the not-for-profit organization and (*b*) a not-for-profit organization transfers assets to a foundation it creates to hold those assets. Paragraphs 17 and 18 of FASB Statement No. 136 describe two types of reciprocal transactions, which are:

*a.* An equity transaction—The resource provider specifies itself or its affiliate as the beneficiary, the resource provider and the recipient organization are financially interrelated organizations (paragraphs 5.15–.17 of this guide discusses financially interrelated organizations), and neither the resource provider nor its affiliate expects payment of the transferred assets, although payment of investment return on the transferred assets may be expected. (All three of these criteria must be met.)

*b.* The resource provider specifies itself or its affiliate as the beneficiary and the transfer is not an equity transaction. (The three criteria in paragraph (*a* above) are not met.)

---

[7] Paragraph 93 of FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, notes that several definitions of *control* exist. Paragraph 24 (b) of FASB Statement No. 57, *Related Party Disclosures*, defines control as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an enterprise through ownership, by contract, or otherwise." The glossary of Statement of Position (SOP) 94-3, *Reporting of Related Entities by Not-for-Profit Organizations* (AICPA, *Technical Practice Aids*, ACC sec. 10,610), defines control as, "the direct or indirect ability to determine the direction of management and policies through ownership, contract, or otherwise." Those definitions of *control* should be considered when determining whether one entity controls another in applying the guidance in FASB Statement No. 136.

**5.21** If the transaction is an equity transaction, the reporting depends upon whether the resource provider or its affiliate is the specified beneficiary. If the resource provider specifies itself as the beneficiary, the resource provider reports an asset—interest in the net assets of the recipient organization (or an increase in a previously recognized interest),[8] and the recipient organization reports an equity transaction as a separate line in its statement of activities. If the resource provider specifies its affiliate as the beneficiary, the resource provider and the recipient organization report an equity transaction as separate lines in their statements of activities, and the affiliate named as beneficiary reports an interest in the net assets of the recipient organization.[9] If the transfer in which the resource provider specifies itself or its affiliate as the beneficiary is not an equity transaction, the recipient organization reports a liability and the resource provider reports an asset.

## Exchange Transactions[10]

**5.22** Exchange transactions are reciprocal transfers in which each party receives and sacrifices something of approximately equal value. In some situations, exchange transactions can be easily distinguished from contributions. For example, purchases of assets or payments of employees' salaries clearly are exchange transactions: each party gives up and receives equivalent economic value. In contrast, an example of a contribution is a donation to a not-for-profit organization's mass fund-raising appeal: donors are providing resources in support of the organization's mission and expect to receive nothing of direct value in exchange.

**5.23** The cost of premiums (such as postcards or calendars) given to potential donors as part of mass fund-raising appeals is a fund-raising expense, and the classification of the donations received from the appeal as contributions is unaffected by the fact that premiums were given to potential donors. The premiums are not provided to potential donors in exchange for the assets contributed; they can be kept by all those from whom funds are solicited, regardless of whether a contribution is made.

**5.24** The cost of premiums (such as coffee mugs) that are given to resource providers to acknowledge receipt of a contribution and that are nominal in value compared with the value of the goods or services donated by the resource provider should also be reported as fund-raising expenses.[11] For example, a not-for-profit organization may provide a coffee mug to people making a contribution of $50 or more; the mug costs the organization $1. The organization should recognize contributions for the total amount contributed and fund-raising expense of $1 for each mug provided to donors.

---

[8] That interest would be eliminated if the beneficiary (resource provider) and the recipient organization were included in consolidated financial statements.

[9] That interest would be eliminated if the beneficiary (affiliate) and the recipient organization were included in consolidated financial statements.

[10] Certain reciprocal transactions for which FASB Statement No. 136 provides guidance are discussed in paragraphs 5.14 and 5.18–.21.

[11] Donors may receive premiums that are greater than nominal in value in connection with some transactions. Such transactions should be reported as part exchange transaction and part contribution. The cost of premiums that are greater than nominal in value should be reported as cost of sales. Chapter 12 of this guide provides guidance concerning reporting exchange transactions.

**5.25** Classifying asset transfers as exchange transactions or as contributions may require the exercise of judgment concerning whether a reciprocal transaction has occurred, that is, whether a recipient not-for-profit organization has given up assets, rights, or privileges approximately equal to the value of the assets, rights, or privileges received. Value should be assessed from both the recipient's and the resource provider's points of view and can be affected by a wide variety of factors; for example, resource providers can retain the right to share in the use of or income from an asset provided to the not-for-profit organization.

**5.26** Table 5-1 contains a list of indicators that may be helpful in determining whether individual asset transfers are contributions, exchange transactions, or a combination of both. Depending on the facts and circumstances, some indicators may be more significant than others; however, no single indicator is determinative of the classification of a particular transaction. Several kinds of voluntary asset transfers that may be difficult to classify are discussed in the following four paragraphs.

**5.27** Some not-for-profit organizations receive dues from their members. These transfers often have elements of both a contribution and an exchange transaction because members receive tangible or intangible benefits from their membership in the organization. For example, if an organization has annual dues of $100 and the only benefit members receive is a monthly newsletter with a fair value of $25, $25 of the dues are received in an exchange transaction and should be recognized as revenue as the earnings process is completed and $75 of the dues are a contribution. It may be difficult, however, to measure the benefits members receive and to determine whether the value of those benefits is approximately equal to the dues paid by the members. Table 5-2 contains a list of indicators that may be helpful in determining whether membership dues are contributions, exchange transactions, or a combination of both. Depending on the facts and circumstances, some indicators may be more significant than others; however, no single indicator is determinative of the classification of a particular transaction.

Table 5-1

**Indicators Useful in Distinguishing Contributions From Exchange Transactions**

| *Indicator* | *Contribution* | *Exchange Transaction* |
|---|---|---|
| Recipient not-for-profit organization's (NPO's) intent in soliciting the asset[1] | Recipient NPO asserts that it is soliciting the asset as a contribution. | Recipient NPO asserts that it is seeking resources in exchange for specified benefits. |
| Resource provider's expressed intent about the purpose of the asset to be provided by recipient NPO | Resource provider asserts that it is making a donation to support the NPO's programs. | Resource provider asserts that it is transferring resources in exchange for specified benefits. |
| Method of delivery | The time or place of delivery of the asset to be provided by the recipient NPO to third-party recipients is at the discretion of the NPO. | The method of delivery of the asset to be provided by the recipient NPO to third-party recipients is specified by the resource provider. |
| Method of determining amount of payment | The resource provider determines the amount of the payment. | Payment by the resource provider equals the value of the assets to be provided by the recipient NPO, or the assets' cost plus markup; the total payment is based on the quantity of assets to be provided. |
| Penalties assessed if NPO fails to make timely delivery of assets | Penalties are limited to the delivery of assets already produced and the return of the unspent amount. (The NPO is not penalized for nonperformance.) | Provisions for economic penalties exist beyond the amount of payment. (The NPO is penalized for nonperformance.) |
| Delivery of assets to be provided by the recipient NPO | Assets are to be delivered to individuals or organizations other than the resource provider. | Assets are to be delivered to the resource provider or to individuals or organizations closely connected to the resource provider. |

[1] This table refers to assets. Assets may include services. The terms *assets* and *services* are used interchangeably in this table.

**Table 5-2**

**Indicators Useful for Determining the Contribution and Exchange Portions of Membership Dues**

| *Indicator* | *Contribution* | *Exchange Transaction* |
|---|---|---|
| Recipient NPO's expressed intent concerning purpose of dues payment | The request describes the dues as being used to provide benefits to the general public or to the NPO's service beneficiaries. | The request describes the dues as providing economic benefits to members or to other organizations or individuals designated by or related to the members. |
| Extent of benefits to members | The benefits to members are negligible. | The substantive benefits to members (for example, publications, admissions, educational programs, and special events) may be available to nonmembers for a fee. |
| NPO's service efforts | The NPO provides service to members and nonmembers. | The NPO benefits are provided only to members. |
| Duration of benefits | The duration is not specified. | The benefits are provided for a defined period; additional payment of dues is required to extend benefits. |
| Expressed agreement concerning refundability of the payment | The payment is not refundable to the resource provider. | The payment is fully or partially refundable if the resource provider withdraws from membership. |
| Qualifications for membership | Membership is available to the general public. | Membership is available only to individuals who meet certain criteria (for example, requirements to pursue a specific career or to live in a certain area). |

**5.28** Revenue derived from membership dues in exchange transactions should be recognized over the period to which the dues relate. Nonrefundable initiation and life membership fees received in exchange transactions should be recognized as revenues in the period in which the fees become receivable if future fees are expected to cover the costs of future services to be provided to members. If nonrefundable initiation and life membership fees, rather than future fees, are expected to cover those costs, nonrefundable initiation and life member fees received in exchange transactions should be recognized as revenue

over the average duration of membership, the life expectancy of members, or other appropriate time periods.

**5.29** Foundations, business organizations, and other types of entities may provide resources to not-for-profit organizations under programs referred to as *grants, awards,* or *sponsorships.*[12] Those asset transfers are contributions if the resource providers receive no value in exchange for the assets transferred or if the value received by the resource providers is incidental to the potential public benefit from using the assets transferred. The asset transfers are exchange transactions if the potential public benefit is secondary to the resource providers' potential direct benefits. For example, a grant made by a resource provider to a not-for-profit organization would likely be a contribution if the activity specified by the grant is to be planned and carried out by the not-for-profit organization and the organization has the right to the benefits of carrying out the activity. If, however, the grant is made by a resource provider that provides materials to be tested in the activity and that retains the right to any patents or other results of the activity, the grant would likely be an exchange transaction.

**5.30** Some transfers of assets between not-for-profit organizations and governments (such as the sale of goods and services) are exchange transactions. Other transfers of assets between not-for-profit organizations and governments (such as unrestricted support given by state and local governments) are contributions. Other kinds of government transfers (sometimes referred to as *grants, awards,* or *appropriations*) have unique characteristics that may make it difficult to determine whether they are contributions or exchange transactions. The indicators described in table 5-1 provide guidance on how to classify such transfers. Depending on the facts and circumstances, some indicators may be more significant than others; however, no single indicator is determinative of the classification of a particular transaction.

**5.31** As discussed in paragraphs 5.38–.46 and in chapters 3, "Basic Financial Statements," and 11, "Net Assets," of this guide, classification of net assets and revenues as either unrestricted, temporarily restricted, or permanently restricted depends on the existence or absence of donor-imposed restrictions on contributions. Therefore, resources received in exchange transactions should be classified as unrestricted revenues and net assets, even in circumstances in which resource providers place limitations on the use of the resources. For example, resources received from governments in exchange transactions in which those governments have placed limitations on the use of the resources should be reported as unrestricted revenues and net assets, because those limitations are not donor-imposed restrictions on contributions.

## Recognition Principles for Contributions

**5.32** Accounting for contributions depends on whether the transfer of assets, including promises to give, is received by the not-for-profit organization with donor-imposed conditions, donor-imposed restrictions, or both. A donor-imposed condition specifies a future and uncertain event (for example, a stipulation that the organization must meet a matching requirement) whose occurrence or failure to occur gives the donor the right of return of the assets or releases the donor from the obligation to transfer assets in the future.

---

[12] Such resource transfers may also have the characteristics of agency transactions. Paragraphs 5.05–.21 discuss agency transactions.

A promise that contains a condition is considered to be unconditional if the possibility that the condition will not be met is remote.[13] For example, a promise that is conditioned on the not-for-profit organization meeting administrative requirements, such as the filing of an annual financial report, should not be considered conditional if the likelihood of not meeting the administrative requirements is remote. Some promises to give are in part conditional and in part unconditional. For example, a not-for-profit organization may guarantee the debt of an unaffiliated entity without receiving commensurate consideration in return. That guarantee is in part conditional—the promise to make payments in future periods upon default—and in part unconditional—the gift of the guarantor's credit support, which enables the entity to obtain a lower interest rate on its borrowing. (Paragraph 10.13 provides additional information about guarantees.) A donor-imposed restriction is a stipulation specifying a use for a contribution that is more specific than the broad limits resulting from the nature and purpose of the organization and from the environment in which it operates.

**5.33** Distinguishing between a condition stipulated by a donor and a restriction on the use of a contribution imposed by a donor may require the exercise of judgment. Because of the uncertainty about whether they will be met, conditions imposed by resource providers may cast doubt on whether the resource provider's intent was to make a contribution, to make a conditional contribution, or to make no contribution. As a result of this uncertainty, donor-imposed conditions should be substantially met by the organization before the receipt of assets (including contributions receivable) is recognized as a contribution. In contrast to donor-imposed conditions, donor-imposed restrictions limit the use of the contribution, but they do not change the transaction's fundamental nature from that of a contribution.

**5.34** Determining whether a promise is conditional or unconditional can be difficult if the promise contains donor stipulations that do not state clearly whether the right to receive payment or delivery of the promised assets depends on meeting those stipulations. It may be difficult to determine whether those stipulations are conditions or restrictions. In cases of ambiguous donor stipulations, a promise containing stipulations that are not clearly unconditional should be presumed to be a conditional promise.

## Donor-Imposed Conditions

**5.35** A transfer of assets with a conditional promise to contribute them should be accounted for as a refundable advance until the conditions have been substantially met or the conditions have been explicitly waived by the donor. (Transfers of assets, including promises to give, on which resource providers have imposed conditions should be recognized as contributions if the likelihood of not meeting the conditions is remote.)

**5.36** Some conditions attached to contributions may be substantially met in stages rather than because of a single event. A portion of those contributions should be recognized as revenue as each of those stages is met. For example, a resource provider promises to contribute $1 for each $1 of contributions received by a not-for-profit organization, up to $100,000, over the next six months. As contributions are received from other resource providers, the conditions would

---

[13] Paragraph 3 of FASB Statement No. 5, *Accounting for Contingencies*, defines an event to be *remote* when "the chance of the future event or events occurring is slight."

be met and the promise would become unconditional. For example, if $10,000 is received in the first month from donors, $10,000 of the conditional promise would become unconditional and should be recognized as contribution revenue. Contributions, such as certain contributions made by governments, that are conditioned upon the organization incurring certain qualifying costs, should be recognized as revenue as those costs are incurred.

**5.37** Unconditional contributions should be recognized as revenue in the period received.[14] Depending on the kind of benefit received, the organization should also recognize (*a*) an increase in assets (for example, cash, securities, contributions receivable, collections [if capitalized, see chapter 7, "Other Assets," of this guide], and property and equipment); (*b*) a decrease in liabilities (for example, accounts payable or notes payable); or (*c*) an expense (for example, donated legal services).

## Donor-Imposed Restrictions

**5.38** Contributions may be received with donor-imposed restrictions. Some restrictions permanently limit the organization's use of contributed assets. Other restrictions are temporary in nature, limiting the organization's use of contributed assets to (*a*) later periods or after specific dates (time restrictions), (*b*) specific purposes (purpose restrictions), or (*c*) both.

**5.39** Restrictions may (*a*) be stipulated explicitly by the donor in a written or oral communication accompanying the contribution or (*b*) result implicitly from the circumstances surrounding receipt of the contributed asset—for example, making a gift to a capital campaign whose stated objective is to raise funds for a new building. Contributions of unconditional promises to give with payments due in future periods should be reported as temporarily restricted contributions unless the donor expressly stipulates, or circumstances surrounding the receipt of the promise make clear that the donor intended it to be used to support activities of the current period.

**5.40** Donors can impose restrictions on otherwise unrestricted net assets, as well as on their own contributions. For example, a donor may make a restricted contribution that is conditioned on the not-for-profit organization restricting a stated amount of its unrestricted net assets. Such restrictions that are not reversible without donors' consent result in a reclassification of unrestricted net assets to restricted net assets.

**5.41** Unconditional contributions received without donor-imposed restrictions should be reported as unrestricted support that increases unrestricted net assets. Unconditional contributions received with donor-imposed restrictions should be reported as restricted support that increases permanently restricted or temporarily restricted net assets, depending on the nature of the restriction.[15] The permanently restricted classification should be used if the limits imposed on the use of the contributed assets are permanent (for example, contributions of cash or securities that must be invested in perpetuity to provide a permanent source of income for the organization or contributions of

---

[14] Unconditional contributions of services and collection items are subject to different recognition criteria. Paragraphs 5.52, 5.53, and 7.06 discuss those transactions.

[15] A subsequent event may arise that raises the possibility that the organization may not satisfy a donor-imposed restriction. AU section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1), provides guidance on the recognition and disclosure of subsequent events.

permanently restricted collection items or of cash that must be used to purchase permanently restricted collection items). The temporarily restricted classification should be used for contributions if the limitations are temporary (for example, a restriction that contributed assets may be used only after some future date, or for some specific program, or to acquire a specific asset).

**5.42** In some situations, an organization may meet donor-imposed restrictions on all or a portion of the amount contributed in the same reporting period in which the contribution is received. In those cases, the contribution (to the extent that the restrictions have been met) may be reported as unrestricted support that increases unrestricted net assets provided that the organization has a similar policy for reporting investment gains and income,[16] reports consistently from period to period, and discloses its accounting policy in the notes to the financial statements.

**5.43** The expiration of donor-imposed restrictions on contributions should be reported in the period or periods in which (*a*) a donor-stipulated time has elapsed (for example, the restriction on a term endowment in which contributed cash is to be invested for 10 years expires at the end of the tenth year) or (*b*) a donor-stipulated purpose for which the contribution was restricted has been fulfilled by the organization (for example, the restriction on a contribution to acquire operating supplies expires when those supplies are acquired by the organization). If 2 or more donor-imposed restrictions are stipulated by the donor, the expiration of the restriction should be reported in the period in which the last remaining restriction is satisfied. Expirations of donor-imposed restrictions should be reported in a statement of activities as reclassifications, decreasing temporarily restricted net assets and increasing unrestricted net assets.

**5.44** Expenses may be incurred for purposes for which both unrestricted and temporarily restricted net assets are available. If an expense is incurred for a purpose for which both unrestricted and temporarily restricted net assets are available, a donor-imposed restriction is fulfilled to the extent of the expense incurred unless the expense is for a purpose that is directly attributable to another specific external source of revenue. For example, an employee's salary may meet donor-imposed restrictions to support the program on which the employee is working. In that situation, the restriction is met to the extent of the salary expense incurred unless incurring the salary will lead to inflows of revenues from a specific external source, such as revenues from a cost reimbursement contract or a conditional promise to give that becomes unconditional when the organization incurs the salary expense.

**5.45** Not-for-profit organizations may receive contributions of long-lived assets (such as property and equipment) or of cash and other assets restricted to the purchase of long-lived assets, for which donors have not expressly stipulated how or how long the long-lived asset must be used by the organization or how to use any proceeds resulting from the asset's disposal. An organization may adopt an accounting policy of implying time restrictions on the use of such contributed assets that expire over the assets' expected useful lives. If an organization adopts such a policy, the contributions received should be reported as restricted support that increases temporarily restricted net assets. Depreciation should be recorded over the asset's useful life, and net assets should be

---

[16] Paragraph 8.19 discusses the accounting policy for reporting investment gains and income if the organization meets donor-imposed restrictions on all or a portion of such gains and income in the same reporting period as the gains and income are recognized.

reclassified periodically from temporarily restricted to unrestricted as depreciation is recognized. Long-lived assets that are subject to an accounting policy implying time restrictions on the use of contributed long-lived assets may be disposed of before the end of their useful lives. In those situations, the gains and losses on the disposal of those assets should be reported as changes in unrestricted net assets and a reclassification should be reported for any remaining temporarily restricted net assets.

**5.46** Other organizations may adopt a policy of not implying time restrictions on contributions of long-lived assets (or of other assets restricted to the purchase of long-lived assets) received without donor stipulations about how long the contributed assets must be used. If an organization adopts such a policy, contributions of long-lived assets with no donor-imposed time restrictions should be reported as unrestricted support. Contributions of cash and other assets restricted to the acquisition of long-lived assets should be reported as restricted support that increases temporarily restricted net assets; those restrictions expire when the long-lived assets are placed in service by the organization.

## Promises to Give

**5.47** Not-for-profit organizations may enter into written or oral agreements with donors involving future nonreciprocal transfers of cash, other assets, and services.[17] Such agreements between not-for-profit organizations and potential donors should be reported as contribution revenue and receivables if such agreements are, in substance, unconditional promises to give,[18] even if the promise is not legally enforceable.

**5.48** Conditional promises to give cash or other assets (such as securities or property and equipment) should be recognized as contribution revenue and receivables when the conditions are substantially met. Unconditional promises to give should be recognized as contribution revenue and receivables in the period in which the promise is received.[19] Depending on the existence and nature of donor-imposed restrictions, unconditional promises to give should be reported either as unrestricted support that increases unrestricted net assets, or as restricted support that increases permanently restricted or temporarily restricted net assets. Use of the *permanently restricted* classification is appropriate if donor-imposed restrictions stipulate that the resources must be maintained permanently (for example, donors' promises to give cash or securities that must be invested in perpetuity). Use of the temporarily restricted classification is appropriate if donor-imposed restrictions (*a*) expire by passage of

---

[17] Paragraph 70 of FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, notes that "promises to give services generally involve personal services that, if not explicitly conditional, are often implicitly conditioned upon the future and uncertain availability of specific individuals whose services have been promised." It is assumed in the remainder of this chapter that promises to give services are conditional and, hence, not recognized until the services are performed.

[18] Paragraph 6 of FASB Statement No. 116 defines *promise to give* as "a written or oral agreement to contribute cash or other assets to another entity." These items are sometimes referred to as *pledges*, a term that FASB Statement No. 116 and this guide avoid because it may be misinterpreted. Paragraphs 5.04–.12 discuss agency transactions.

[19] If a donor uses a recipient organization to transfer a contribution to a specified beneficiary, the beneficiary should recognize its rights to the assets (financial or nonfinancial) held by a recipient organization as an asset unless the recipient organization is explicitly granted variance power. (See paragraph 15 of FASB Statement No. 136.) Paragraph 5.12 discusses a beneficiary's reporting of its rights to assets held by a recipient organization.

time or (*b*) can be fulfilled or removed by actions of the organization pursuant to donor stipulations.

**5.49** Unconditional promises to give that are due in future periods and are not permanently restricted generally increase temporarily restricted net assets, rather than unrestricted net assets. If, however, the donor explicitly stipulates that the promise to give is to support current-period activities or if other circumstances surrounding the promise make it clear that the donor's intention is to support current-period activities, unconditional promises to give should be reported as unrestricted support that increases unrestricted net assets.

**5.50** Before a promise to give can be recognized, sufficient verifiable evidence should exist documenting that a promise was made by the donor and received by the not-for-profit organization. Such evidence may be included in written or verifiable oral communications, including (*a*) written agreements, (*b*) pledge cards, and (*c*) oral promises documented by tape recordings, written contemporaneous registers, follow-up written confirmations, and other means that permit subsequent verification of the oral communications. A communication that does not indicate clearly whether it is a promise is considered an unconditional promise to give if it indicates an unconditional intention to give that is legally enforceable. Promises to give that do not discuss the specific time or place for the contribution but that are otherwise clearly unconditional in nature should be considered unconditional promises to give.

**5.51** Not-for-profit organizations may receive communications that are intentions to give, rather than promises to give. For example, communications from individuals indicating that the organization has been included in the individual's will as a beneficiary are intentions to give. Such communications are not unconditional promises to give, because individuals retain the ability to modify their wills during their lifetimes. (When the probate court declares the will valid, the not-for-profit organization should recognize contribution revenue and a receivable at the fair value of its interest in the estate, unless the promise is conditioned upon future or uncertain events, in which case a contribution should not be recognized until the conditions are substantially met. Not-for-profit organizations should disclose information about conditional promises in valid wills in conformity with paragraph 25 of FASB Statement No. 116.) Solicitations for donations that clearly include wording such as "information to be used for budget purposes only" or that clearly and explicitly allow resource providers to rescind their indications that they will give are intentions to give rather than promises to give and should not be reported as contributions.

## Contributed Services

**5.52** Contributed services should be reported as contribution revenue and as assets or expenses only if the services create or enhance a nonfinancial (that is, nonmonetary) asset (for example, property and equipment) or—

- Would typically need to be purchased by the organization if they had not been provided by contribution,
- Require specialized skills, and
- Are provided by individuals with those skills (such as accounting, financial, construction, educational, electrical, legal, medical, and other services provided by accountants, investment advisers, contractors, teachers, electricians, lawyers, doctors, and other professionals and craftspeople)

If such contributions are reported, they should be measured at fair value.[20] Examples of situations in which it may be appropriate to recognize contributed services are included in paragraphs 195 to 206 of FASB Statement No. 116.

**5.53** Contributed services (and the related assets and expenses) should be recognized if employees of separately governed affiliated organizations regularly perform services (in other than an advisory capacity) for and under the direction of the donee organization and the recognition criteria for contributed services are met.

## Gifts in Kind

**5.54** Some not-for-profit organizations receive noncash assets—such as property, equipment, and inventory—from resource providers. Reporting these transfers, sometimes referred to as *gifts in kind*, as agency transactions or as contributions depends on the extent of discretion that the not-for-profit recipient has over the use or subsequent disposition of the assets. (Determining whether a not-for-profit recipient receives assets as an agent is discussed in paragraphs 5.05–.10. Paragraph 5.11 describes the accounting and disclosures of an agent that receives nonfinancial assets.) Information about gifts-in-kind transactions may be required to be disclosed under FASB Statement No. 57.

**5.55** A not-for-profit organization that is the specified beneficiary of an agency transaction should recognize its rights to gifts in kind held by the agent unless the agent is granted variance power. (Paragraph 5.12 describes more fully the specified beneficiary's accounting.) If gifts-in-kind transfers are not agency transactions, the noncash assets received by the not-for-profit organization should be recognized as contributions when received from or unconditionally promised by the donor. Gifts in kind that can be used or sold should be measured at fair value.[21] In determining fair value, organizations should consider the quality and quantity of the gifts, as well as any applicable discounts that would have been received by the organization, including discounts based on that quantity if the assets had been acquired in exchange transactions. If the gifts have no value, as might be the case for certain clothing and furniture that cannot be (*a*) used internally by the not-for-profit organization or for program purposes or (*b*) sold by the organization, the item received should not be recognized.

**5.56** Not-for-profit organizations may also receive items, such as tickets, gift certificates, works of art, and merchandise, that are to be used for fund-raising purposes by transferring them to other resource providers (the ultimate resource provider or recipient) during fund-raising events. The ultimate resource provider or recipient may acquire the items in transactions that are part exchange transactions and part contributions.[22] Such gifts in kind can be linked to asset transfers from the original resource providers to the ultimate resource providers (recipients) because they are, in substance, part of the same transaction; these gifts in kind should be reported as contributions and measured at fair value when originally received by a not-for-profit organization.

---

[20] Whether such contributions should be reported is unaffected by whether the not-for-profit organization could afford to purchase the services at their fair value.

[21] Fair value would generally not increase when a gift in kind is passed from one not-for-profit organization to another. However, fair value could increase if an organization adds value to the gift, such as by cleaning and packaging the gift. Any increases should be evaluated to determine whether the not-for-profit organization did, in fact, add to the fair value of the assets.

[22] Paragraphs 13.21–.26 of this guide discuss reporting special events associated with an organization's fund-raising efforts.

The difference between the amount received for those items from the ultimate resource providers (recipients) and the fair value of the gifts in kind when originally contributed to the organization should be recognized as adjustments to the original contributions when the items are transferred to the ultimate resource providers (recipients). For example, a public radio station receives from the local community theater (the original resource provider) a ticket with a fair value of $75, to be auctioned to the highest bidder; a listener (the ultimate resource provider or recipient) subsequently acquires the ticket at auction for $100. The initial transfer of the ticket to the not-for-profit organization should be reported as a $75 contribution and the ticket should be reported as an asset; an additional $25 contribution should be reported when the ticket is transferred to the listener at auction, and no cost for the ticket should be reported on the statement of activities. If a listener acquires the ticket for $45, rather than $100, a reduction of $30 in contributions should be reported when the ticket is transferred to the listener at auction, because the transfer at auction is part of the transaction that was initiated when the organization received the ticket. Holding the ticket from the time of initial receipt to the time of ultimate transfer at auction does not create a transaction separate from the initial contribution.

## Contributed Utilities and Use of Long-Lived Assets

**5.57** Not-for-profit organizations may receive unconditional contributions of the use of electric, telephone, and other utilities and of long-lived assets (such as a building or the use of facilities) in which the donor retains legal title to the long-lived asset. Organizations receiving such contributions should recognize contribution revenue in the period in which the contribution[23] is received and expenses in the period the utilities or long-lived assets are used.[24] If the transaction is an unconditional promise to give (as described in paragraphs 5.47–.51) for a specified number of periods, the promise should be reported as contributions receivable and as restricted support that increases temporarily restricted net assets.[25]

**5.58** Unconditional promises to give the use of long-lived assets (such as 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. For example, not-for-profit organizations may use facilities under lease agreements that call for lease payments at amounts below the fair rental value of the property. In such circumstances, the not-for-profit organization should report a contribution for the difference between the fair rental value of the property and the stated amount of the lease payments.[26] (However, amounts reported as contributions should not exceed the fair value of the long-lived asset at the time the organization receives the unconditional promise to give.) The contribution receivable may be described in the financial statements based on the item whose use is being contributed, such as a building, rather than as contributions receivable.

---

[23] As discussed in paragraph 5.01, contributions include both the use of facilities and utilities, as well as promises to give those items in the future.

[24] Whether such contributions should be reported is unaffected by whether the not-for-profit organization could afford to purchase the utilities or facilities at their fair value.

[25] Paragraphs 5.61–.69 discuss measurement principles for initial recognition of contributions received.

[26] See footnote 25.

## Contributed Collection Items

**5.59** Not-for-profit organizations may receive contributions of works of art, historical treasures, and similar items that meet the definition of collections in paragraph 11 of FASB Statement No. 116. The recognition and measurement principles for contributions of collections depend on the collections-capitalization policy adopted by the organization. Accounting for collections is discussed in chapter 7 of this guide.

## Split-Interest Agreements

**5.60** A split-interest agreement is a form of contribution in which a not-for-profit organization receives benefits that are shared with other beneficiaries designated by the donor. Common kinds of such agreements include charitable lead and remainder trusts, charitable gift annuities, and pooled (life) income funds. Because of the specialized nature of these arrangements, they are discussed separately in chapter 6 of this guide.

# Measurement Principles for Contributions

**5.61** Contribution revenue should be measured at the fair value of the assets or services received or promised or the fair value of the liabilities satisfied. (Contributions arising from unconditional promises to give that are expected to be collected[27] within one year of the financial statement date may be measured at their net realizable value.) Paragraphs 3.24–.43 of this guide discuss FASB Statement No. 157, which defines fair value and establishes a framework for measuring fair value.[*]

The fair value of contributed services that create or enhance nonfinancial assets should be estimated based on (*a*) the fair value of the services received or (*b*) the fair value of the assets created (or the change in the fair value of the asset that is being enhanced), whichever is more readily determinable. As discussed in paragraphs 3.39 and 3.42 of this guide, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset. Market participant assumptions should include assumptions about the effect of a restriction on the sale or use of an asset if market participants would consider the effect of the restriction in pricing the asset. Examples 8 and 9 (paragraphs A29–A30) of FASB Statement No. 157 explain

---

[27] The use of the word *expected* in the phrase *expected to be received* or the phrase *expected to be collected*, when used to describe the receipt of cash or other assets from an unconditional promise to give, is not intended to limit the organization's choice of present value techniques to an expected present value technique as described in paragraphs B12–B19 of FASB Statement No. 157.

[*] The discussion of FASB Statement No. 157 within paragraph 5.61 of this guide replaces the following text from the May 1, 2006 version of this guide: "Fair value can best be measured by quoted market prices. If such prices are not available, fair value can be estimated based on one of the following: quoted market prices for similar assets; the asset's replacement cost; independent appraisals of the asset's fair value; or other valuation techniques, such as discounting the estimated future cash flows [footnote omitted]." That guidance in that text, derived primarily from paragraph 19 of FASB Statement No. 116, was superseded by Statement No. 157. FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year or its interim periods. However, FSP FAS 157-2 delays the effective date of FASB Statement No. 157 until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for fair value measurements of all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). See footnote † to paragraph 3.25 for more information about the types of assets and liabilities to which the deferral applies.

that restrictions that are an attribute of an asset, and therefore would transfer to a market participant, are the only restrictions reflected in fair value. Donor restrictions that are specific to the donee are reflected in the classification of net assets, not in the measurement of fair value.

**5.62** Major uncertainties about the existence of value of a contributed asset may indicate that a contribution should not be recognized. Such uncertainties are often present when an item has no use other than for scientific or educational research or for its historical significance. Examples of such items include flora, fauna, photographs, and objects identified with historic persons, places, or events.

**5.63** If a promise to give has not previously been recognized as contribution revenue because it was conditional, fair value should be measured when the conditions are met.

**5.64** The present value of the future cash flows is one valuation technique for measuring the fair value of contributions arising from unconditional promises to give cash; other valuation techniques also are available, as described in FASB Statement No. 157.[28] Exhibit 5-1 illustrates the use of present value techniques for initial recognition and measurement of unconditional promises to give cash that are expected to be collected one year or more after the financial statement date.

**Exhibit 5-1**

**Initial Recognition of Unconditional Promises to Give Cash**

*Facts*

Assume that a not-for-profit organization receives a promise (or promises from a group of homogeneous donors) to give $100 in five years, that the anticipated future cash flows from the promise(s) are $70, and that the present value of the future cash flows is $50.

*Solution*

| | | | |
|---|---|---|---|
| dr. | Contributions Receivable | $70 | |
| cr. | Contribution Revenue—Temporarily Restricted | | $50 |
| cr. | Discount on Contributions Receivable | | $20 |

(To report contributions receivable and revenue using a present value technique to measure fair value.)

[*Note to Readers*: Some organizations may use a subsidiary ledger to retain information concerning the $100 face amount of contributions promised in order to monitor collections of contributions promised.]

**5.65** A present value technique is one valuation technique for measuring the fair value of an unconditional promise to give noncash assets; other valuation techniques also are available, as described in FASB Statement No. 157.[29] If present value techniques are used, the fair value of contributions arising from unconditional promises to give noncash assets might be determined

[28] See footnote 5.

[29] See footnote 5.

based on the present value of the projected fair value of the underlying noncash assets at the date and in the quantities that those assets are expected to be received,[30] if the date is one year or more after the financial statement date. (Both the (*a*) likelihood of the promise being fulfilled[31] and (*b*) future fair value of those underlying assets, such as the future fair value per share of a promised equity security, should be considered in determining the future amount to be discounted.) In cases in which the future fair value of the underlying asset is difficult to determine, the fair value of an unconditional promise to give noncash assets may be based on the fair value of the underlying asset at the date of initial recognition. (No discount for the time value of money should be reported if an asset's fair value at the date of initial recognition is used to measure the fair value of the contribution.)

**5.66** If present value techniques are used to measure the fair value of unconditional promises to give, a not-for-profit organization should determine the amount and timing of the future cash flows of unconditional promises to give cash (or, for promises to give noncash assets, the quantity and nature of assets expected to be received). In making that determination, not-for-profit organizations should consider all the elements in paragraph 3.35, including when the receivable is expected to be collected, the creditworthiness of the other parties, the organization's past collection experience and its policies concerning the enforcement of promises to give, expectations about possible variations in the amount or timing, or both, of the cash flows (that is, the uncertainty inherent in the cash flows), and other factors concerning the receivable's collectibility.

## Discounting

**5.67** If present value techniques are used to measure fair value, the present value of unconditional promises to give should be measured using a discount rate that is consistent with the general principles for present value measurement discussed in paragraphs B2–B6 of FASB Statement No. 157.[†] In conformity with paragraph 12 of APB Opinion No. 21, *Interest on Receivables and Payables*, the discount rate should be determined at the time the unconditional promise to give is initially recognized and should not be revised subsequently unless the organization has elected to measure the promise to give at fair value in conformity with FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment*

---

[30] Throughout the remainder of this chapter, the phrase *the future fair value of the underlying asset* [or *underlying security,* or *underlying noncash asset*] is used to refer to the projected fair value of the underlying asset [or underlying security, or underlying noncash asset] at the date the asset [or security, or noncash asset] is expected to be received.

[31] The quantity, nature, and timing of assets expected to be received, such as the number of shares of a promised equity security, the company in which those shares represent an equity interest, and when those shares will be received should be considered in determining the likelihood of the promise being fulfilled.

[†] The guidance in FASB Statement No. 157 replaces the guide's previous requirement to use a risk-free rate of return. Paragraphs B12 to B14 of FASB Statement No. 157 discuss a present value technique for which a risk-free rate of return is appropriate (Method 1 of the expected present value technique). FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year or its interim periods. However, FSP FAS 157-2 delays the effective date of FASB Statement No. 157 until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for fair value measurements of all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). See footnote † to paragraph 3.25 for more information about the types of assets and liabilities to which the deferral applies.

of *FASB Statement No. 115*, as discussed further in paragraph 5.70.[‡] If an organization elects to measure the unconditional promise to give at fair value and uses a present value technique to measure fair value, the discount rate assumptions, and all other elements discussed in paragraph 3.35 of this guide, should be revised at each measurement date to reflect current market conditions.

**5.68** Discounts on contributions receivable that are measured at present value should be amortized between the date the promise to give is initially recognized and the date the cash or other contributed assets are received. In conformity with paragraph 15 of APB Opinion No. 21, the interest method should be used to amortize the discount. Other methods of amortization may be used if the results are not materially different. The amount of the periodic amortization of the discount should be included as a component of contribution revenue and should be reported as an increase in permanently restricted, temporarily restricted, or unrestricted net assets, depending on the net asset class in which the promise was originally reported.

**5.69** Contributions receivable should be reported net of the discount that arises if measuring a promise to give at present value. The discount should be separately disclosed by reporting it as a deduction from contributions receivable either on the face of a statement of financial position or in the notes to the financial statements.

## Subsequent Measurement

**5.70** The fair value of contributions arising from unconditional promises to give cash and noncash assets may change because of (*a*) changes in the quantity or nature of assets expected to be received (such as changes in the amounts of future cash flows), (*b*) changes in the timing of assets expected to be received,[32] (*c*) changes in the future fair value of underlying noncash assets, and (*d*) changes in the time value of money.

Unconditional promises to give cash should be subsequently measured using one of the following:

- Fair value, if an election is made in conformity with FASB Statement No. 159.
- The guidance in paragraph 5.71 if the fair value election in conformity with FASB Statement No. 159 is not made.

Unconditional promises to give financial instruments, including debt or equity securities, should be subsequently measured using one of the following:

- Fair value, if an election is made in conformity with FASB Statement No. 159.[||]

---

[‡] FASB Statement No. 159 is effective as of the beginning of the first fiscal year that begins after November 15, 2007. Earlier adoption is permitted if certain conditions described in paragraph 30 of the statement are met.

[32] This guide does not address accounting for changes in the timing of assets expected to be received. FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, provides useful discussion of techniques to address changes in estimated cash flows. Statements of Financial Accounting Concepts are not sources of established accounting principles as described in AU section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles (AICPA, *Professional Standards*, vol. 1), and, thus, do not amend, modify, or justify a change from GAAP currently in effect.

[||] FASB Statement No. 159 is effective as of the beginning of the first fiscal year that begins after November 15, 2007. Earlier adoption is permitted if certain conditions described in paragraph 30 of the statement are met.

- The guidance in paragraphs 5.71–.74 for unconditional promises to give equity securities with readily determinable fair values or debt securities (if the fair value election in conformity with FASB Statement 159 is not made).
- The guidance in paragraphs 5.71–.72 and 5.75 for promises to give financial instruments other than equity securities with readily determinable fair values or debt securities (if the fair value election in conformity with FASB Statement No. 159 is not made).

Unconditional promises to give assets other than cash or financial instruments should be subsequently measured using the guidance in paragraphs 5.71–.72 and 5.75.

### *Changes in the Quantity or Nature of Assets Expected to Be Received*

**5.71** If the fair value of contributions arising from unconditional promises to give cash or noncash assets decreases because of changes in the quantity or nature of assets expected to be received, the decrease should be recognized in the period(s) in which the expectation changes. Such decreases should be reported as expenses or losses (bad debt) in the net asset class in which the net assets are represented.[33] No increase in net assets should be recognized if the fair value of contributions arising from unconditional promises to give increases because of changes in the quantity or nature of assets expected to be received between the date the unconditional promises to give are recognized and the date they are collected, except as provided in the next sentence. If the fair value of contributions arising from unconditional promises to give increases because of changes in the quantity or nature of assets expected to be received, and previous decreases in the fair value of those promises have resulted in expenses or losses from bad debts, such increases should be reported as recoveries of those expenses or losses, to the extent that those expenses or losses have been recognized, in the net asset classes in which the net assets are represented. Amounts collected, other than recoveries of bad debt expenses or losses, in excess of the carrying amount of contributions receivable should be reported as contribution revenue in the appropriate net asset class.

### *Changes in the Fair Value of Underlying Noncash Assets*

**5.72** As discussed in paragraph 5.70, the fair value of contributions arising from unconditional promises to give noncash assets may change because of changes in the future fair value of the underlying noncash assets. If, in a period subsequent to initial measurement, an observed change in the current fair value of the asset to be contributed occurs, that change in fair value may or may not result in changes in the future fair value of the underlying noncash asset, depending on the method and assumptions used for determining the future fair value of the underlying noncash asset. For purposes of subsequent measurement, the method for determining the future fair value of the underlying noncash asset should be the same as the method used for determining that amount for purposes of initial measurement. (Paragraph 5.65 discusses the measurement principles for initial recognition of unconditional promises to give noncash assets, including consideration of the future fair value of the

---

[33] As discussed in chapters 3 and 13 of this guide, all expenses should be reported as decreases in unrestricted net assets. Therefore, decreases in contributions because of changes in the amounts of assets expected to be received should be reported as losses if they are decreases in temporarily restricted net assets or permanently restricted net assets.

underlying asset.) Accordingly, assumed relationships, such as the relationship between the market price of the noncash asset at the time the initial measurement is made and its projected market price at the date the asset is expected to be received, should be presumed to continue in determining whether the future fair value of the underlying noncash asset has changed. (As discussed in paragraph 5.65, the fair value of an unconditional promise to give noncash assets may be based on the fair value of the underlying noncash asset at the date of initial recognition. If that method is used at initial measurement, for subsequent measurement, observed changes in the current fair value of the asset to be contributed should be treated as if they were changes in the fair value of contributions arising from unconditional promises to give noncash assets because of changes in the future fair value of the underlying asset. If that method is not used at initial measurement, for subsequent measurement, observed changes in the current fair value of the asset to be contributed may or may not result in changes in the future fair value of the underlying asset, and, therefore, may or may not result in changes in the fair value of contributions arising from unconditional promises to give noncash assets because of changes in the future fair value of the underlying asset.)

**5.73** Paragraph 5.74 discusses accounting for changes in the fair value of contributions arising from unconditional promises to give equity securities with readily determinable fair values or debt securities because of changes in the future fair value of the underlying securities. Paragraph 5.75 discusses accounting for changes in the fair value of contributions arising from unconditional promises to give noncash assets other than equity securities with readily determinable fair values or debt securities because of changes in the future fair value of the underlying noncash assets.

**5.74** The fair value of contributions arising from unconditional promises to give equity securities with readily determinable fair values or debt securities may change between the date the unconditional promise to give is recognized and the date the asset promised is received because of changes in the future fair value of the underlying securities. Such changes should be reported as increases and decreases in contribution revenue in the period(s) in which the change occurs, in the net asset class in which the contribution was originally reported or in the net asset class in which the net assets are represented.

**5.75** The fair value of contributions arising from unconditional promises to give noncash assets other than equity securities with readily determinable fair values or debt securities may decrease between the date the unconditional promise to give is recognized and the date the asset promised is received because of decreases in the future fair value of the underlying noncash assets. Such decreases should be reported as decreases in contribution revenue in the period(s) in which the decrease occurs, in the net asset class in which the contribution was originally reported or in the net asset class in which the net assets are represented. No additional revenue should be recognized if the future fair value of those underlying noncash assets increases between the date the unconditional promise to give is recognized and the date the asset promised is received.

### *Illustration*

**5.76** Table 5-3 illustrates the accounting for changes in the fair value of unconditional promises to give subsequent to initial recognition, but before collection.

**Table 5-3**

**Accounting for Unconditional Promises to Give That Are Not Measured Subsequently at Fair Value (Subsequent to Initial Recognition But Before Collection)**

| | *Reason for the Change in Fair Value* | | | |
|---|---|---|---|---|
| *Underlying Asset* | *Change in Collectibility of the Receivable* | | *Change in the Fair Value of the Underlying Asset* | |
| | *Increase in Fair Value* | *Decrease in Fair Value* | *Increase in Future Fair Value* | *Decrease in Future Fair Value* |
| Cash | No adjustment[1] | Recognize expense or loss (bad debt) | Not applicable | Not applicable |
| FASB Statement No. 124 securities[2] | No adjustment[1] | Recognize expense or loss (bad debt) | Recognize additional contribution revenue | Recognize a decrease in contribution revenue |
| Other assets | No adjustment[1] | Recognize expense or loss (bad debt) | No adjustment | Recognize a decrease in contribution revenue |

[1] Recoveries of previously recognized decreases in fair value resulting from changes in estimates of collectibility (up to the amount of decreases previously recognized), however, should be recognized as reductions of bad debt expense or loss.

[2] For purposes of this table, *FASB Statement No. 124 securities* are defined as equity securities with readily determinable fair values and all debt securities.

## Financial Statement Presentation

**5.77** *Contribution revenue* may be reported as a separate line item on a statement of activities. However, this does not preclude reporting separate line items for government contracts, membership dues,[34] special events, or similar revenue sources in other revenue categories or in the notes to the financial statements.

**5.78** The notes to the financial statements should also include the following:

- The accounting policies adopted by the organization concerning the following:

[34] Accounting for the portion of membership dues that is an exchange transaction is different than accounting for the portion that is a contribution. Paragraphs 5.27 and 5.28 discuss revenue recognition principles for membership dues.

  - Whether the organization implies time restrictions on the use of contributed long-lived assets (and contributions of cash and other assets restricted to purchasing them) received without donor stipulations about how long the contributed assets must be used (Paragraphs 5.45–.46 provide guidance concerning the application of this policy.)
  - Whether the organization classifies donor-restricted contributions as unrestricted or restricted support if restrictions are satisfied in the same reporting period in which the contributions are received (Paragraph 5.42 provides guidance concerning the application of this policy.)
  - Whether the organization recognizes contributions of collection items (Paragraphs 7.05–.09 provide guidance concerning the application of this policy.)

- Disclosures relating to the liquidity of the organization's contributions receivable, including the following:
  - Contributions receivable pledged as collateral or otherwise limited as to use.
  - A schedule of unconditional promises to give (showing the total amount separated into amounts receivable in less than one year, in one to five years, and in more than five years) and the related allowance for uncollectible promises receivable arising from subsequent decreases due to changes in the quantity or nature of assets expected to be received (see paragraph 5.71), and the unamortized discount.[35]
  - The amount of conditional promises to give—in total and, with descriptions, the amount of each group of similar promises (for example, those conditioned upon the development of new programs, upon the purchase or construction of new property and equipment, and upon the raising of matching funds within a specified time period).

- Disclosures required by paragraph 32 of FASB Statement No. 157 in the format described in paragraph 34 of that statement, if unconditional promises to give are subsequently measured at fair value.
- Disclosures required by paragraphs 18–19 and 21 of FASB Statement No. 159, if an organization elects the fair value option pursuant to FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*, or No. 159 for reporting unconditional promises to give.

---

[35] The amount of unconditional promises to give included in the schedule represents amounts reported as contributions receivable. For example, assume that, on the last day of its fiscal year, an organization receives promises to give $100 in five years, that the estimated future cash flows from the promises are $70, and that the present value of the estimated future cash flows is $50. The notes to the financial statements should disclose unconditional promises to give of $70 and unamortized discount of $20.

- Disclosures required by paragraph 22 of FASB Statement No. 159, if an election to report unconditional promises to give is made after initial recognition pursuant to paragraph 9(e) of that statement.
- Disclosures required by APB Opinion No. 21.
- Disclosure of how the not-for-profit organization computes its fund-raising ratio if it includes that ratio in its financial statements, as described in paragraph 20 of FASB Statement No. 136.

**5.79** The notes to the financial statements should include the following disclosures concerning contributions of services received during the period:

- The nature and extent of contributed services received by the organization
- A description of the programs or activities for which the services were used
- The amount of contributed services recognized during the period

Not-for-profit organizations are encouraged to report in the notes to the financial statements, if practical, the fair value of contributed services received but not recognized.

**5.80** As stated in paragraph 19 of FASB Statement No. 136, if a not-for-profit organization transfers assets to a recipient organization and specifies itself or its affiliate as beneficiary, the not-for-profit organization should disclose the following information for each period for which a statement of financial position is presented:

*a.* The identity of the recipient organization to which the transfer was made

*b.* Whether variance power was granted to the recipient organization and, if so, a description of the terms of the variance power

*c.* The terms under which amounts will be distributed to the resource provider or its affiliate

*d.* The aggregate amount recognized in the statement of financial position for those transfers and whether that amount is recorded as an interest in the net assets of the recipient organization or as another asset (for example, as a beneficial interest in assets held by others or a refundable advance)

## Illustrative Disclosures

**5.81** The following section provides examples of notes to financial statements that illustrate some of the disclosures discussed in this chapter.

### Example 1—Donor-Imposed Restrictions

Note X: Summary of Significant Accounting Policies

All contributions are considered to be available for unrestricted use unless specifically restricted by the donor. Amounts received that are designated for future periods or restricted by the donor for specific purposes are reported as temporarily restricted or permanently restricted support that increases those net asset classes. However, if a restriction is fulfilled in the same time period in which the contribution is received, the organization reports the support as unrestricted.

**Example 2—Promises to Give**

Note X: Summary of Significant Accounting Policies

Unconditional promises to give that are expected to be collected within one year are recorded at net realizable value. Unconditional promises to give that are expected to be collected in future years are recorded at the present value of their future cash flows. The discounts on those amounts are computed using risk-adjusted interest rates applicable to the years in which the promises are received. Amortization of the discounts is included in contribution revenue. Conditional promises to give are not included as support until the conditions are substantially met.

Note Y: Promises to Give

Included in "Contributions Receivable" are the following unconditional promises to give:

| | *20X1* | *20X0* |
|---|---|---|
| Capital campaign | $1,220 | |
| Restricted to future periods | 795 | $530 |
| Unconditional promises to give before unamortized discount and allowance for uncollectibles | 2,015 | 530 |
| Less: Unamortized discount | (180) | (24) |
| Subtotal | 1,835 | 506 |
| Less: Allowance for uncollectibles | (150) | (30) |
| Net unconditional promises to give | $1,685 | $476 |
| Amounts due in: | | |
| Less than one year | $1,220 | |
| One to five years | 725 | |
| More than five years | 70 | |
| Total | $2,015 | |

Discount rates ranged from 4 percent to 4.5 percent and from 3.5 percent to 4 percent for 20X1 and 20X0, respectively.

In 20X0, the organization received $650 for a capital campaign which must be returned if the organization does not receive $1,300 in donations to the capital campaign. The $650 received was recorded on the 20X0 statement of financial position as a refundable advance. In 20X1, the organization received $500 in cash donations and $865 in unconditional promises to give to this campaign. As a result, the $650 was recognized as temporarily restricted contributions in 20X1.

In addition, the organization received the following conditional promises to give that are not recognized as assets in the statements of financial position:

| | *20X1* | *20X0* |
|---|---|---|
| Conditional promise to give upon the establishment of a library program | $ 100 | $100 |
| Conditional promise to give upon obtaining $2,500 in unconditional promises to give to the capital campaign | 5,000 | |

[*The following disclosure is encouraged but not required.*]

The organization received an indication of an intention to give from an individual long-time donor. The anticipated gift is an extensive collection of pre-Columbian textiles with great historical and artistic significance. The value of this intended gift has not been established, nor has the gift been recognized as an asset or contribution revenue.

### Example 3—Accounting Policy for Contributed Property and Equipment

Note X: Summary of Significant Accounting Policies

Contributed property and equipment is recorded at fair value at the date of donation. In the absence of donor stipulations regarding how long the contributed assets must be used, the organization has adopted a policy of implying a time restriction on contributions of such assets that expires over the assets' useful lives. As a result, all contributions of property and equipment, and of assets contributed to acquire property and equipment, are recorded as restricted support.

*OR*

Contributed property and equipment is recorded at fair value at the date of donation. If donors stipulate how long the assets must be used, the contributions are recorded as restricted support. In the absence of such stipulations, contributions of property and equipment are recorded as unrestricted support.

### Example 4—Contributed Services

The organization recognizes contribution revenue for certain services received at the fair value of those services. Those services include the following items:

| | *20X1* | *20X0* |
|---|---|---|
| Home outreach program: | | |
| Salaries: | | |
| Social work interns—261 and 315 hours at $12.00 per hour | $3,132 | $3,780 |
| Registered nurse—200 and 220 hours at $15.00 per hour | 3,000 | 3,300 |
| Total salaries | 6,132 | 7,080 |
| Management and general: | | |
| Accounting services | 10,000 | 19,000 |
| Total contributed services | $16,132 | $26,080 |

In addition, approximately 80,000 hours, for which no value has been assigned, were volunteered by tutors in the home outreach program.

### Example 5—Beneficial Interest in Assets Held by Others

In 19XX, the organization transferred $1,000,000 from its investment portfolio to the Any Town Community Foundation to establish an endowment fund. Under the terms of the agreement, in the first quarter of each year, the organization receives a distribution equal to the investment return generated by the transferred assets during the prior year. The organization can withdraw

all or a portion of the original amount transferred, any appreciation on those transferred assets, or both, provided that a majority of the governing boards of the organization and the Foundation approve of the withdrawal. At the time of the transfer, the organization granted variance power to the Foundation. That power gives the Foundation the right to distribute the investment income to another not-for-profit organization of its choice if the organization ceases to exist or if the governing board of Any Town Community Foundation votes that support of the organization (*a*) is no longer necessary or (*b*) is inconsistent with the needs of the Any Town community. At June 30, 20X1, the endowment fund has a value of $1,234,567, which is reported in the statement of financial position as beneficial interest in assets held by others. (See paragraph 53 of FASB Statement No. 136.)

## Auditing

**5.82** Since for-profit organizations do not usually receive contributions or enter into agency transactions, the specific audit objectives, selected controls, and auditing procedures related to contributions, contributions receivable, and agency transactions are unique to not-for-profit organizations and are presented below.

**5.83** A not-for profit organization that receives a significant amount of contributions may have an increased risk of material misstatement if it does not have proper internal controls in place. Paragraph .54 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), states that obtaining an understanding of internal control involves evaluating the design of a control and determining whether it has been implemented. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing or detecting and correcting material misstatements. Implementation of a control means that the control exists and that the entity is using it. An improperly designed control may represent a significant deficiency or a material weakness in the entity's internal control and the auditor should consider whether to communicate this to those charged with governance and management.

**5.84** In order to have an effective system of internal control, a not-for-profit organization that receives significant amounts of contributions should have an internal control system that provides effective controls to assure that all contributions received are recorded and that suitable collection efforts are pursued for unconditional promises to give. The internal control system also should provide effective controls to assure that revenues arising from conditional promises to give are recognized when the conditions have been substantially met and that restrictions on contributions are recognized in the appropriate net asset class.

**5.85** Contributions received are measured at fair value. AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), addresses audit considerations relating to the measurement and disclosure of assets, liabilities and specific components of equity presented or disclosed at fair value in financial statements. Interpretation No. 1, "Auditing Interests in Trusts Held by a Third-Party Trustee and Reported at Fair Value" of AU section 328 (AICPA, *Professional Standards*, vol. 1, AU sec. 9328), provides guidance for auditing interests in trusts held by a third-party trustee. That interpretation is discussed further in paragraph 6.46.

**5.86** Paragraph .34 of AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1), states that "confirmation of accounts receivable is a generally accepted auditing procedure," and that there is a presumption that the auditor will request the confirmation of accounts receivable except under certain specified circumstances. That paragraph defines *accounts receivable* as "(*a*) the entity's claims against customers that have arisen from the sale of goods or services in the normal course of business, and (*b*) a financial institution's loans." Though under that definition contributions receivable are not accounts receivable to which that presumption would apply, the auditor may nevertheless decide to request confirmation of contributions receivable.

**5.87** Receivables are usually confirmed principally to provide evidence about the existence assertion. FASB Statement No. 116 specifies that for a promise to give to be recognized in financial statements, there must be sufficient evidence in the form of verifiable documentation that a promise was received. If the documentation is not present, an asset should not be recognized. The verifiable documentation required by FASB Statement No. 116 for recognition of promises to give may not be sufficient evidence concerning the existence assertion. Confirming recorded promises to give (contributions receivable) may provide additional evidence about the existence of promises to give, the existence or absence of restrictions, the existence or absence of conditions, and the periods over which the promises to give become due. If the auditor confirms promises to give, AU section 330 provides requirements and guidance concerning the confirmation process.

**5.88** The following table illustrates the use of assertions in developing audit objectives and designing substantive tests. The examples are not intended to be all-inclusive nor is it expected that all the procedures would necessarily be applied in an audit. The auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure to obtain sufficient appropriate audit evidence. The use of assertions in assessing risks and designing appropriate audit procedures to obtain audit evidence is described in paragraphs .14–.26 of AU section 326, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1). Various audit procedures and the purposes for which they may be performed are described in paragraphs .27–.41 of AU section 326.

## Auditing Considerations

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| | | ***Transactions*** | |
| *Contributed Revenues* | | | |
| Occurrence | Amounts recognized as contribution revenues represent valid unconditional contributions. | Controls ensure that only unconditional contributions are recognized in the financial statements. | Examine documentation supporting recognition of contribution revenues noting information such as absence of conditions. |

**Auditing Considerations—continued**

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| | ***Transactions—continued*** | | |
| Completeness | All unconditional contributions are recognized. | Controls ensure that all unconditional contributions are recognized in the financial statements. Controls ensure that revenue is recognized when the conditions on conditional promises to give have been substantially met. | Select from data accumulated and maintained by the fund-raising function, determine whether a contribution should have been recognized and, if so, vouch it to a recognized contribution, investigating reconciling items. |
| Valuation and Allocation | Contribution revenues are appropriately valued. | Controls ensure the appropriate valuation of contribution revenue at the time of initial recognition. | Review and test the methods and assumptions used to measure contribution revenue at the time of initial recognition. |
| Cut-off | Contributions are reported in the period in which they were given. | Controls assure that contributions occurring near fiscal period end are recorded in the proper period. | Examine contributions reported before and after fiscal period end to determine if they are reported in the appropriate period. |
| *Contributed Services, Utilities, Facilities, and Use of Long-Lived Assets* | | | |
| Occurrence completeness; valuation and allocation | Assets, expenses, and revenues from contributed services, utilities, facilities, and use of long-lived assets meet the appropriate recognition criteria; all such contributions that meet the recognition criteria are recognized and appropriately measured. | Controls ensure that only contributed services, utilities, facilities, and use of long-lived assets that meet the appropriate recognition criteria are recognized; controls ensure that all such contributions that meet the recognition criteria are recognized and appropriately measured. | Review the documentation underlying recognition of contributed services, utilities, facilities, and use of long-lived assets for completeness and propriety of amounts recognized. |

*(continued)*

**Auditing Considerations—continued**

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| | | ***Account Balances*** | |
| *Contributions Receivable* | | | |
| Occurrence | Amounts recognized as contributions receivable represent valid unconditional promises to give. | Controls ensure that only unconditional promises to give are recognized in the financial statements. | Examine documentation supporting recognition of promises to give, noting information such as absence of conditions and the periods over which the promises to give become due. |
| Completeness | All unconditional promises to give are recognized. | Controls ensure that all unconditional promises to give are recognized in the financial statements. Controls ensure that conditional promises to give are recognized when the conditions have been substantially met. | Compare detail of contributions receivable with data accumulated and maintained by the fund-raising function and investigate reconciling items. |
| Valuation and Allocation | Contributions receivable are appropriately valued. | Controls ensure the appropriate valuation of promises to give at the time of initial recognition. | Review and test the methods and assumptions used to measure promises to give at the time of initial recognition. |
| | | The valuation of promises to give is periodically reviewed by management. | Review promises to give for collectibility, and, if appropriate, changes in fair value of the underlying asset. |
| | | Writeoffs of uncollectible promises to give are identified and approved in accordance with the entity's established policy. | |

## Auditing Considerations—continued

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| | | ***Account Balances—continued*** | |
| *Agency Transactions* | | | |
| Occurrence and Completeness | Assets and liabilities from agency transactions meet the criteria for classification and recognition as agency transactions. | Controls ensure that (1) only resources received and paid in agency transactions are recognized as agency transactions and (2) all such transactions are recognized. | Review the documentation underlying the receipt of assets from resource providers for propriety of classification and recognition as resources that are to be transferred to others. |
| | All agency transactions are recognized. | | Review the documentation underlying the distribution of assets to others for propriety of classification and recognition. |
| | | | Review the historical patterns of the distribution of gifts in kind and other assets to determine the extent of the organization's discretion over those distributions. |
| | | ***Presentation and Disclosures*** | |
| *Contribution Revenues and Contributions Receivable* | | | |
| Classification and understandability | Restricted contributions are reported in the proper net asset class. | Contributions are reviewed for restrictions and other limitations. | Review the documentation underlying contributions and promises to give (including donor correspondence and governing board minutes) for propriety of classification. |
| | Disclosures related to contributions are clear and understandable. | Controls ensure that contributions are appropriately presented and disclosed. | Determine the appropriateness of disclosures for conditional and unconditional promises to give. |

*(continued)*

**Auditing Considerations—continued**

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| | ***Presentation and Disclosures—continued*** | | |
| *Agency Transactions* | | | |
| Rights and obligations | Agency transactions are not included in reported amounts of contributions. | Controls ensure that agency transactions are identified and are not included in contribution totals. | Determine whether agency transactions are excluded from the statement of activities. If they are not, determine that agency transactions are reported as described in paragraph 109 of FASB Statement No. 136. |

# Chapter 6

# *Split-Interest Agreements*

## Introduction

**6.01** Some donors enter into trust or other arrangements under which not-for-profit organizations (NPOs) receive benefits that are shared with other beneficiaries. Recognition and measurement principles for these arrangements, commonly known as *split-interest agreements*, are discussed in this chapter.[1] The application of these principles to five widely used types of such agreements—charitable lead trusts, perpetual trusts held by third parties,[2] charitable remainder trusts, charitable gift annuities, and pooled (life) income funds—is also illustrated.

## Types of Split-Interest Agreements

**6.02** Under a split-interest agreement, a donor makes an initial gift to a trust or directly to the NPO in which the NPO has a beneficial interest but is not the sole beneficiary. The terms of some agreements do not allow donors to revoke their gifts; other agreements may be revocable by donors in certain situations. The time period covered by the agreement is expressed either as a specific number of years (or in perpetuity) or as the remaining life of an individual or individuals designated by the donor. The assets are invested and administered by the organization, a trustee, or a fiscal agent, and distributions are made to a beneficiary or beneficiaries during the term of the agreement. At the end of the agreement's term, the remaining assets covered by the agreement are distributed to or retained by either the NPO or another beneficiary or beneficiaries.

**6.03** Under some kinds of agreements, referred to in this guide as *lead interests*, the NPO receives the distributions during the agreement's term. In other kinds of agreements, referred to as *remainder interests*, the donor (or other individuals or organizations designated by the donor) receives those distributions and the NPO receives all or a portion of the assets remaining at the end of the agreement's term. Under either kind of agreement, donors may impose restrictions on the NPO's use of all or a portion of any assets received.

---

[1] This footnote, which previously had been added to this guide as a conforming change to reflect the provisions of Financial Accounting Standards Board (FASB) Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, has been deleted. The guidance provided in the deleted footnote, while not inconsistent with Statement No. 136, is not included in Statement No. 136 and therefore should not have been added to this guide as a conforming change. The text of the deleted footnote was as follows: "In some circumstances, the not-for-profit organization (NPO) that serves as trustee or fiscal agent for a split-interest agreement and the not-for-profit beneficiary are financially interrelated. (Paragraphs 5.15–.17 discuss the characteristics of financially interrelated organizations.) In those circumstances, the not-for-profit trustee or fiscal agent should follow the recognition and measurement guidance in this chapter as if it were both trustee and charitable beneficiary. A not-for-profit beneficiary that is not also trustee should follow the guidance in paragraph 5.12 for recognizing its interest in the split-interest agreement."

[2] Though perpetual trusts held by third parties may not meet the definition of a split-interest agreement because the NPO may be the sole beneficiary, they are included in this chapter because they present some of the same accounting issues as do split-interest agreements.

## Recognition and Measurement Principles

**6.04** NPOs should report irrevocable split-interest agreements. Assets received under those agreements should be recorded at their fair value when received.[3] Assets held under such agreements as investments should be reported in conformity with the guidance in chapter 8, "Investments," of this guide. The contribution portion of an agreement (that is, the part that represents the unconditional transfer of assets in a voluntary nonreciprocal transaction) should be recognized as revenue or gain.[4] Liabilities incurred in the exchange portion of an agreement (usually an agreement to pay an annuity to the donor) should also be recognized.

**6.05** In the absence of donor-imposed conditions, NPOs should recognize contribution revenue and related assets and liabilities when irrevocable split-interest agreements naming them trustee or fiscal agent are executed. If an unrelated third party (for example, a bank, trust company, or private individual) acts as trustee or fiscal agent, a contribution should be recognized when the NPO is notified of the agreement's existence. However, if the third party has variance power to redirect the benefits to another organization or if the NPO's rights to the benefits are conditional, the NPO should not recognize its potential for future distributions from the asset held by the recipient organization.[5] (See paragraphs 12, 16, and 85 of Financial Accounting Standards Board (FASB) Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*.) Contribution revenue should not be recognized under such agreements until the organization has an unconditional right to receive benefits under the agreement.

## Recognition of Revocable Agreements

**6.06** Revocable split-interest agreements should be accounted for as intentions to give. Assets received by NPOs acting as a trustee under revocable split-interest agreements should be recognized at fair value when received and as refundable advances. (Contribution revenue for the assets received should be recognized when the agreements become irrevocable or when the assets are distributed to the NPO for its unconditional use, whichever occurs first.) Assets held under such agreements as investments should be reported in conformity with the guidance in chapter 8. Income earned on assets held under such agreements that is not available for the organization's unconditional use, and any subsequent adjustments to the carrying value of those assets, should be recognized as adjustments to the assets and as refundable advances.

---

[3] Some split-interest agreements include promises to give noncash assets, such as homes. Paragraph 5.65 of this guide includes guidance concerning determining the fair value of unconditional promises to give noncash assets.

[4] As discussed in footnote 1 to chapter 5, "Contributions Received and Agency Transactions," of this guide, contributions may be reported as revenues or gains, depending on whether they are part of the organization's ongoing major activities or are peripheral or incidental transactions. For purposes of this chapter, the term *contribution revenue* is used to apply to either situation.

[5] As noted in paragraph 9, FASB Statement No. 136 establishes standards for a beneficiary's reporting of assets held in trust, but it does not establish standards for a trustee's reporting of those assets. Paragraphs 5.05–.21 of this guide discuss the requirements of FASB Statement No. 136.

## Initial Recognition of Unconditional Irrevocable Agreements

**6.07** At the date of initial recognition of a split-interest agreement, contributions should be measured at fair value. Present value techniques are one valuation technique for measuring fair value; other valuation techniques are also available, as described in FASB Statement No. 157, *Fair Value Measurements*.[6] The following should be considered in applying present value techniques when estimating the fair value of split-interest agreements. Under a lead interest agreement, the fair value of the contribution can be estimated directly based on the present value of the future distributions to be received by the NPO as a beneficiary. Under a remainder interest agreement, future distributions will be received by the NPO only after obligations to other beneficiaries are satisfied. In those cases, the fair value of the contribution may be estimated based on the fair value of the assets contributed by the donor less the fair value of the payments to be made to other beneficiaries. Any present value technique for measuring the fair value of the contribution or payments to be made to other beneficiaries must consider the elements described in paragraph 3.35 of this guide, including (*a*) the estimated return on the invested assets during the expected term of the agreement, (*b*) the contractual payment obligations under the agreement, and (*c*) a discount rate commensurate with the risks involved.[7] The discount rate should be determined at the time the contribution is initially recognized and should not be revised subsequently, in conformity with paragraph 12 of Accounting Principles Board Opinion No. 21, *Interest on Receivables and Payables*, unless the measurement objective for periods subsequent to the period of initial recognition is fair value.[8]

**6.08** Contribution revenues recognized under split-interest agreements should be classified as increases in temporarily restricted net assets unless the donor has permanently restricted the organization's use of its interest (lead or remainder) in the assets or the donor gives the organization the immediate right to use without restrictions the assets it receives.[9] If the donor has permanently restricted the organization's use of its interest, the contribution should be classified as an increase in permanently restricted net assets. If the organization has the immediate right to use its interest without restrictions, the contribution should be classified as increases in unrestricted net assets.

---

[6] This guide discusses present value techniques as one possible valuation technique to measure the contribution revenue and obligation to other beneficiaries of a split-interest agreement. Paragraphs 3.24–.43 of this guide discuss FASB Statement No. 157, *Fair Value Measurements*, which defines *fair value*, establishes a framework for measuring fair value and expands disclosures about fair value measurements. Appendix B of FASB Statement No. 157 provides standards for using present value techniques when the measurement objective is fair value. FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year or its interim periods. However, FASB Staff Position (FSP) FAS 157-2, *Effective Date of FASB Statement No. 157*, delays the effective date of FASB Statement No. 157 until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for fair value measurements of all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). See footnote † to paragraph 3.25 for more information about the types of assets and liabilities to which the deferral applies.

[7] Reference to IRS guidelines and actuarial tables used in calculating the donor's charitable deduction for income tax purposes may be helpful in assessing the reasonableness of the method used for measuring fair value.

[8] Paragraphs 6.12–.16 discuss the circumstances in which the measurement objective for periods subsequent to the period of initial recognition is fair value.

[9] Under many charitable gift annuity agreements, the assets received from the donor are held by the NPO as part of its general assets and are available for its unrestricted use.

**6.09** When the NPO serves as trustee or when the assets contributed by the donor are otherwise under the control of the NPO, present value techniques are one valuation technique for measuring the fair value of the contribution; other valuation techniques also are also available, as described in FASB Statement No. 157.[10] When the NPO serves as trustee or when the assets contributed by the donor are otherwise under the control of the NPO, cash and other assets received under split-interest agreements should be recognized at fair value at the date of initial recognition. If those assets, or a portion of those assets, are being held for the benefit of others, such as the donor or third parties designated by the donor, a liability, measured at fair value, should also be recognized at the date of initial recognition.[11,12] If present value techniques are used to measure fair value, the liability generally is measured at the present value of the future payments to be made to the other beneficiaries. In some cases, such as under remainder interest agreements, the present value of the future payments to be made to other beneficiaries can be estimated directly based on the terms of the agreement. In other cases, such as under lead interest agreements, the future payments will be made by the NPO only after the organization receives its benefits. In those situations, the present value of the future payments to be made to other beneficiaries may be estimated by the fair value of the assets contributed by the donor under the agreement less the fair value of the benefits to be received by the NPO. If present value techniques are used, the fair value of the benefits to be received by the NPO should be measured at the present value of the benefits to be received over the expected term of the agreement.

**6.10** In arrangements in which cash or other assets contributed by donors under split-interest agreements are held by independent trustees, such as a charitable trust for which a bank is a trustee, or by other fiscal agents of the donors or are otherwise not controlled by the NPO, the NPO should recognize its beneficial interest in those assets. If the NPO (beneficiary) has an unconditional right to receive all or a portion of the specified cash flows from a charitable trust (or other identifiable pool of assets), contribution revenue and the beneficial interest in the trust should be measured at fair value (see paragraph 15 of FASB Statement No. 136). Present value techniques are one valuation technique for measuring the fair value of the contribution and the beneficial interest; other valuation techniques are also available, as described in FASB Statement No. 157.[13] If present value techniques are used, the contribution revenue and the beneficial interest in the trust should be measured at the present value of the future distributions expected to be received over the term of the agreement.

---

[10] See footnote 6.

[11] Additional annuity reserves may be required by the laws of the state where the NPO is located or by the state where the donor resides. Legally mandated reserves should be disclosed in the notes to the financial statements. In addition, some NPOs voluntarily set aside additional reserves as a cushion against unexpected actuarial losses. Voluntary reserves should be included as part of unrestricted net assets, but may be disclosed as a separate component, such as board-designated unrestricted net assets (see chapter 11, "Net Assets," of this guide).

[12] In April 2002, the FASB's Derivatives Implementation Group issued Implementation Issue No. B35, *Embedded Derivatives: Application of Statement 133 to a Not-for-Profit Organization's Obligation Arising from an Irrevocable Split-Interest Agreement*. The implementation guidance requires that the liability for remainder unitrusts with either period-certain payments or period-certain-plus-life-contingent payments and certain lead interest trusts be bifurcated into a debt host contract and an embedded derivative that is measured at fair value. Paragraphs 6.12–.16 discuss subsequent measurement of the obligations under split-interest agreements, including measurement of embedded derivatives.

[13] See footnote 6.

## Recognition During the Agreement's Term

**6.11** During the term of the agreement, certain transactions and events should be recognized as changes in the value of split-interest agreements in a statement of activities and classified as temporarily restricted, permanently restricted, or unrestricted net assets, depending on the classification used when the contribution revenue was recognized initially.

**6.12** In circumstances in which cash or other assets contributed by donors under split-interest agreements are held by independent trustees, such as a charitable trust for which a bank is a trustee, or by other fiscal agents of the donors or otherwise not controlled by the NPO, the measurement objective for periods subsequent to the period of initial recognition is fair value. The change in the value of split-interest agreements should be the change in the fair value of the organization's beneficial interest, which should be determined using the same valuation technique that was used to measure the asset initially. Accordingly, in circumstances in which the fair value is measured at the present value of the future cash flows, all elements discussed in paragraph 3.35 of this guide, including discount rate assumptions should be revised at each measurement date to reflect current market conditions.

**6.13** In circumstances in which assets held in trust and related liabilities are recognized under lead and remainder interest agreements for which an NPO serves as a trustee or fiscal agent, the liability for future payments to be made to other beneficiaries is measured at fair value if the organization elects the fair value option pursuant to FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*.* If the organization does not elect the fair value option, the following transactions and events should be included in the measurement of the liability: (*a*) amortization of the discount associated with the contribution and (*b*) revaluations of future payments to beneficiaries, based on changes in life expectancy, and other actuarial assumptions.

**6.14** In circumstances in which the NPO serves as a trustee or fiscal agent and present value techniques are used to measure the liability, the discount rate should not be revised subsequent to initial recognition, consistent with paragraphs 5.67 and 6.07 of this guide, unless the measurement objective is fair value. The measurement objective is fair value for (*a*) embedded derivatives subject to the measurement provisions of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, (*b*) obligations for which the organization elects the fair value option pursuant to FASB Statement No. 159,* and (*c*) obligations containing embedded derivatives that the organization has irrevocably elected to measure in their entirety at fair value in conformity with FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*. A hybrid instrument is a financial instrument that contains an embedded derivative.

**6.15** FASB's Derivatives Implementation Group Issue No. B35, *Embedded Derivatives: Application of Statement 133 to a Not-for-Profit Organization's*

* As discussed in paragraphs 3.44–.46 of this guide, FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*, permits an organization to irrevocably elect fair value as the initial and subsequent measure for certain financial liabilities with changes in fair value recognized in the statement of activities as those changes occur. FASB Statement No. 159 is effective as of the beginning of the first fiscal year that begins after November 15, 2007. Earlier adoption is permitted if certain conditions described in paragraph 30 of the statement are met.

*Obligation Arising From an Irrevocable Split-Interest Agreement* (appendix B [paragraph 6.48] of this chapter) explains that the obligation for certain split-interest agreements contain embedded derivatives. Specifically, the implementation guidance requires that the liability for remainder unitrusts with either period-certain payments or period-certain-plus-life-contingent payments and certain lead interest trusts be bifurcated into a debt host contract and an embedded derivative that is measured at fair value. (Paragraph 6.16 discusses alternative treatments for reporting split-interest agreements that contain embedded derivatives.) The debt host is the liability for the payment to the beneficiary that would be required if the fair value of the trust assets does not change over the specified period. The embedded derivative represents the liability (or contra-liability) for the increase (or decrease) in the payments to the beneficiary due to changes in the fair value of the trust assets over the specified period. Thus, in circumstances in which the liability is measured using present value techniques, the discount rate assumptions on the debt host should not be revised subsequent to initial recognition, consistent with paragraphs 5.67 and 6.07 of this guide. If the fair value of the embedded derivative is measured using present value techniques, all elements discussed in paragraph 3.35 of this guide, including the discount rate assumptions on the embedded derivative should be revised at each measurement date to reflect current market conditions. In conformity with paragraph 16 of FASB Statement No. 133, if an organization cannot reliably identify and measure the embedded derivative, the entire split-interest liability should be measured at fair value (that is, all elements discussed in paragraph 3.35 of this guide, including discount rate assumptions, should be revised to reflect current market conditions).

**6.16** Alternatively, an organization that serves as a trustee or fiscal agent can irrevocably elect to subsequently measure the obligation for future payments to be made to other beneficiaries at fair value pursuant to FASB Statement No. 159, or if the obligation contains an embedded derivative, at fair value in conformity with FASB Statement No. 155. The election may be made on an instrument-by-instrument basis, for elections made pursuant to FASB Statement No. 155, and should be supported by concurrent documentation or a preexisting documented policy for automatic election. If an organization elects to measure the obligation for future payments to be made to other beneficiaries at fair value, the entire liability should be remeasured at fair value (that is, if the fair value is measured using a present value technique, all the elements discussed in paragraph 3.35 of this guide, including the discount rate assumptions for the entire obligation should be revised at each measurement date to reflect current market conditions).[14]

**6.17** In addition, when assets held in trust and related liabilities are recognized under lead and remainder interest agreements for which an NPO serves as a trustee or fiscal agent, income earned on those assets, gains and losses, and distributions made to other beneficiaries under the agreements should be reported in the organization's statements of financial position, activities, and cash flows.

---

[14] Paragraphs 3.44–.46 of this guide provide additional information about FASB Statements No. 159 and No. 155. FASB Statement No. 159 is effective as of the beginning of the first fiscal year that begins after November 15, 2007. Earlier adoption is permitted if certain conditions described in paragraph 30 of the statement are met. A copy of FASB's Derivatives Implementation Group Issue No. B35 and further discussion of FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*, is included in this guide as appendix B [paragraph 6.48] to this chapter.

**6.18** Amounts should be reclassified from temporarily restricted net assets to unrestricted net assets as distributions are received by NPOs under the terms of split-interest agreements, unless those assets are otherwise temporarily restricted by the donor. In that case, they should be reclassified to unrestricted net assets when the restrictions expire.

### Recognition Upon Termination of Agreement

**6.19** Upon termination of a split-interest agreement, asset and liability accounts related to the agreement should be closed. Any remaining amounts in the asset or liability accounts should be recognized as changes in the value of split-interest agreements and classified as changes in permanently restricted, temporarily restricted, or unrestricted net assets, as appropriate. If assets previously distributed to the NPO become available for its unrestricted use upon termination of the agreement, appropriate amounts should be reclassified from temporarily restricted to unrestricted net assets.

## Financial Statement Presentation

**6.20** Assets and liabilities recognized under split-interest agreements should be disclosed separately from other assets and liabilities in a statement of financial position or in the related notes. Contribution revenue and changes in the value of split-interest agreements recognized under such agreements should also be disclosed as separate line items in a statement of activities or in the related notes. The notes to the financial statements should include the following disclosures related to split-interest agreements:

- A description of the general terms of existing split-interest agreements
- The basis used (for example, cost, lower of cost or market, fair market value) for recognized assets
- The discount rates and actuarial assumptions used, if present values techniques are used in reporting the assets and liabilities related to split-interest agreements
- The disclosures required by FASB Statement Nos. 155 and No. 159, if an organization elects the fair option pursuant to FASB Statements No. 155 or No. 159
- The disclosures required by paragraph 32 of FASB Statement No. 157 in the format described in paragraph 34 of that statement, if the asset and liabilities of split-interest agreements are measured at fair value on a recurring basis in periods subsequent to initial recognition

## Examples of Split-Interest Agreements

**6.21** Many kinds of split-interest agreements have been developed. The examples in this section demonstrate how the recognition and measurement principles discussed in this chapter apply to some common kinds of agreements.

Appendix A [paragraph 6.47] to this chapter provides journal entries related to these examples.

## Charitable Lead Trust

**6.22** A charitable lead trust is an arrangement in which a donor establishes and funds a trust with specific distributions to be made to a designated NPO over a specified period. The organization's use of the assets distributed may be restricted by the donor. The distributions may be for a fixed dollar amount, an arrangement called a charitable lead annuity trust, or for a fixed percentage of the trust's fair market value as determined annually, a charitable lead unitrust. Upon termination of the trust, the remainder of the trust assets is paid to the donor or to the beneficiaries designated by the donor.

**6.23** For example, NPO A receives cash from a donor under an irrevocable charitable lead annuity trust agreement designating the organization as trustee and lead beneficiary. Under the terms of the trust, organization A will invest the assets and receive a specified dollar amount each year for its unrestricted use until the death of the donor. At that time, the remaining assets in the trust revert to the donor's estate.

**6.24** Contribution revenue, assets held in trust, and a liability for amounts held for others should be recognized by organization A in the period in which the trust is established. Revenue should be reported as temporarily restricted support and measured at fair value. The present value of the specified dollar amount to be received annually over the expected life of the donor is one possible technique to measure the fair value of the contribution; other valuation techniques are also available (as described in FASB Statement No. 157).[15] The assets held in trust by organization A should be recorded at fair value at the date of initial recognition. The difference between the fair value of the assets received and the contribution revenue represents the present value of the liability to pay the donor's estate upon the termination of the trust.

**6.25** In subsequent periods, both the income earned on the trust assets and recognized gains and losses should be reflected in the trust asset and liability accounts. Adjustments of the liability to reflect amortization of the discount and revaluations of the future cash flows based on revisions in the donor's life expectancy should be recognized as changes in the value of split-interest agreements and classified as changes in temporarily restricted net assets in a statement of activities. Amounts should be reclassified from temporarily restricted to unrestricted net assets as the annual distributions to organization A are made and recognized during the term of the trust. Upon the death of the donor, the assets are distributed to the donor's estate, the asset and liability accounts are closed, and any difference between the balances in those accounts should be recognized as a change in the value of split-interest agreements in the temporarily restricted net asset class. (In this example, the timing of the distribution of the remainder interest to the beneficiary was dependent on the donor's death. If instead the distribution were required to be paid at the end of a specified period, the liability to the beneficiary would have contained an embedded derivative as described in FASB's Derivatives Implementation Group Issue

---

[15] See footnote 6.

No. B35. Paragraphs 6.14–.16 discuss measuring an obligation that contains an embedded derivative.)

**6.26** If organization A is not the trustee and does not exercise control over the trust's assets, it should recognize its beneficial interest in those assets as temporarily restricted contribution revenue and as a beneficial interest, measured at fair value as discussed in paragraph 6.10. Distributions from the trust should be reflected as a reduction in the beneficial interest and as reclassifications from temporarily restricted net assets to unrestricted net assets. Changes in the fair value of the beneficial interest should be recognized as adjustments to the beneficial interest in the statement of financial position and as changes in the value of split-interest agreements in the statement of activities in the temporarily restricted net asset class. If present value techniques are used to estimate fair value, those changes would reflect the revision of all elements discussed in paragraph 3.35 of this guide, including the passage of time, revaluations of expected future cash flows based on revisions in the donor's life expectancy, and discount rate assumptions to reflect current market conditions. Any balance in the beneficial interest account remaining upon termination of the trust should be recognized as a change in the value of split-interest agreements in the statement of activities in the temporarily restricted net asset class.

## Perpetual Trust Held by a Third Party

**6.27** A perpetual trust held by a third party is an arrangement in which a donor establishes and funds a perpetual trust administered by an individual or organization other than the NPO's beneficiary.[16] Under the terms of the trust, the NPO has the irrevocable right to receive the income earned on the trust assets in perpetuity, but never receives the assets held in trust. Distributions received by the organization may be restricted by the donor.

**6.28** For example, a donor establishes a trust with the donor's bank serving as trustee. Funds contributed to the trust are to be invested in perpetuity. Under the terms of the trust, NPO B is to be the sole beneficiary and is to receive annually the income on the trust's assets as earned in perpetuity. Organization B can use the distributions from the trust in any way that is consistent with its mission.

**6.29** The arrangement should be recognized by organization B as contribution revenue and as an asset, measured at fair value, when the organization is notified of the trust's existence, as discussed in paragraph 6.10.[17] The contribution should be classified as permanently restricted support, because the trust is similar to donor restricted permanent endowment that the organization does not control, rather than a multiyear promise to give. Annual distributions from the trust are reported as investment income that increase unrestricted net assets. Periodically in conjunction with preparing its financial statements, the NPO should remeasure its beneficial interest at fair value, using the same valuation technique that was used to measure the asset initially. The adjustment

---

[16] Paragraphs 5.18–.21 provide guidance for transactions in which a perpetual trust held by a third party (trustee or other recipient organization) is established by an NPO for its own benefit or for the benefit of its affiliate.

[17] The fair value of the contribution generally can be measured using the fair value of the assets contributed to the trust, unless facts and circumstances indicate that the fair value of the beneficial interest differs from the fair value of the assets contributed to the trust.

should be recognized as permanently restricted gains or losses (see paragraph 15 of FASB Statement No. 136).

## Charitable Remainder Trust

**6.30** A charitable remainder trust is an arrangement in which a donor establishes and funds a trust with specified distributions to be made to a designated beneficiary or beneficiaries over the trust's term. Upon termination of the trust, an NPO receives the assets remaining in the trust. The NPO may ultimately have unrestricted use of those assets, or the donor may place permanent or temporary restrictions on their use. The distributions to the beneficiaries may be for a specified dollar amount, an arrangement called a charitable remainder annuity trust, or for a specified percentage of the trust's fair market value as determined annually, a charitable remainder unitrust. Some charitable remainder unitrusts limit the annual payout to the lesser of the stated percentage or the actual income earned. Obligations to the beneficiaries are limited to the trust's assets.

**6.31** For example, a donor establishes a charitable remainder unitrust, with NPO C serving as trustee. Under the trust's terms, the donor's spouse is to receive an annual distribution equal in value to a specified percentage of the fair market value of the trust's assets each year until the spouse dies. The income earned on the trust's assets must remain in the trust until the spouse dies. At that time, the remaining assets of the trust are to be distributed to organization C for use as a permanent endowment.

**6.32** Organization C should recognize the contribution in the period in which the trust is established. The assets held in trust by organization C and the liability to the donor's spouse should be recorded at fair value when received, as discussed in paragraph 6.09. If the liability is measured using present value techniques, the liability to the donor's spouse should be recorded at the present value of the future payments to be distributed over the spouse's expected life. The amount of the contribution is the difference between these amounts and should be classified as permanently restricted support.

**6.33** In subsequent periods, income earned on trust assets, recognized gains and losses, and distributions paid to the spouse should be reflected in the organization's statement of financial position. Adjustments to the liability to reflect amortization of the discount, revaluations of the present value of the estimated future payments to the spouse, and changes in actuarial assumptions should be recognized in a statement of activities as a change in the value of split-interest agreements in the permanently restricted net asset class. Upon the death of the spouse, the liability should be closed and any balance should be recognized as a change in the value of split-interest agreements in the statement of activities in the permanently restricted net asset class. (In this example, the period for which distributions were made to the beneficiary was dependent solely on the donor's death and the payment amounts varied based on the fair value of the unitrust assets. If instead the variable-amount distributions were required to be paid for a specified number of years—or for the greater of the donor's life or a specified number of years, the liability to the beneficiary would have contained an embedded derivative as described in Derivatives Implementation Group Issue No. B35. Paragraphs 6.14–.16 discuss measuring an obligation that contains an embedded derivative.

**6.34** If organization C is not the trustee and does not exercise control over the assets contributed to the trust, the agreement should be recognized as a beneficial interest in a trust. Organization C should recognize, as permanently restricted contribution revenue and as a beneficial interest, the fair value of the beneficial interest, as discussed in paragraph 6.10. Adjustments to the beneficial interest to reflect changes in the fair value (see paragraph 15 of FASB Statement No. 136) should be measured using the same valuation technique as was used to measure the asset initially and recognized as changes in the value of split-interest agreements. For example, if present value techniques were used to estimate fair value, the adjustment would reflect the revision of all elements discussed in paragraph 3.35 of this guide, including the passage of time, revaluation of the present value of the future payments to the spouse, changes in actuarial assumptions during the term of the trust, and discount rates based on current market conditions. Upon the death of the spouse, the beneficial interest is closed, the assets received from the trust are recognized at fair value, and any difference is reported as a change in the value of split-interest agreements in permanently restricted net assets.

## Charitable Gift Annuity

**6.35** A charitable gift annuity is an arrangement between a donor and an NPO in which the donor contributes assets to the organization in exchange for a promise by the organization to pay a fixed amount for a specified period of time to the donor or to individuals or organizations designated by the donor. The agreements are similar to charitable remainder annuity trusts except that no trust exists, the assets received are held as general assets of the NPO, and the annuity liability is a general obligation of the organization.

**6.36** For example, NPO D and a donor enter into an arrangement whereby assets are transferred from the donor to organization D. Organization D agrees to pay a stated dollar amount annually to the donor's spouse until the spouse dies.

**6.37** Organization D should recognize the agreement in the period in which the contract is executed. The assets received should be recognized at fair value when received, and an annuity payment liability should be recognized at fair value as discussed in paragraph 6.09. Unrestricted[18] contribution revenue should be recognized as the difference between these two amounts.

**6.38** In subsequent periods, payments to the donor's spouse reduce the annuity liability. Adjustments to the annuity liability to reflect amortization of the discount and changes in the life expectancy of the donor's spouse should be recognized in a statement of activities as changes in the value of split-interest

---

[18] The contribution portion of a charitable gift annuity agreement should be recognized as unrestricted support if both (*a*) the donor does not restrict the use of the assets contributed to the organization and (*b*) neither the agreement nor state law requires the assets received by the NPO to be invested until the income beneficiary's death. If either of these situations exists, the contribution should be classified as restricted and should be reclassified if temporary restrictions or legal requirements are satisfied. If neither of these situations exist but state law imposes other limitations on the organization, such as limitations on the manner in which some net assets are invested, such limitations should be disclosed in the notes to the financial statements.

agreements in unrestricted net assets. Upon the death of the donor's spouse, the annuity liability should be closed and a change in the value of split-interest agreements should be recognized in the statement of activities.

## Pooled (Life) Income Fund

**6.39** Some NPOs form, invest, and manage pooled (or life) income funds.[19] These funds are divided into units, and contributions of many donors' life-income gifts are pooled and invested as a group. Donors are assigned a specific number of units based on the proportion of the fair value of their contributions to the total fair value of the pooled income fund on the date of the donor's entry to the pooled fund. Until a donor's death, the donor (or the donor's designated beneficiary or beneficiaries) is paid the actual income (as defined under the arrangement) earned on the donor's assigned units. Upon the donor's death, the value of these assigned units reverts to the NPO.

**6.40** For example, a donor contributes assets to NPO E's pooled (life) income fund and is assigned a specific number of units in the pool. The donor is to receive a life interest in any income earned on those units. Upon the donor's death, the value of the units is available to organization E for its unrestricted use.

**6.41** Organization E should recognize its remainder interest in the assets received as temporarily restricted contribution revenue in the period in which the assets are received from the donor. The contribution should be measured at fair value. Present value techniques are one valuation technique for measuring the fair value of the contribution; other valuation techniques are also available, as described in FASB Statement No. 157.[20] If present value techniques are used, the contribution may be measured at the fair value of the assets to be received, discounted for the estimated time period until the donor's death. The contributed assets should be recognized at fair value when received. The difference between the fair value of the assets when received and the revenue recognized should be recorded as deferred revenue, representing the amount of the discount for future interest.

**6.42** Periodic income on the fund and payments to the donor should be reflected as increases and decreases in a liability to the donor. Amortization of the discount should be recognized as a reduction in the deferred revenue account and as a change in the value of split-interest agreements and reported as a change in temporarily restricted net assets. Upon the donor's death, any remaining balance in the deferred revenue account should be closed and a change in the value of split-interest agreements should be recognized. A reclassification to unrestricted net assets is also necessary to record the satisfaction of the time restriction on temporarily restricted net assets.

# Auditing

**6.43** Since for-profit organizations do not usually enter into split-interest agreements, the specific audit objectives, selected controls, and auditing procedures related to such agreements are unique to NPOs and are presented in

---

[19] Net income unitrusts are similar to pooled life-income funds, because the corpus is maintained. Accordingly, financial reporting for net income unitrusts is similar to reporting for pooled life-income funds.

[20] See footnote 6.

the following paragraphs. (See also the discussion concerning confirming receivables in paragraphs 5.85–.86 of this guide.)

**6.44** Reporting split-interest agreements requires the organization to measure fair value of assets and liabilities. AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), addresses audit considerations relating to the measurement and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements.

**6.45** Auditing Interpretation No. 1, "Auditing Interests in Trusts Held by a Third-Party Trustee and Reported at Fair Value " of AU section 328 (AICPA, *Professional Standards*, vol. 1, AU sec. 9328), provides additional guidance for auditing interests in trusts held by a third-party trustee. It states that in circumstances in which the auditor determines that the nature and extent of auditing procedures should include verifying the existence and testing the measurement of investments held by a trust, simply receiving a confirmation from the trustee, either in aggregate or on an investment-by-investment basis, does not in and of itself constitute adequate audit evidence with respect to the requirements for auditing the fair value of the interest in the trust under AU section 328. In addition, receiving confirmation from the trustee for investments in aggregate does not constitute adequate audit evidence with respect to the existence assertion. Receiving confirmation from the trustee on an investment-by-investment basis, however, typically would constitute adequate audit evidence with respect to the existence assertion. In circumstances in which the auditor is unable to audit the existence or measurement of interests in trusts at the financial statement date, the auditor should consider whether that scope limitation requires the auditor to either qualify his or her opinion or to disclaim an opinion, as discussed in paragraphs .22–.26 of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1).

**6.46** The following table illustrates the use of assertions in developing audit objectives and designing substantive tests. The examples are not intended to be all-inclusive nor is it expected that all the procedures would necessarily be applied in an audit. The auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure to obtain sufficient appropriate audit evidence. The use of assertions in assessing risks and designing appropriate audit procedures to obtain audit evidence is described in paragraphs .14–.26 of AU section 326, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1). Various audit procedures and the purposes for which they may be performed are described in paragraphs .27–.41 of AU section 326.

## Auditing Considerations[†]

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| *Transactions* | | | |
| Occurrence | Amounts recognized as contribution revenues, resulting from split-interest agreements represent valid revenues. | Management authorizes split-interest agreements. | Review split-interest agreements and correspondence with donors or trustees. |
| Completeness | All unconditional split-interest agreements are recognized. | Controls ensure that split-interest agreements are known and recorded. | Review minutes of governing board and governing board committee meetings for evidence of split-interest agreements. |
| | All income received under split-interest agreements is recorded. | Management reviews income distribution terms of split-interest agreements and determines that periodic reports and remittances from trustees conform to those terms. Donor relations and fund-raising staff notify appropriate management upon death of beneficiaries. | Compare income distribution terms of split-interest agreements to periodic reports and remittances from trustees; trace periodic reports and remittances from trustees to cash receipts records. |
| Valuation and Allocation | Assets, liabilities, and revenues recognized at the inception of split-interest agreements are measured at fair value when received. Fair value is measured using appropriate measurement methods. | Documentation supports the determination of assets, liabilities, revenues, and changes in the value of split-interest agreements at the inception of the agreements. If the organization elects fair value measurements as described in FASB Statement No. 159 or FASB Statement No. 155, documentation supports the election. | Review documentation, including reports of actuaries, supporting the determination of fair value of assets, liabilities, and revenues. If present value techniques were used, review the techniques to determine if they meet the provisions of paragraphs B2 and B3 of FASB Statement No. 157. Review documentation supporting the present value of future present |

[†] As discussed in paragraphs 3.44–.46 of this guide, FASB Statement Nos. 159 and 155 permit an organization to irrevocably elect fair value as the initial and subsequent measure for certain financial assets and liabilities, with changes in fair value recognized in the statement of activities as those changes occur. FASB Statement No. 159 is effective as of the beginning of the first fiscal year that begins after November 15, 2007. Earlier adoption is permitted if certain conditions described in paragraph 30 of the statement are met.

## Auditing Considerations—continued

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| *Transactions—continued* | | | |
| | | | value of payments to be made to other beneficiaries at the inception of split-interest agreements and over their term (if that valuation technique is used); consider the need to apply provisions of AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), in conjunction with auditing any actuarial calculations. |
| Rights and Obligations | Restrictions on contributions arising from split-interest agreements have been met. | Split-interest agreements are reviewed for restrictions. | Review split-interest agreements and donor correspondence. |
| *Account Balances* | | | |
| Occurrence | Amounts recognized as (1) cash, investments, contributions receivable, and other assets held in trust under split-interest agreements, (2) beneficial interests in trusts held by others, and (3) liabilities for amounts held for others resulting from split-interest agreements represent valid revenues, assets, and liabilities. | Management authorizes split-interest agreements. | Review split-interest agreements and correspondence with donors or trustees. |
| | | Donor relations and fund-raising staff notify appropriate management upon death of beneficiaries. | Determine whether beneficiaries are still living if term of agreement is based on a beneficiary's life. |
| Completeness | All unconditional split-interest agreements are recognized. | Controls ensure that split-interest agreements are known and recorded. | Review minutes of governing board and governing board committee meetings for evidence of split-interest agreements. |
| | All income received under split-interest agreements is recorded. | Management reviews income distribution terms of split-interest agreements and determines that periodic reports and remittances from trustees conform to those terms. | Compare income distribution terms of split-interest agreements to periodic reports and remittances from trustees; trace periodic reports and remittances from trustees to cash receipts records. |

*(continued)*

**Auditing Considerations—continued**

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| Valuation and Allocation | Assets and liabilities are measured using appropriate measurement methods.<br><br>If present value techniques are used to measure the liability to other beneficiaries, amortization of the discount associated with the contribution and revaluations (based on changes in actuarial assumptions) of the liabilities to beneficiaries are recognized during the term of split-interest agreements.<br><br>(*a*) Beneficial interests in trusts held by others, (*b*) embedded derivatives subject to the measurement provisions of FASB Statement No. 133, and (*c*) assets and liabilities for which an election pursuant to FASB Statement 159 or FASB Statement 155 was made are remeasured at fair value and changes recognized during the term of split-interest agreements. | Documentation supports the determination of assets, liabilities, revenues, and changes in the value of split-interest agreements over the term of the agreements. If the organization elects fair value measurements as described in FASB Statement No. 159 or FASB Statement No. 155, documentation supports the election. | Review documentation, including reports of actuaries, supporting the determination of fair value of assets, and the calculation of liabilities, If present value techniques were used, review the techniques to determine if they meet the provisions of paragraphs B2 and B3 of FASB Statement No. 157. Review documentation supporting the present value of future present value of payments to be made to other beneficiaries at the inception of split-interest agreements and over their term (if that valuation technique is used); consider the need to apply provisions of AU section 336 in conjunction with auditing any actuarial calculations. |
| | Restrictions on contributions arising from split-interest agreements have been met. | Split-interest agreements are reviewed for restrictions. | Review split-interest agreements and donor correspondence. |
| *Presentation and Disclosure* | | | |
| Rights and Obligations | Restrictions on contributions arising from split-interest agreements have been met. | Split-interest agreements are reviewed for restrictions. | Review split-interest agreements and donor correspondence. |

## Auditing Considerations—continued

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| *Presentation and Disclosure—continued* | | | |
| | Contribution revenues recognized under split-interest agreements are reported in the proper net asset class. | | Determine that appropriate reclassifications are made on the statement of activities as assets are distributed to the organization, upon death of beneficiaries, or as restrictions otherwise expire. |
| | Contribution revenues and changes in the value of split-interest agreements that are recognized during the term of split-interest agreements are reported in the proper net asset class. | | |
| | Temporarily restricted net assets are reclassified as unrestricted net assets as restrictions expire. | | |

6.47

## Appendix A—Journal Entries

**1.** This appendix provides journal entries related to the examples in paragraphs 6.21–.42.

**2.** ***Charitable Lead Trust (not-for-profit organization is trustee)*** (paragraphs 6.22–.25)

Not-for-profit organization (NPO) A enters into an irrevocable charitable lead annuity trust arrangement with a donor whereby

- the donor establishes a trust with NPO A serving as trustee.
- the terms of the trust are that NPO A is to receive an annuity of $X per year until the donor's death.
- distributions received from the trust by NPO A are unrestricted.
- upon the death of the donor, the remaining balance in the trust passes to the donor's estate.

*Solution:*

Creation of the trust:

dr. Assets Held in Charitable Lead Trust

cr. Liability for Amounts Held for Others

cr. Contribution Revenue—Temporarily Restricted

(Assets and revenue measured at fair value when received, as discussed in paragraph 6.24)

Over the term of the trust:

dr. Assets Held in Charitable Lead Trust

cr. Liability for Amounts Held for Others

(Trust income and changes in fair value of assets held in trust, to the extent recognized)

dr. Cash

cr. Assets Held in Charitable Lead Trust

(Distribution of income to NPO)

dr. Temporarily Restricted Net Assets—Reclassifications Out

cr. Unrestricted Net Assets—Reclassifications In

(Reclassification of amounts received by NPO)

dr. Liability for Amounts Held for Others

cr. Change in Value of Split-Interest Agreements—Temporarily Restricted

(Amortization of discount and revaluation based on changes in actuarial assumptions—debit and credit could be reversed)

Termination of the trust:

dr. Liability for Amounts Held for Others

dr. Change in Value of Split-Interest Agreements—Temporarily Restricted (or cr.)

cr. Assets Held in Charitable Lead Trust

(Return of assets to donor's estate)

**3. *Charitable Lead Trust (NPO is not trustee)*** (paragraph 6.26)

The fact situation is the same as in the previous example except that the NPO is not the trustee.

<u>*Solution:*</u>

Creation of the trust:

dr. Beneficial Interest in Lead Trust

cr. Contribution Revenue—Temporarily Restricted

(Beneficial interest in trust assets measured at fair value, as discussed in paragraph 6.10)

Over the term of the trust:

dr. Cash

cr. Beneficial Interest in Lead Trust

(Distribution of income to NPO)

dr. Temporarily Restricted Net Assets—Reclassifications Out

cr. Unrestricted Net Assets—Reclassifications In

(Reclassification of amount received by NPO)

dr. Beneficial Interest in Lead Trust

cr. Change in Value of Split-Interest Agreements—Temporarily Restricted

(Change in fair value—debit and credit could be reversed)

Termination of the trust:

dr. Change in Value of Split-Interest Agreements—Temporarily Restricted

cr. Beneficial Interest in Lead Trust

(Closeout interest)

**4. *Perpetual Trust Held by a Third Party*** (paragraphs 6.27–.29)

Donor enters into an irrevocable perpetual trust agreement with a third-party trustee with NPO B as the income beneficiary whereby

- the donor establishes a trust with its bank serving as trustee, with a payment to the trust to be invested in perpetuity by the trustee.

- the terms of the trust are that NPO B is to be the sole beneficiary and receive the income on the trust assets as earned in perpetuity with no restrictions on its use.

*Solution:*

Creation of the trust:

dr. Beneficial Interest in Perpetual Trust

cr. Contribution Revenue—Permanently Restricted

(Assets and revenue measured at fair value, as discussed in paragraph 6.10 and in footnote 17 to paragraph 6.29)

Each period:

dr. Cash

cr. Investment Income (Unrestricted)

(Income received from trust [net asset class based on stipulations of the trust])

dr. Beneficial Interest in Perpetual Trust

cr. Gain or Loss—Permanently Restricted

(To adjust asset for changes in fair value—debit and credit could be reversed)

**5. *Charitable Remainder Trust (NPO is trustee)*** (paragraphs 6.30–.33)

NPO C enters into a charitable remainder unitrust agreement with a donor whereby:

- A trust is established by the donor to be administered by NPO C.
- The donor's spouse is to receive an annual distribution of X percent of the fair market value of the trust's assets each year until the spouse dies.
- At the time of death of the donor's spouse, the remaining assets of the trust are to be distributed to NPO C as permanent endowment.

*Solution:*

Creation of the trust:

dr. Assets Held in Charitable Remainder Trust

cr. Liability Under Unitrust Agreement

cr. Contribution Revenue—Permanently Restricted

(Assets and liability, as discussed in paragraph 6.09)

Over the term of the trust:

dr. Assets Held in Charitable Remainder Trust

cr. Liability Under Unitrust Agreement

(Trust income and change in fair value of assets held in trust, to the extent recognized)

dr. Liability Under Unitrust Agreement

cr. Assets Held in Charitable Remainder Trust

(Payment to beneficiary)

dr. Liability Under Unitrust Agreement

cr. Change in Value of Split-Interest Agreements—Permanently Restricted

(Amortization of discount and adjustment of liability to reflect change in actuarial assumptions—debit and credit could be reversed)

Termination of the trust:

dr. Liability Under Unitrust Agreement

cr. Change in Value of Split-Interest Agreements—Permanently Restricted

(To close liability)

dr. Endowment Assets

cr. Assets Held in Charitable Remainder Trust

(To close trust and recognize assets as endowment)

**6. *Charitable Remainder Trust (NPO is not trustee)*** (paragraph 6.34)

The fact situation is the same as in the previous example, except that the NPO does not serve as trustee.

Solution:

Creation of the trust:

dr. Beneficial Interest in Remainder Trust

cr. Contribution Revenue—Permanently Restricted

(Beneficial interest measured at fair value, as discussed in paragraph 6.10)

Over the term of the trust:

dr. Beneficial Interest in Remainder Trust

cr. Change in Value of Split-Interest Agreements—Permanently Restricted

(Change in fair value—debit and credit could be reversed)

Termination of the trust:

dr. Endowment Assets

cr. Beneficial Interest in Remainder Trust

cr. Change in Value of Split-Interest Agreements—Permanently Restricted

(NPO receives distribution of trust assets from trustee, measured at fair value; the receivable account is closed and the change in value of split-interest agreements reflects the difference)

**7. *Charitable Gift Annuity*** (paragraphs 6.35–.38)

NPO D enters into a charitable gift annuity contract with a donor whereby

- assets are transferred to NPO D and are available for unrestricted use by NPO D.
- NPO D agrees to pay a stated dollar amount annually to the donor's spouse until the spouse dies, at which time the remaining assets are available for the unrestricted use of NPO D.

<u>*Solution:*</u>

Creation of the annuity:

dr. Assets

cr. Annuity Payment Liability

cr. Contribution Revenue—Unrestricted

(Assets and liabilities are measured at fair value when received, as discussed in paragraph 6.09)

Over the term of the annuity:

dr. Annuity Payment Liability

cr. Cash

(Payment to annuity beneficiary)

dr. Change in Value of Split-Interest Agreements—Unrestricted

cr. Annuity Payment Liability

(Amortization of discount on liability and recording of any change in the life expectancy of the beneficiary—debit and credit could be reversed)

Termination of the annuity:

dr. Annuity Payment Liability

cr. Change in Value of Split-Interest Agreements—Unrestricted

(To close the annuity payment liability)

**8. *Pooled (Life) Income Fund*** (paragraphs 6.39–.42)

NPO E forms, invests, and manages a pooled income (or life-income) fund. The fund is divided into units, and contributions from many donors are pooled. Donors are assigned a specific number of units based on the proportion of the fair market value of the contribution to the total fair market value of the fund. A donor makes a contribution to the fund, is assigned a specific number of units, and will receive the actual income earned on those units until his or her death. The assets contributed must be invested in the fund until the donor's death. At that time, the value of the units assigned to the donor will revert to NPO E, and those assets will be available to NPO E without restriction.

<u>*Solution:*</u>

Contribution of assets:

dr. Assets of Pooled Income Fund

cr. Contribution Revenue—Temporarily Restricted

cr. Discount for Future Interest (Deferred Revenue)

(Assets and contribution revenue recorded at fair value on date of receipt, as discussed in paragraph 6.41)

Over the term of the agreement:

dr. Assets of Pooled Income Fund

cr. Liability to Life Beneficiary

(Income earned on units assigned to donor)

dr. Liability to Life Beneficiary

cr. Assets of Pooled Income Fund

(Payment to life beneficiary)

dr. Discount for Future Interest (Deferred Revenue)

cr. Change in Value of Split-Interest Agreements—Temporarily Restricted

(Amortization of discount and changes in the life expectancy of the beneficiary)

Termination of the agreement:

dr. Discount for Future Interest (Deferred Revenue)

cr. Change in Value of Split-Interest Agreement—Unrestricted

(To close discount upon the death of the life beneficiary)

dr. Cash or Investment Assets

cr. Assets of Pooled Income Fund

(To recognize assets available for use upon the death of the life beneficiary)

dr. Temporarily Restricted Net Assets—Reclassification Out

cr. Unrestricted Net Assets—Reclassification In

(Reclassification based on the expiration of the time restriction)

6.48

# Appendix B—Derivatives Implementation Group

**Issue No. B35**

| | |
|---|---|
| Title: | Embedded Derivatives: Application of Statement 133 to a Not-for-Profit Organization's Obligation Arising from an Irrevocable Split-Interest Agreement |
| Paragraph references: | 5, 10(c), 12 |
| Date cleared by Board: | April 9, 2002 |
| Date posted to website: | April 10, 2002 |
| Affected by: | FASB Statement No. 155, *Accounting for Certain Hybrid Instruments*, issued February 2006, FASB Statement No. 157, *Fair Value Measurements*[*] |

## Question

When does a not-for-profit (NFP) organization's obligation arising from an irrevocable split-interest agreement contain an embedded derivative instrument that should be bifurcated and accounted for as a derivative instrument pursuant to the requirements of paragraph 12 in Statement 133?

## Background

### General

Split-interest agreements are agreements in which donors enter into trusts or other arrangements under which NFP organizations receive benefits that are shared with other beneficiaries. A typical split-interest agreement has two components—a lead interest and a remainder interest. The lead interest is the right to the benefits (cash flows or use) of the transferred assets during the term of the agreement, which generally starts upon the signing of the agreement and terminates either (1) after a specified number of years (*period-certain*) or (2) upon the occurrence of a certain event, commonly either the death of the donor or the death of the lead interest beneficiary (*life-contingent*). The remainder interest is the right to receive all or a portion of the assets remaining at the end of the agreement's term.

Chapter 6 of the AICPA Audit and Accounting Guide, *Not-for-Profit Organizations* (NFP Guide), addresses the accounting for irrevocable split-interest agreements by NFP organizations. In an irrevocable split-interest agreement, the donor may give the NFP organization the right to control the contributed assets by either (1) naming them trustee of the trust holding the assets or (2)

---

[*] FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year or its interim periods. However, FSP FAS 157-2 delays the effective date of FASB Statement No. 157 until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for fair value measurements of all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). See footnote † to paragraph 3.25 for more information about the types of assets and liabilities to which the deferral applies.

granting them the right to hold the assets as general assets of their organization. In either case, the assets are recorded on the NFP organization's statement of financial position at their fair value when received. The NFP organization's obligation to make specified cash payments to a designated beneficiary or to convey the remaining assets to the donor or the donor's beneficiary is recognized as a liability[1] and measured based on the present value of the future expected payments to the beneficiary. Although the NFP organization's liability may coincidentally be equal to fair value, that liability is not measured at fair value under generally accepted accounting principles (GAAP) because the NFP Guide requires that the discount rate used in estimating the present value of future expected payments to the beneficiary be determined at the time the contribution is initially recognized and is not revised subsequently.

## Perceived Conflict with Statement 133

Paragraph 5 of Statement 133 indicates that its scope includes NFP organizations, but the Statement does not specifically address the application of its provisions to the accounting for NFP organizations' obligations arising from split-interest agreements. Nevertheless, Statement 133 could apply to certain liabilities of NFP organizations arising from split-interest agreements.

Paragraph 6 of Statement 133 specifies the characteristics that a contract must have to be considered a derivative instrument in its entirety under that Statement. Paragraph 12 addresses contracts that do not in their entirety meet the definition of a derivative instrument in paragraph 6 but may contain provisions that constitute an embedded derivative instrument that could warrant separate accounting. Paragraph 12 states, in part, that an embedded derivative instrument shall be separated from the host contract and accounted for as a derivative instrument if and only if all of the following criteria are met:

*a.* The economic characteristics and risks of the embedded derivative instrument are not clearly and closely related to the economic characteristics and risks of the host contract.

*b.* The contract ("the hybrid instrument") that embodies both the embedded derivative instrument and the host contract is not remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur.

*c.* A separate instrument with the same terms as the embedded derivative instrument would, pursuant to paragraphs 6-11, be a derivative instrument subject to the requirements of this Statement. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

The accounting for the liability in an irrevocable split-interest agreement under the NFP Guide could be in conflict with the accounting under Statement 133 if that liability contains an embedded derivative that meets the criteria in paragraph 12 of Statement 133 requiring separate accounting for that derivative.

---

[1] The use of the term *liability* in this Issue is consistent with the use of that term in the NFP Guide. This Issue does not address whether or not the obligation is a liability or a form of minority interest.

**Two General Types of Structures**

*General Structure of a Lead Trust for an NFP Organization:* Assets such as cash or shares of stock are contributed by the donor to the control of the NFP organization (either through the NFP organization's role as trustee of a trust holding the assets, or directly by the NFP organization holding the assets as general assets of their organization). The NFP organization receives periodic cash payments (the lead interest) that are either a fixed dollar amount or a specified percentage of the fair value of the assets as of the beginning of each period. (Note: Some of the assets may need to be liquidated in order to make the required payments.) At the termination of the agreement, the remaining assets revert to the donor or the donor's beneficiary (the remainder interest). During the term of the agreement, the NFP organization has a liability for the remainder interest. The NFP organization's liability for its obligation to the donor or the donor's beneficiary is based in part on the fair value of the assets.

*General Structure of a Remainder Trust for an NFP Organization:* Assets such as cash or shares of stock are contributed by the donor to the control of the NFP organization (either through the NFP organization's role as trustee of a trust holding the assets, or directly by the NFP organization holding the assets as general assets of their organization). The NFP organization (or the trust) makes periodic payments to the donor or the donor's beneficiary that are either a fixed dollar amount or a specified percentage of the fair value of the assets during the term of the agreement. (Some of the assets may need to be liquidated to make the payments.) At the termination of the agreement, the remaining assets revert to the NFP organization. During the term of the agreement, the NFP organization has a liability for the lead interest. If the lead interest payments to the donor or the donor's beneficiary are based on a specified percentage of the fair value of the assets, the NFP organization's liability for its obligation to the donor or the donor's beneficiary is based on the fair value of the contributed assets.

Two aspects of the split-interest agreement's payment terms for the lead interest—whether the payments are a fixed or variable cash amount and whether the agreement is period-certain or life-contingent—affect the accounting treatment for the NFP organization's liability for the payment or payments to the donor or the donor's beneficiary. Paragraph 10(c) of Statement 133 notes that, generally, contracts of the type that are within the scope of FASB Statements No. 60, *Accounting and Reporting by Insurance Enterprises,* No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments,* and No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts,* are not subject to the requirements of Statement 133, because payment of benefits is a result of an identified insurable event, such as the death of an identified individual (mortality risk). Paragraph 7 of Statement 97 indicates that mortality risk is present if, under the terms of an annuity contract, the enterprise is required to make payments contingent upon the continued survival of a specific individual or group of individuals.

## Response

The NFP organization's liability for its obligation to the donor or the donor's beneficiary under an irrevocable split-interest agreement should be analyzed to determine whether it qualifies for the exception in paragraph 10(c), in which case that liability would not be subject to the requirements of Statement 133. For example, if the obligation is solely life-contingent (that is, contingent upon

the survival of an identified individual, in which case the payments are made only if the individual is alive when the payments are due), that obligation would qualify for the exception in paragraph 10(c). That conclusion is consistent with the guidance to Question 4 in Statement 133 Implementation Issue No. B25, "Deferred Variable Annuity Contracts with Payment Alternatives at the End of the Accumulation Period." If the NFP organization's liability for its obligation under the split-interest agreement does not qualify for the exception in paragraph 10(c) because the agreement is not solely life-contingent, the NFP organization must determine whether that liability meets the definition of a derivative in its entirety under paragraph 6 or whether it contains an embedded derivative instrument that could warrant separate accounting under paragraph 12.

The NFP organization's liability for its obligation under a split-interest agreement would typically not meet the definition of a derivative instrument in its entirety because it would not meet the criterion in paragraph 6(*b*). That criterion requires the contract to have no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. In contrast, the initial net investment for the liability recognized for typical split-interest agreements is its fair value (generally measured at the present value of the estimated future payments). If the NFP organization's liability for its obligation under the split-interest agreement does not in its entirety meet the definition of a derivative instrument in paragraph 6, that liability must be analyzed to determine whether it contains provisions that constitute an embedded derivative instrument that warrants separate accounting under paragraph 12. Generally, the liability representing an obligation under a split-interest agreement contains an embedded derivative that warrants separate accounting if the payments are variable and the agreement is period-certain (rather than life-contingent). The following examples, although not all-inclusive, provide an understanding of the applicability of paragraph 12 to various split-interest agreements.

**Example 1: Remainder Trust (period-certain, fixed payments) [also known as a Charitable Remainder Annuity Trust]**

Shares of common stock are contributed to the control of the NFP organization who is required to pay the donor or the donor's beneficiary an annual fixed cash payment for 20 years, after which time the remaining shares revert to the NFP organization. During the term of the agreement (20 years), the NFP organization has a liability that does not require bifurcation of an embedded derivative. Since the periodic cash payment is a fixed dollar amount, the liability has no underlying and, thus, does not meet the criterion in paragraph 6(a) of the definition of a derivative instrument. Because there is no underlying, there is also no embedded derivative that warrants separate accounting under paragraph 12.

**Example 2: Remainder Trust (period-certain, variable payments) [also known as Charitable Remainder Unitrust]**

Shares of common stock are contributed to the control of the NFP organization who is required to make 20 annual cash payments to the donor or the donor's beneficiary that are equal to a specified percentage of the fair value of the assets as of the beginning of each annual period. After the 20 payments have been made, the remaining shares will revert to the NFP organization. During the term of the agreement (20 years), the NFP organization has a liability that

must be bifurcated because it contains an embedded derivative instrument that warrants separate accounting. Under paragraph 12, the liability represents a hybrid instrument that is composed of a debt host contract and an embedded equity-based derivative that is not clearly and closely related to the debt host and that would meet the definition of a derivative if it were freestanding. That is, it has an underlying (price of shares) and a notional amount (number of shares in the trust at the beginning of each annual period), it satisfies the no-or-smaller initial net investment characteristic in paragraph 6(b), and it would meet the net settlement characteristic in paragraph 6(c) (because each annual payment is adjusted for the effect of the equity-based derivative). That analysis is consistent with the analysis under paragraph 185 of Statement 133 for equity-indexed debt. (The debt host represents the liability for the series of 20 annual payments that would be required based on the assumption that the fair value of the common stock does not change over the 20-year period. The embedded equity-based derivative relates to the increase or decrease in each of the 20 annual payments due to changes in the fair value of the common stock.)

**Example 3: Remainder Trust (life-contingent, variable or fixed payments)**

Shares of common stock are contributed to the control of the NFP organization who is required to make annual cash payments to the donor or the donor's beneficiary that are either a fixed dollar amount or a specified percentage of the fair value of the assets at the beginning of each annual period until the death of the donor or the donor's beneficiary, upon which time the remaining shares will revert to the NFP organization. During the term of the agreement, the NFP organization has a liability that is not bifurcated because it is solely life-contingent and thus qualifies for the exception in paragraph 10(c).

**Example 4: Remainder Trust (period-certain-plus-life-contingent, fixed payments)**

Shares of common stock are contributed to the control of the NFP organization who is required to pay the donor or the donor's beneficiary an annual fixed cash payment for the longer of the beneficiary's remaining life or a specified period. The remaining shares then revert to the NFP organization. During the term of the agreement, the NFP organization has a liability that, for purposes of applying Statement 133, must be analyzed as consisting of two separate liabilities: one liability relating to the period-certain cash payments and a second liability relating to the possible additional cash payments that are contingent upon the beneficiary living beyond the end of the period-certain payments. The NFP organization's liability does not require the bifurcation of any embedded derivative because the portion of the liability related to the fixed period-certain payments has no underlying, and the portion of the liability related to the possible life-contingent payments qualifies for the exception in paragraph 10(c).

**Example 5: Remainder Trust (period-certain-plus-life-contingent, variable payments)**

Shares of common stock are contributed to the control of the NFP organization who is required to pay the donor or the donor's beneficiary an annual cash payment equal to a specified percentage of the fair value of the assets at the beginning of each annual period for the greater of the beneficiary's remaining life or a specified period. The remaining assets revert to the NFP organization. During the term of the agreement, the NFP organization has a liability that, for purposes of applying Statement 133, must be analyzed as consisting of two separate liabilities: one liability relating to the period-certain cash payments

and a second liability relating to the possible additional cash payments that are contingent upon the beneficiary living beyond the end of the period-certain payments. Statement 133 requires that the equity-based derivative embedded in the portion of the liability related to the period-certain variable cash payments be bifurcated from a debt host contract (consistent with the analysis in Example 2). The equity-based derivative embedded in the portion of the liability related to the possible life-contingent cash payments that can occur after the end of the specified period is not subject to Statement 133 because it qualifies for the exception in paragraph 10(c).

**Example 6: Lead Trust (period-certain, fixed or variable payments)**

An NFP organization receives cash from a donor, which is invested by the NFP organization in common equity securities. The donor designates the organization as lead beneficiary. The NFP organization receives an annual cash payment of either a fixed amount or a specified percentage of the fair value of the investment amount at the beginning of each annual period for a specified period of time. After that time, the remaining assets revert to the donor or the donor's beneficiary. During the term of the agreement, the NFP organization has a liability that must be bifurcated. Under paragraph 12, the liability represents a hybrid instrument that is composed of a debt host contract and an embedded equity-based derivative that is not clearly and closely related to the debt host and that would meet the definition of a derivative if it were freestanding. That is, it has an underlying (price of shares) and a notional amount (number of shares at the beginning of each annual period), it satisfies the no-or-smaller initial net investment characteristic in paragraph 6(*b*), and it would meet the net settlement characteristic in paragraph 6(*c*). Regardless of whether the lead interest payments are fixed or variable, the value of the liability representing the remainder interest—the assets remaining at the end of the agreement that will be paid to the donor or the donor's beneficiary—is affected by changes in the equity value, thus requiring the equity-based derivative to be bifurcated. That analysis is consistent with the analysis under paragraph 185 of Statement 133 for equity-indexed debt.

**Example 7: Lead Trust (life-contingent, fixed or variable payments)**

An NFP organization receives cash from a donor, which is invested by the NFP organization in common equity securities. The donor designates the organization as lead beneficiary. The NFP organization receives an annual cash payment of either a fixed dollar amount or a specified percentage of the fair value of the investment amount at the beginning of each annual period until the death of the donor or the donor's beneficiary, at which time the remaining assets revert to the donor or the donor's beneficiary. During the term of the agreement, the NFP organization has a liability that is not subject to Statement 133 because the remainder interest liability relates to a single payment whose amount and timing is life-contingent and thus qualifies for the exception in paragraph 10(*c*).

**Example 8: Lead Trust (period-certain-plus-life-contingent, variable or fixed payments)**

An NFP organization receives cash from a donor, which is invested by the NFP organization in common equity securities. The donor designates the organization as lead beneficiary. The NFP organization receives an annual cash payment for either a specified percentage of the fair value of the assets at the beginning of each annual period or a fixed dollar amount. That cash payment is made for the greater of the beneficiary's (or the donor's) remaining life or a specified period. After that time, the remaining assets revert to the donor or the donor's

beneficiary. During the term of the agreement, the NFP organization has a liability that is not subject to Statement 133 because, unlike the liability in Example 5, the period-certain aspect of the liability cannot be separated from the life-contingent aspect of the liability (because there is only one payment whose timing and value are affected by mortality risk). Thus, the remainder interest liability relates to a single payment whose amount and timing is life-contingent and thus qualifies for the exception in paragraph 10(*c*). (If payment occurs only when the beneficiary (or donor) is alive, such as in an agreement where the period is for the *lesser of* the beneficiary's (donor's) remaining life or a specified period, then every payment is life-contingent and qualifies for the exception in paragraph 10(*c*).) It should be noted that if during the terms of a *greater-of*-period-certain-or-life-contingent agreement, the beneficiary dies prior to the end of the period-certain terms in the agreement, that change in circumstance eliminates the life-contingent aspect of the contract. Thus, the agreement is now only a period-certain agreement and mirrors the agreement outlined in Example 6, requiring bifurcation of the embedded derivative.

### Other Split-Interest Agreements When the Contributed Assets Are Other Than Equity Securities

Some split-interest agreements may involve the gift of corporate or U.S. government debt securities, or other securities that are not equity. In determining whether or not those split-interest agreements contain an embedded derivative, the same analysis should be applied as that given in the above examples and as outlined in paragraph 12 of Statement 133. The notion of clearly and closely related, as defined in paragraph 12(a), shall involve an assessment of the economic characteristics and risks associated with the non-equity securities in relation to the economic characteristics and risks of the NFP organization's debt host contract. Generally, because of the differences in credit risk, the change in the fair value of corporate bonds (based on that corporation's credit and interest rate risk) will not be clearly and closely related to the change in the economic characteristics and risks of the NFP organization's debt host contract. Thus, an embedded derivative requiring bifurcation and separate accounting for the embedded derivative would exist.

### Other Split-Interest Agreements When the NFP Organization Does Not Have Control of the Contributed Assets

Some NFP organizations are parties to split-interest agreements that are similar to those outlined above but involve a third party who maintains control of the donor's contributed assets. The NFP organization does not have an obligation to pay either the remainder or lead interest to the designated beneficiary, as that responsibility remains with the third party who maintains control of the assets (thus, the NFP organization does not recognize a liability). However, the NFP organization does have an asset and contribution revenue representing their entitlement to the lead interest payments or the remainder interest, as stipulated in the agreement. In accordance with the NFP Guide, the NFP organization should recognize its beneficial interest in those assets by debiting Beneficial Interest in Split-Interest Agreement and crediting Temporarily Restricted Contribution Revenue, at fair value. Subsequent changes in the fair value of the beneficial interest are recognized in the statement of activities. Thus, under paragraph 12 of Statement 133, the embedded derivative in the above contract would not be bifurcated, as the criterion under subparagraph 12(b) is not met.

## Effective Date

The effective date of the implementation guidance in this Issue for each reporting entity is the first day of its first fiscal year beginning after June 15, 2002. Restatement of previously issued financial statements is not required.

*The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.*

# Chapter 7

# Other Assets

## Introduction

**7.01** Some assets held by not-for-profit organizations are similar to those held by for-profit entities. This chapter considers assets that are not discussed elsewhere in this Audit and Accounting Guide (guide) and that present accounting issues unique to not-for-profit organizations.

## Inventory

**7.02** Not-for-profit organizations may acquire merchandise inventory for resale; for example, items held for sale by a bookstore, dining service, kitchen, or thrift shop. Merchandise inventory may be acquired by not-for-profit organizations in exchange transactions or from contributions. (Paragraphs 5.22–.31 and chapter 12, "Revenues and Receivables From Exchange Transactions," of this guide, discuss exchange transactions.) Accounting Research Bulletin (ARB) No. 43, *Restatement and Revision of Accounting Research Bulletins*, chapter 4 as amended, discusses the general principles applicable to the pricing of inventory.

**7.03** Contributions of inventory should be reported in the period received and should be measured at fair value. (Paragraphs 3.24–.43 of this guide discuss Financial Accounting Standards Board (FASB) Statement No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements.)* In accordance with FASB Statement No. 157, the fair value of contributed inventory is its estimated selling price. Inputs for measuring fair value may be obtained from published catalogs, vendors, independent appraisals, and other sources. If methods such as estimates, averages, or computational approximations, such as average value per pound or subsequent sales, can reduce the cost of measuring the fair value of inventory, use of those methods is appropriate, provided the methods are applied consistently, and the results of applying those methods are reasonably expected not to be materially different from the results of a detailed measurement of the fair value of contributed inventory. If the gifts have no value, as might be the case for certain clothing and furniture that cannot be (*a*) used internally by the not-for-profit organization or for program purposes or (*b*) sold by the organization, the item received should not be recognized. (Paragraphs 5.54–.56 of this guide discuss gifts in kind.)

---

* Financial Accounting Standards Board (FASB) Statement No. 157, *Fair Value Measurements*, is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year. However, FASB Staff Position (FSP) FAS 157-2, *Effective Date of FASB Statement No. 157*, delays the effective date of FASB Statement No. 157 until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for fair value measurements of all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). See footnote † to paragraph 3.25 for more information about the types of assets and liabilities to which the deferral applies.

## Prepaid Expenses, Deferred Charges, and Similar Costs

**7.04** Not-for-profit organizations may incur costs that relate to future rather than to current-period activities. Except as discussed elsewhere in this chapter, the recognition and measurement principles for those costs are similar to those used by business organizations. Accordingly, amounts expended for prepaid expenses and deposits should be reported as assets. (In conformity with Statement of Position [SOP] 93-7, *Reporting on Advertising Costs* [AICPA, *Technical Practice Aids*, ACC sec. 10,590], advertising costs should not be capitalized unless they are costs of direct-response advertising that is expected to result in future benefits, such as gift shop sales.)

## Collections

**7.05** Appendix D of FASB Statement of Financial Accounting Standards No. 116, *Accounting for Contributions Received and Contributions Made*, defines *collections* as follows:

> Works of art, historical treasures, or similar assets that are (*a*) held for public exhibition, education, or research in furtherance of public service rather than financial gain, (*b*) protected, kept unencumbered, cared for, and preserved, and (*c*) subject to an organizational policy that requires the proceeds of items that are sold to be used to acquire other items for collections.

**7.06** Accounting for collections depends on whether an organization adopts a policy of recognizing collections as assets. When organizations initially adopt FASB Statement No. 116, they may choose to (*a*) capitalize their collections, including all items acquired in prior periods that have not been previously capitalized and all items acquired in future periods (that is, *retroactive capitalization*); (*b*) capitalize only those items acquired after initial adoption of FASB Statement No. 116 (that is, *prospective capitalization*); or (*c*) capitalize no collections. Capitalization of part of the collections (that is, *selective capitalization*) is prohibited.

**7.07** If an organization adopts a policy of capitalizing collections, items acquired in exchange transactions 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[1] and should be measured at fair value.[2] (Paragraphs 3.24–.43 of this guide discuss FASB Statement No. 157, which defines *fair value*, establishes a framework for measuring fair value, and expands disclosures about fair value measurements.)[†] As discussed in paragraphs 3.39 and paragraphs 3.42 of this guide, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset. Market

---

[1] Contributions should be classified as increases in unrestricted, temporarily restricted, or permanently restricted net assets, depending on the existence and type of restrictions imposed by donors. Chapter 5, "Contributions Received and Agency Transactions," of this guide provides guidance concerning accounting for contributions with donor-imposed restrictions.

[2] For practical reasons, items that are retroactively capitalized on initial application of FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, can be recognized at their (*a*) cost or fair value at the date of acquisition or (*b*) cost or current market value at the date of initial recognition.

[†] See footnote * in paragraph 7.03.

participant assumptions should include assumptions about the effect of a restriction on the sale or use of an asset if market participants would consider the effect of the restriction in pricing the asset. Examples 8–9 (paragraphs A29–A30) of FASB Statement No. 157 explain that restrictions that are an attribute of an asset, and therefore would transfer to a market participant, are the only restrictions reflected in fair value. Donor restrictions that are specific to the donee are reflected in the classification of net assets, not in the measurement of fair value. Major uncertainties about the future service potential or economic benefit of contributed collection items, for example, items acquired for scientific or educational research having no alternative future uses, may indicate that they should not be recognized.

**7.08** If an organization adopts a policy of not capitalizing collections, no assets or contributions should be recognized from the acquisition of collection items. Cash flows from purchases, sales, and insurance recoveries of unrecognized, noncapitalized collection items should be reported as investing activities on the statement of cash flows. Additional disclosures described in paragraphs 7.12–.13 should be made if an organization elects not to capitalize collections.

**7.09** Contributions made by not-for-profit organizations of previously recognized collection items should be reported as expenses and decreases in assets in the period in which the contributions are made, and should be measured at fair value. (A gain or loss should be recognized on contributions made of previously recognized collection items if their fair value differs from their carrying amount.) Contributions made by not-for-profit organizations of previously unrecognized collection items should not be recognized on the face of the financial statements; disclosure of those contributions should be made in notes to the financial statements.

**7.10** Works of art, historical treasures, and similar assets that are not collection items should be recognized as assets. Items acquired in exchange transactions should be measured at cost. Contributions of those items should be measured at fair value at the date of contribution and should be recognized in a statement of activities as support that increases the appropriate net asset classes.

## Financial Statement Presentation

**7.11** If an organization adopts a policy of retroactively or prospectively capitalizing collections that meet the definition in FASB Statement No. 116, a statement of financial position should include the total amount capitalized on a separate line item, *Collections* or *Collection Items*. The amount capitalized for works of art, historical treasures, and similar assets that do not meet the definition should be disclosed separately on the face of the statement of financial position or in the notes.

**7.12** A not-for-profit organization that does not recognize and capitalize its collections should report the following on the face of its statement of activities, separately from revenues, expenses, gains, and losses:[3]

- Costs of collection items purchased as a decrease in the appropriate class of net assets
- Proceeds from sale of collection items as an increase in the appropriate class of net assets

---

[3] Paragraph 141 of FASB Statement No. 116 illustrates these disclosures.

- Proceeds from insurance recoveries of lost or destroyed collection items as an increase in the appropriate class of net assets.

Similarly, an entity that capitalizes its collections prospectively should report proceeds from sales and insurance recoveries of items not previously capitalized separately from revenues, expenses, gains, and losses.

**7.13** A not-for-profit organization that does not recognize and capitalize its collections or that capitalizes collections prospectively should describe its collections, including their relative significance, and its accounting and stewardship policies for collections. If collection items not capitalized are deaccessed during that period, it also should (*a*) describe the items given away, damaged, destroyed, lost, or otherwise deaccessed during the period or (*b*) disclose their fair value. In addition, a line item should be shown on the face of the statement of financial position that refers to the disclosures required by this paragraph. That line item should be dated if collections are capitalized prospectively, for example, "Collections acquired since January 1, 19X1 (Note X)."

## Illustrative Disclosures

**7.14** This section provides examples of notes to the financial statements that illustrate some of the financial statement disclosures concerning collection items.

### Example 1—Organizations That Capitalized Collections Prior to FASB Statement No. 116

Note X: Summary of Significant Accounting Policies

The organization has capitalized its collections since its inception. If purchased, items accessioned into the collection are capitalized at cost, and if donated, they are capitalized at their fair value on the accession date (the date on which the item is accepted by the Acquisitions Committee of the Board of Trustees). Gains or losses on the deaccession of collection items are classified on the statement of activities as unrestricted or temporarily restricted support depending on donor restrictions, if any, placed on the item at the time of accession.

### Example 2—Organizations That Capitalize Collections Retroactively Upon Initial Adoption of FASB Statement No. 116

Note X: Summary of Significant Accounting Policies

In 19X1, the organization capitalized its collections retroactively in conformity with FASB Statement No. 116. To the extent that reliable records were available, the organization capitalized collection items acquired prior to 19X1 at their cost at the date of purchase or, if the items were contributed, at their fair value at the accession date (the date on which the item was accepted by the Acquisitions Committee of the Board of Trustees). Other collection items, particularly those acquired prior to 19X1 when detailed curatorial records began to be maintained, have been capitalized at their appraised or estimated current market value. In some cases, collection items held solely for their potential educational value or historical significance were determined to have no alternative use and were not assigned values for the purpose of capitalization. The collection items capitalized retroactively were determined to have a total value of $11,138,100. This amount is reflected as a change in accounting principle on the statement of activities.

## Example 3—Organizations That Capitalize Their Collections Prospectively Upon Initial Adoption of FASB Statement No. 116

Note X: Summary of Significant Accounting Policies

Collection items acquired on or after July 1, 19X0: Accessions of these collection items are capitalized at cost, if the items were purchased, or at their fair value on the accession date (the date on which the item is accepted by the Acquisitions Committee of the Board of Trustees), if the items were contributed. Gains or losses from deaccessions of these items are reflected on the statement of activities as changes in the appropriate net asset classes, depending on the existence and type of donor-imposed restrictions.

Collection items acquired prior to July 1, 19X0: Collection items accessioned prior to July 1, 19X0 were recorded as decreases in unrestricted net assets, if the items were purchased. No financial statement recognition was made for contributed collection items. Proceeds from insurance recoveries or deaccessions of these items are reflected on the statements of activities as changes in the appropriate net asset classes, depending on the existence and type of donor-imposed restrictions.

Note Y: Accounting Change

In 19X1, the organization adopted FASB Statement No. 116. The organization has determined that the cost to capitalize its collections retroactively would be excessive because records of the cost of purchased items and of the fair value at the date of contribution of donated items are unreliable or do not exist. However, such information is available for current-year acquisitions and will be maintained on an ongoing basis. Therefore, the organization has elected to capitalize prospectively all collection items acquired after July 1, 19X0, the date of initial adoption of FASB Statement No. 116.

Note Z: Collections

The organization's collections are made up of artifacts of historical significance, scientific specimens, and art objects. Each of the items is cataloged for educational, research, scientific, and curatorial purposes, and activities verifying their existence and assessing their condition are performed continuously.

During 20X1, a significant number of American pioneer artifacts from the 1800s were destroyed while in transit to an exhibition in which they were to be displayed. Because those items were purchased prior to July 1, 19X0, the insurance proceeds of $22,000, which reimbursed the organization in full for the artifacts' fair value, are reflected as an increase in unrestricted net assets on the statement of activities. No other collection items were deaccessioned in 20X1 or 20X0.

## Example 4—Organizations That Do Not Capitalize Collections

Note X: Summary of Significant Accounting Policies

The collections, which were acquired through purchases and contributions since the organization's inception, are not recognized as assets on the statement of financial position. Purchases of collection items are recorded as decreases in unrestricted net assets in the year in which the items are acquired, or as temporarily or permanently restricted net assets if the assets used to purchase the items are restricted by donors. Contributed collection items are not reflected on the financial statements. Proceeds from deaccessions or insurance recoveries are reflected as increases in the appropriate net asset classes.

Note Z: Collections

The organization's collections are made up of artifacts of historical significance, scientific specimens, and art objects that are held for educational, research, scientific, and curatorial purposes. Each of the items is cataloged, preserved, and cared for, and activities verifying their existence and assessing their condition are performed continuously. The collections are subject to a policy that requires proceeds from their sales to be used to acquire other items for collections.

During 20X1, a significant number of American pioneer artifacts from the 1800s were destroyed while in transit to an exhibition in which they were to be displayed. These artifacts were contributed in 20XX, with a restriction that limited any future proceeds from deaccessions to acquisitions of artifacts from a similar period. As a result, the insurance proceeds of $22,000, which reimbursed the organization in full for the artifacts' fair value, are reflected as an increase in temporarily restricted net assets on the statement of activities. No other collection items were deaccessioned in 20X1 or 20X0.

# Auditing

**7.15** Many audit objectives, controls, and auditing procedures for other assets of not-for-profit organizations are similar to those of other organizations. In addition, the auditor may need to consider the specific audit objectives, selected controls, and auditing procedures that are unique to not-for-profit organizations and that are presented at the end of this chapter.

## Inventory

**7.16** As discussed in paragraph 7.03, in certain circumstances, the fair value of contributed inventory may be measured using methods such as estimates, averages, or computational approximations. Such methods may be used in connection with the financial statement assertion of valuation. However, such methods are unrelated to the assertions of existence and occurrence. AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), sets forth requirements and guidance when auditing the measurement and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements, and AU section 331, *Inventories* (AICPA, *Professional Standards*, vol. 1), which provides requirements and guidance concerning inventory observation.

### *Collection Items*

**7.17** Examples of auditing procedures that might be applied for collection items are presented in the table at the end of this chapter. If collection items are not capitalized, the auditor should perform procedures to understand the organization's controls over recording accessions (including contributions) and deaccessions of collection items, controlling the collections, and periodically physically inspecting them. Those auditing procedures are performed, in part, to provide evidence supporting the disclosures required by paragraph 27 of FASB Statement No. 116. They are also part of the auditor's work in obtaining an understanding of the organization's controls over collection items and contributions of such items. The objective of performing those procedures when the collection is not recognized is not to obtain evidence to corroborate a recorded amount, since no amount has been recorded. Instead, the objective is

to help the auditor understand the organization's control environment, which is a component of its internal control.

**7.18** As noted in chapter 2, "General Auditing Considerations," of this guide, AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), requires the auditor to understand the organization's control environment, an important part of which is management's philosophy and operating style and its integrity and ethics. Management's philosophy and operating style include management's approach to taking and monitoring business risks and its attitudes and actions toward financial reporting. Management's integrity and ethics include the emphasis management places on meeting budget, profit, and other financial and operating goals. In addition, AU section 314 requires auditors to understand the effect of information technology on internal control and assessment of risk.

**7.19** The required understanding of the control environment should be sufficient to enable the auditor to evaluate the design of the controls and determine whether they have been implemented. To obtain this understanding, the auditor should perform risk assessment procedures such as inquiries, observation, inspection and analytic procedures. What is sometimes referred to as a *transaction review* or *walk-through* of relevant custodial controls might be adequate for the auditor to gain the requisite level of knowledge about controls over the collection as part of understanding the control environment.

**7.20** The following table illustrates the use of assertions in developing audit objectives and designing substantive tests. The examples are not intended to be all-inclusive nor is it expected that all the procedures would necessarily be applied in an audit. The auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure to obtain sufficient appropriate audit evidence. The use of assertions in assessing risks and designing appropriate audit procedures to obtain audit evidence is described in paragraphs .14–.26 of AU section 326, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1). Various audit procedures and the purposes for which they may be performed are described in paragraphs .27–.41 of AU section 326.

**Auditing Considerations**

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| | | ***Transactions*** | |
| *All Collection Items* | | | |
| Occurrence | Collection items acquired in the current period by purchase and contribution were authorized. | Controls ensure that purchased collection items are authorized, contributed collection items are appropriately accessioned, and deaccessions are authorized. | Review documentation supporting accessions and deaccessions of collection items. |

*(continued)*

## Auditing Considerations—continued

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| | ***Transactions—continued*** | | |
| | Deaccessions from collections occurred and were authorized. | | Review minutes of governing board and governing board committee meetings for authorization of major accessions and deaccessions. |
| | | | Make inquiries of curatorial personnel about deaccessioned collection items. |
| *Capitalized Collection Items (Excluding Matters Related to Retroactive Capitalization)* | | | |
| Completeness; valuation and allocation | All collection items acquired in exchange transactions are recognized as assets at cost. | Controls exist to ensure that all purchases and contributions of collection items are recognized as assets (at cost and fair value, respectively) and that contribution revenues are recognized for contributed collection items. | Review minutes of governing board and governing board committee meetings for evidence of current period purchases and contributions. |
| | All contributed collection items are recognized as assets and as contributions at fair value. | | Review documentation and procedures supporting the determination of cost or fair value. |
| | ***Account Balances*** | | |
| *All Collection Items* | | | |
| Occurrence | Collection items exist. | Procedures for controlling collections and periodically physically inspecting them. | Review the organization's procedures for controlling collections and physically inspecting them. |
| | | | Consider whether to observe the physical inspection. |
| | | | Review actions taken by management to investigate discrepancies disclosed by the physical inspection and to adjust the records. |

## Auditing Considerations—continued

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| | ***Account Balances—continued*** | | |
| Rights and obligations | Restrictions on contributed collection items have been met. | Contributions of collection items are reviewed for restrictions and management monitors compliance with restrictions. | Review donor correspondence to determine the presence or absence of restrictions. |
| | | | Review minutes of governing board and governing board committee meetings for evidence of restrictions. |
| | | | If specific collection items are restricted, review collection item transactions for propriety of use and disposition. |
| *Retroactive Capitalization of Collection Items* | | | |
| Occurrence; completeness; valuation and allocation; rights and obligations; presentation and disclosure | Retroactively capitalized collection items exist, are the property of the organization, are properly valued, and are reported in the appropriate net asset class; all collection items owned by the organization are capitalized. | Procedures for controlling collections and determining their cost or fair value at date of acquisition or their current cost or current market value at date of initial recognition. | Review documents and procedures supporting the determination of cost or fair value at date of acquisition or current cost or current market value at date of initial recognition. |
| | | | Review donor correspondence to determine the presence or absence of restrictions. |
| | | | Review minutes of governing board and governing board committee meetings for evidence of restrictions. |

(continued)

## Auditing Considerations—continued

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| | ***Account Balances—continued*** | | |
| | | | Review documentation underlying contributed collection items for propriety of classification. |
| | | | Consider the need to apply provisions of AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), in conjunction with determining the reliability of carrying values. |
| | ***Presentation and Disclosure*** | | |
| *Noncapitalized Collection Items* | | | |
| Valuation | Noncapitalized works of art, historical treasures, and similar assets meet the definition of *collections* in FASB Statement No. 116. | Policies and procedures for determining that noncapitalized assets are *collections*. | Review policies and procedures determining the appropriateness of classifying assets as noncapitalized collections. |
| | | | Determine whether proceeds of sales of collection items are used to acquire other items for the collection. |
| Completeness | Appropriate disclosures referenced in a line item on the face of the statement of financial position, meet the requirements of FASB Statement No. 116. | | Ensure that required line item is present. |
| Classification | Purchases, sales, involuntary conversions, and other deaccessions of noncapitalized collection items are appropriately displayed in the statement of activities and the statement of cash flows. | | Determine the appropriateness of display and disclosures related to noncapitalized collections. |

## Auditing Considerations—continued

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| | ***Presentation and Disclosure—continued*** | | |
| *Capitalized Collection Items (Excluding Matters Related to Retroactive Capitalizations)* | | | |
| Classification | Contributed and deaccessioned collection items are reported in the appropriate net asset class. | | Review documentation underlying collection items for propriety of classification. |

# Chapter 8

# Investments[1]

## Introduction

**8.01** Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, provides measurement guidance for investments in equity securities with readily determinable fair values and all investments in debt securities, as well as reporting standards for all investments held by not-for-profit organizations, subject to the exceptions in the following sentence. FASB Statement No. 124 does not apply to investments in equity securities that are accounted for under the equity method or to investments in consolidated subsidiaries, nor does it apply to investments in derivative instruments that are subject to the requirements of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.* If an investment would otherwise be in the scope of FASB Statement No. 124 and it has within it an embedded derivative that is subject to FASB Statement No. 133, the host instrument (as described in FASB Statement No. 133) remains within the scope of FASB Statement No. 124.

**8.02** A derivative instrument is defined in FASB Statement No. 133, as amended, (paragraphs 6–7) as follows:

> A derivative instrument is a financial instrument or other contract with all three of the following characteristics:
>
> *a.* It has (1) one or more underlyings and (2) one or more notional amounts[2] or payment provisions or both. Those terms determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required.
>
> *b.* It requires no initial net investment or an initial investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
>
> *c.* Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.
>
> *Underlying, notional amount, and payment provision.* An underlying is a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other

---

[1] Cash held temporarily by a custodian for investment purposes may be included as part of investments on a statement of financial position rather than as cash.

[2] Sometimes other names are used. For example, the notional amount is called a face amount in some contracts.

> variable (including the occurrence or nonoccurrence of a specified event such as a scheduled payment under a contract). An underlying may be a price or rate of an asset or liability but is not the asset or liability itself. A notional amount is a number of currency units, shares, bushels, pounds, or other units specified in the contract. The settlement of a derivative instrument with a notional amount is determined by interaction of that notional amount with the underlying. The interaction may be simple multiplication, or it may involve a formula with leverage factors or other constants. A payment provision specifies a fixed or determinable settlement to be made if the underlying behaves in a specified manner.

Options, futures, forwards, and swaps are common examples of derivative instruments. Investments in convertible debt securities are an example of an instrument with an embedded derivative. Unique to not-for-profit organizations are embedded derivatives related to certain split interest agreements. Issue No. B35, *Embedded Derivatives: Application of Statement 133 to a Not-for-Profit Organization's Obligation Arising from an Irrevocable Split-Interest Agreement,* issued by the FASB staff, is included as appendix B to chapter 6 [paragraph 6.47]. Accounting and reporting of investments in derivative instruments is subject to the requirements of FASB Statement No. 133. A brief summary of FASB Statement No. 133, as amended, is provided in paragraphs 8.28–.31 of this guide.

**8.03** Investments not covered by FASB Statement No. 124, FASB Statement No. 133, as amended, or AICPA Statement of Position (SOP) 94-3, *Reporting of Related Entities by Not-for-Profit Organizations* (AICPA, *Technical Practice Aids*, ACC sec. 10,610), are referred to in this guide as other investments. Other investments include, among others, investments in real estate, mortgage notes, venture capital funds, partnership interests, oil and gas interests, and certain equity securities that do not have a readily determinable fair value. Guidance for measuring other investments is discussed in appendix A [paragraph 8.36].

**8.04** The various AICPA Industry Audit Guides, Audit and Accounting Guides, and SOPs that are superseded by this guide included guidance concerning other investments. This guide retains the measurement guidance for accounting for other investments included in the AICPA publications that are superseded by this guide, until such time as the FASB or the Accounting Standards Executive Committee (AcSEC) issues more definitive guidance. Accordingly, this chapter incorporates the measurement guidance for other investments currently found in the various AICPA publications that are superseded by this guide,[3] except as stated in the next sentence. The guidance has been conformed to FASB Statement No. 124 and subsequently issued standards, as discussed in paragraph A.10 of appendix A of this chapter.

**8.05** Not-for-profit organizations acquire various kinds of investments by contribution or purchase. This chapter discusses the accounting recognition, measurement, and disclosure requirements for investments in (*a*) equity securities with a readily determinable fair value not accounted for under the equity

---

[3] Paragraphs A.8–A.10 of appendix A [paragraph 8.36] of this chapter summarize the measurement guidance for other investments retained from the earlier AICPA publications that are superseded by this guide.

method and not required to be consolidated, (*b*) debt securities, (*c*) derivative instruments, and (*d*) other investments. Split-interest gifts, including investments held by others, are discussed in chapter 6, "Split-Interest Agreements," of this guide.

**8.06** SOP 94-3, which is included as appendix B [paragraph 8.37] of this chapter, was issued in September 1994. When this guide was written the FASB was studying the concept of a reporting entity and issues related to consolidations, the application of the equity method of accounting, and accounting for various types of joint ventures. Accordingly, those matters were not covered by this guide.*

**8.07** For all investments except investments in equity securities that are accounted for under the equity method and investments in consolidated subsidiaries, this chapter provides accounting and auditing guidance concerning the initial recognition and measurement, investment income, the measurement attributes used for subsequent valuation, unrealized and realized gains and losses, and financial statement display and disclosure. Many of the requirements under generally accepted accounting principles (GAAP) in these areas are the same as those for for-profit entities; accordingly, this chapter focuses on those issues that are unique to not-for-profit organizations.

## Initial Recognition

**8.08** Investments are initially recorded at their acquisition cost (including brokerage and other transaction fees) if they were purchased and at fair value if they were received as a contribution or through an agency transaction.[4] (Paragraphs 3.24–.43 of this guide discuss FASB Statement No. 157, *Fair Value Measurements*, which defines *fair value*, establishes a framework for measuring fair value, and expands disclosures about fair value measurements.)[†] Chapter 5, "Contributions Received and Agency Transactions," of this guide, includes guidance concerning distinguishing contributions from agency transactions and discusses the classification of contributions.

---

* On September 27, 2007, the Financial Accounting Standards Board (FASB) issued an exposure draft, *Proposed FSP SOP 94-3-a and AAG-HCO-a, Omnibus Changes to Consolidation and Equity Method Guidance for Not-for-Profit Organizations*, which would make several changes to the guidance on consolidation and the equity method of accounting in AICPA Statement of Position (SOP) 94-3, *Reporting of Related Entities by Not-for-Profit Organizations* (AICPA, *Technical Practice Aids*, ACC sec. 10610). Readers should be alert to the issuance of a final standard.

[4] Guidance in this chapter concerning the classification of investment income, unrealized gains and losses, and realized gains and losses applies to investments other than investments held by a not-for-profit organization as an agent. If a not-for-profit organization is holding an investment as an agent and has little or no discretion in determining how the investment income, unrealized gains and losses, and realized gains and losses resulting from those investments will be used, those investment activities should be reported as agency transactions and, therefore, as changes in assets and liabilities, rather than as changes in net assets.

[†] FASB Statement No. 157, *Fair Value Measurements*, is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year. However, FASB Staff Position (FSP) FAS 157-2, *Effective Date of FASB Statement No. 157*, delays the effective date of FASB Statement No. 157 until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for fair value measurements of all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). See footnote † to paragraph 3.25 for more information about the types of assets and liabilities to which the deferral applies.

## Investment Income

**8.09** Investment income includes dividends, interest, rents, royalties, and similar payments and should be recognized as earned. The revenue (often referred to as income) should be reported as an increase in unrestricted, temporarily restricted, or permanently restricted net assets, depending on donor stipulations on the use of the income.[5] For example, if there are no donor-imposed restrictions on the use of the income, it should be reported as an increase in unrestricted net assets. On the other hand, a donor may stipulate that a gift be invested in perpetuity with the income to be used to support a specified program. The initial gift creates permanently restricted net assets; the investment income is temporarily restricted for support of the donor-specified program. If the restrictions on the income are met, the statement of activities should report a reclassification from temporarily restricted net assets to unrestricted net assets.

**8.10** FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, specifies that a statement of activities should report the gross amounts of revenues and expenses. It also notes, however, that "investment revenues may be reported net of related expenses, such as custodial fees and investment advisory fees, provided that the amount of the expenses is disclosed either in the statement of activities or in notes to financial statements" (paragraph 24 of FASB Statement No. 117). Chapter 13, "Expenses, Gains, and Losses," of this guide, discusses investment expenses.

## Valuation Subsequent to Acquisition

**8.11** FASB Statement No. 124 provides that investments in equity securities with readily determinable fair value and all debt securities should be reported at their fair value. FASB Statement No. 133 provides that investments in derivative instruments should be reported as either assets or liabilities and measured at fair value. (Paragraphs 3.24–.43 of this guide discuss FASB Statement No. 157, which defines fair value and establishes a framework for measuring fair value.[†] Paragraphs 8.28–.31 further discuss derivative instruments.) As noted in paragraph 8.03, AICPA guidance concerning the carrying amounts of other investments subsequent to acquisition is diverse. Organizations should follow the guidance in appendix A [paragraph 8.36] of this chapter for their other investments.

## Unrealized and Realized Gains and Losses

**8.12** Unrealized gains and losses arise from changes in the fair value of investments, exclusive of dividend and interest income recognized but not yet received and exclusive of any write-down of the carrying amount of investments for impairment. Unrealized gains and losses are recognized in some circumstances (for example, when the investments are carried at fair value), but not in others (for example, when the investments are carried at cost). To the extent that unrealized gains and losses are recognized, they should be reported in the

---

[5] Paragraph 8.19 discusses an alternative accounting policy for circumstances in which temporary restrictions on investment income are met in the same reporting period as the income is recognized.

[†] See footnote † in paragraph 8.08.

statement of activities as increases or decreases in unrestricted net assets unless their use is temporarily or permanently restricted by donors to a specified purpose or future period.[6]

**8.13** Realized gains and losses arise from selling or otherwise disposing of investments. Realized gains and losses should be reported in the statement of activities as changes in unrestricted net assets unless their use is temporarily or permanently restricted by explicit donor-imposed stipulations or by law.[7] (Paragraph 8.12 discusses unrealized gains and losses. If realized gains and losses arise from selling or otherwise disposing of investments for which unrealized gains and losses have been recognized in the statement of activities of prior reporting periods, the amount reported in the statement of activities as gains or losses upon the sale or other disposition of the investments should exclude the amount that has previously been recognized in the statement of activities. However, the components of that gain or loss may be reported as the realized amount [the difference between amortized cost and the sales proceeds] and the unrealized amount recognized in prior reporting periods. Table 8-1 illustrates this reporting.)

**Table 8-1**

| *Facts* | |
|---|---|
| 1. | In 20X1, a not-for-profit organization with a December 31 year end purchases an equity security with a readily determinable fair value for $5,000. |
| 2. | At December 31, 20X1, the fair value of the security is $7,000. |
| 3. | During 20X2, the security is sold for $11,000. |
| *Reporting Gains and Losses* | |
| 20X1 | Recognize a $2,000 gain and adjust the carrying value to $7,000. (The reported gain equals $7,000 fair value less $5,000 carrying value.) |
| 20X2 | Recognize a $4,000 gain and adjust the carrying value to zero. (The gain may be reported as the net of $11,000 selling price less the $7,000 carrying value at the time the security was sold. Alternatively, the gain may be displayed as the realized gain of $6,000 [$11,000 selling price less $5,000 cost] less the $2,000 unrealized gain previously recognized.) |

## Investment Pools

**8.14** A not-for-profit organization may pool part or all of its investments (including investments arising from contributions with different kinds of restrictions) for portfolio management purposes. The number and the nature of the pools may vary from organization to organization.

---

[6] Paragraph 8.19 discusses an alternative accounting policy for circumstances in which temporary restrictions on gains are met in the same reporting period as the gains are recognized.

[7] See footnote 6.

**8.15** When a pool is established, ownership interests are initially assigned (typically through unitization) to the various pool categories (sometimes referred to as *participants*) based on the market value of the cash and securities placed in the pool by each participant. Current market value is used to determine the number of units allocated to additional assets placed in the pool and to value withdrawals from the pool. Investment income and realized gains and losses (and any recognized unrealized gains and losses) are allocated equitably based on the number of units assigned to each participant.

## Donor-Restricted Endowment Funds

**8.16** A donor's stipulation that requires a gift to be invested in perpetuity or for a specified term creates a donor-restricted endowment fund. Donors or relevant law may require a not-for-profit organization to retain permanently some portion of gains and losses (net appreciation) on donor-restricted endowment funds. Unless net appreciation on donor-restricted endowment funds is temporarily or permanently restricted by a donor's explicit stipulation or by a law that extends a donor's restriction to them, net appreciation on donor-restricted endowment funds should be reported as a change in unrestricted net assets.[8] Paragraph 11 of FASB Statement No. 124 notes that "...if a donor allows the organization to choose suitable investments, the gains are not permanently restricted unless the donor or the law requires that an amount be retained permanently. Instead, those gains are unrestricted if the investment income is unrestricted or are temporarily restricted if the investment income is temporarily restricted by the donor." Accordingly, in the absence of donor stipulations or law to the contrary, donor restrictions on the use of income of an endowment fund also extend to the net appreciation on the endowment fund.

**8.17** Classification of recognized gains and losses should be based on the underlying facts and circumstances. If limitations exist that preclude the use of net gains on permanently restricted net assets, either as a result of explicit or clear implicit donor stipulations or by the law of the relevant jurisdiction, the net gains are permanently restricted. Paragraph 125 of FASB Statement No. 117 notes that "because donor stipulations and laws vary, not-for-profit organizations must assess the relevant facts and circumstances for their endowment gifts and their relevant laws to determine if net appreciation on endowments is available for spending or is permanently restricted."

**8.18** Paragraphs 12–13 of FASB Statement No. 124 provide the following:

> 12. In the absence of donor stipulations or law to the contrary, losses on the investments of a donor-restricted endowment fund shall reduce temporarily restricted net assets to the extent that donor-imposed temporary restrictions on net appreciation of the fund have not been met before a loss occurs. Any remaining loss shall reduce unrestricted net assets.
>
> 13. If losses reduce the assets of a donor-restricted endowment fund below the level required by the donor stipulations or law, [footnote omitted] gains that restore the fair value of the

[8] Legal limitations that require the governing board to act to appropriate net appreciation for expenditure under a statutorily prescribed standard of ordinary business care and prudence do not extend donor restrictions to the net appreciation. Accordingly, unless the donor has explicitly restricted the net appreciation on an endowment fund, net appreciation subject to such limitations should be reported as a change in unrestricted net assets.

> assets of the endowment fund to the required level shall be classified as increases in unrestricted net assets.

(After the fair value of the assets of the endowment fund equals the required level, gains that are restricted by the donor should be classified as increases in temporarily restricted net assets or permanently restricted net assets, depending on the donor's restrictions on the endowment fund.)

## Financial Statement Presentation

**8.19** Gains and investment income that are limited to specific uses by donor-imposed restrictions may be reported as increases in unrestricted net assets if the restrictions are met in the same reporting period as the gains and income are recognized, provided that the organization has a similar policy for reporting contributions received,[9] reports consistently from period to period, and discloses its accounting policy in the notes to the financial statements.

**8.20** Realized and unrealized losses on investments may be netted against realized and unrealized gains on a statement of activities.

**8.21** Some not-for-profit organizations manage their investments on a total return basis. Under the total return concept, organizations focus on the overall return on their investments, including both investment income and net appreciation. They then use a spending-rate formula to determine how much of that return will be used for current operations.

**8.22** Under FASB Statement No. 117, however, all investment income and recognized gains and losses must be reported on the statement of activities and classified as unrestricted unless restricted by the donor or applicable law. Organizations are permitted to provide information on the face of the statement of activities and the notes to the financial statements about the total return on investments by segregating the total return between operating and nonoperating components based on a spending-rate formula. Alternatively, an organization with concerns about the ability to make meaningful comparisons when not-for-profit organizations and business entities are engaged in the same industry may report in a manner similar to business entities by identifying securities as available-for-sale or held-to-maturity and excluding the unrealized gains and losses on those securities from an operating measure within the statement of activities. If investment return reported in the statement of activities is separated into operating and nonoperating, certain information, as discussed in paragraph 8.25 of this guide, is required to be disclosed. Those disclosures are illustrated in paragraphs 100–106 of FASB Statement No. 124.

**8.23** FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, as amended, requires that an organization disclose all significant concentrations of credit risk arising from all financial instruments, whether from an individual counterparty or groups of counterparties. An individual concentration of risk could exist, for example, if an organization invests a significant amount in the securities of a single corporation or government entity. A group concentration could exist, for example, if an organization invests a significant amount in debt securities of a single industry or a single

---

[9] Paragraph 5.42 discusses the accounting policy for reporting contributions received if the organization meets donor-imposed restrictions on all or a portion of the amount contributed in the same reporting period as the contribution is received.

geographic region. Further, as explained in FSP SOP 94-6-1, *Terms of Loan Products That May Give Rise to a Concentration of Credit Risk*, the terms of certain loans (for example, program investments that permit low payments in early years of the loan and higher payments later in the loan's life) may result in a concentration of credit risk. FASB Statement No. 107, as amended, also requires disclosures of fair value and carrying amounts for all financial instruments for which it is practicable to estimate that value. (Investments reported under FASB Statement No. 124 and derivative financial instruments reported under FASB Statement No. 133 are already carried at fair value and would not require that disclosure, if they are separately reported in the body of the financial statements.) FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities—an amendment to FASB Statement No. 107*, states that disclosures about the fair value of financial instruments prescribed in FASB Statement No. 107, as amended, are optional if an organization meets all of the following three criteria: (1) the organization is a nonpublic entity, (2) the organization's total assets are less than $100 million on the date of the financial statements, and (3) the organization has no derivative instruments. For purposes of FASB Statement No. 126, a nonpublic entity is any entity other than one (*a*) whose debt or 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, (*b*) that is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets), (*c*) that makes a filing with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market, or (*d*) that is controlled by an entity covered by (*a*), (*b*), or (*c*).[‡]

**8.24** FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, a replacement of FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, requires that organizations that enter into securities lending transactions or repurchase agreements disclose their policies for requiring collateral or other security. It also requires that if an organization accepts collateral that it is permitted by contract or custom to sell or repledge, it also disclose the fair value at the end of the period of that collateral and of the portion of that collateral that has been sold or repledged.

**8.25** For each period for which a statement of activities is presented, a not-for-profit organization should disclose:

*a.* The composition of investment return including, at a minimum, investment income, net realized gains or losses on investments reported at other than fair value, and net gains or losses on investments reported at fair value

*b.* A reconciliation of investment return to amounts reported in the statement of activities if investment return is separated into operating and nonoperating amounts, together with a description of the policy used to determine the amount that is included in the

[‡] The definition of nonpublic entity was amended by FSP FAS 126-1, *Applicability of Certain Disclosure and Interim Reporting Requirements for Obligors for Conduit Debt Securities*, which is effective for fiscal periods beginning after December 15, 2006. An entity may elect to retrospectively apply the guidance to all prior periods.

measure of operations and a discussion of circumstances leading to a change, if any, in that policy

*c.* The information required by paragraph 19 of FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*, as modified by paragraph 23(c) of that statement

*d.* The information required by paragraph 22 of FASB Statement No. 159 if the organization made an election pursuant to paragraph 9(d) or 9(e) during the period

**8.26** For each period for which a statement of financial position is presented, a not-for-profit organization should disclose:

*a.* The aggregate carrying amount of investments by major types, for example, equity securities, U.S. Treasury securities, corporate debt securities, mortgage-backed securities, oil and gas properties, and real estate

*b.* The basis for determining the carrying amount for investments other than equity securities with readily determinable fair values and all debt securities

*c.* The method(s) and significant assumptions used to estimate the fair values of investments other than financial instruments[10] if those other investments are reported at fair value

*d.* The aggregate amount of the deficiencies for all donor-restricted endowment funds for which the fair value of the assets at the reporting date is less than the level required by donor stipulations or law

*e.* The information discussed in paragraph A.5 of appendix A of this chapter if the organization has cost-method investments in an unrealized loss position

*f.* The information discussed in paragraph A.7 of appendix A of this chapter if the organization has cost-method investments

*g.* The information required by paragraphs 32–33 of FASB Statement No. 157, if applicable

*h.* The information required by paragraph 18 of FASB Statement No. 159

**8.27** For the most recent period for which a statement of financial position is presented, a not-for-profit organization should disclose:

*a.* The nature of and carrying amount for each individual investment or group of investments that represents a significant concentration of market risk

---

[10] Paragraph 10 of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, requires organizations to disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments. FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities*, amends FASB Statement No. 107 to make the disclosures about fair value of financial instruments prescribed in FASB Statement No. 107 optional for certain nonpublic entities. (See paragraph 8.23 of the guide.)

*b.* The information discussed in paragraph A.6 of appendix A of this chapter if the organization has cost-method investments in an unrealized loss position

*c.* The information required by paragraph 21 of FASB Statement No. 159

Additionally, paragraph 15 of FASB Statement No. 159 requires that, if an organization elects the fair value option, it display on the face of its statement of financial position (either by separate line items or parenthetically) the assets and liabilities reported at fair value separately from the carrying amounts of similar assets and liabilities measured using another measurement attribute.

## Accounting for Derivative Instruments and Hedging Activities

**8.28** FASB Statement No. 133, as amended, establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, (collectively referred to as derivatives) and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. If certain conditions are met, a derivative may be specifically designated as (*a*) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment, (*b*) a hedge of the exposure to variable cash flows of a forecasted transaction, or (*c*) a hedge of the foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a foreign-currency- denominated forecasted transaction. (However, the special accounting for a hedge of the exposure to variable cash flows of a forecasted transaction is not available to not-for-profit organizations.) The accounting for changes in the fair value of a derivative (that is, gains and losses) depends on the intended use of the derivative and the resulting designation.

**8.29** FASB Statement No. 133 (paragraph 43) makes certain provisions regarding reporting of changes in the value of a derivative and a hedged item by not-for-profit organizations and other entities that do not report earnings:

> An entity that does not report earnings as a separate caption in a statement of financial performance (for example, a not-for-profit organization or a defined benefit plan pension plan) shall recognize the gain or loss on a hedging instrument and a nonhedging derivative instrument as a change in net assets in the period of change unless the hedging instrument is designated as a hedge of the foreign currency exposure of a net investment in a foreign operation. In that case, the provisions of paragraph 42 of this Statement shall be applied. Entities that do not report earnings shall recognize the changes in the carrying amount of the hedged item pursuant to paragraph 22 in a fair value hedge as a change in net assets in the period of change. Those entities are not permitted to use cash

flow hedge accounting because they do not report earnings separately. Consistent with the provisions of FASB Statement No. 117, this statement does not prescribe how a not-for-profit organization should determine the components of an operating measure, if one is presented.

The changes in fair value of derivative instruments or hedged items are classified as unrestricted unless their use is temporarily or permanently restricted by donors or by law.[11]

**8.30** FASB Statement No. 133 (paragraphs 44–47) contains extensive disclosure requirements.[||]

**8.31** The FASB has established the Derivatives Implementation Group (DIG) to assist the board and its staff in providing implementation guidance regarding FASB Statement No. 133. Issues addressed by the DIG and the status of related guidance can be found at the FASB's Web site www.fasb.org. Readers may also find useful the FASB publication *Accounting for Derivative Instruments and Hedging Activities*, which contains Statement No. 133, as amended, as well as the results of DIG, which are cleared by the FASB, with cross-references between the issues and the paragraphs of the statement. Note that in April 2002, the FASB staff also issued implementation guidance Issue No. B35, *Embedded Derivatives: Application of Statement 133 to a Not-for-Profit Organization's Obligation Arising from a Split-Interest Agreement*. Refer to appendix B of chapter 6 [paragraph 6.47], "Split-Interest Agreements," for a copy of the implementation guidance.

## Auditing

**8.32** Many audit objectives, controls, and auditing procedures for investments of not-for-profit organizations are similar to those of other organizations. For further information about auditing investments and implementing AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1), see the AICPA Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*. AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), addresses audit considerations relating to the measurement and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements. In addition, the auditor may need to consider the specific audit objectives, selected controls, and auditing procedures that are unique to not-for-profit organizations and that are presented at the end of this chapter.

**8.33** Interpretation No. 1, "Auditing Investments in Securities Where a Readily Determinable Fair Value Does Not Exist" of AU section 332 (AICPA,

---

[11] Paragraph 8.19 discusses an alternative accounting policy for circumstances in which temporary restrictions on gains are met in the same period in which the gains are recognized.

[||] On December 8, 2006, the FASB issued an exposure draft of a proposed FASB statement, *Disclosures about Derivative Instruments and Hedging Activities*, an amendment of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, which amends and expands the disclosure requirements for derivative instruments. The proposed statement would also amend FASB Statement No. 52, *Foreign Currency Translation*, and No. 107. Readers should be alert to the issuance of a final standard.

*Professional Standards*, vol. 1, AU sec. 9332), provides additional guidance for auditing securities, such as hedge funds, for which a readily determinable fair value does not exist. Not-for-profit organizations may elect to report those securities at fair value in conformity with paragraphs A.10–A.13 of appendix A [paragraph 8.36] of this chapter. The interpretation states that in circumstances in which the auditor determines that the nature and extent of auditing procedures should include verifying the existence and testing the measurement of investments in securities, simply receiving a confirmation from a third party, either in aggregate or on a security-by-security basis, does not in and of itself constitute adequate audit evidence with respect to the valuation assertion in AU section 332. In addition, receiving confirmation from a third party for investments in aggregate does not constitute adequate audit evidence with respect to the existence assertion under AU section 332. Receiving confirmation from a third party on a security-by-security basis, however, typically would constitute adequate audit evidence with respect to the existence assertion under AU section 332. When auditing investments for which readily determinable fair value does not exist, auditors may find useful the practice aid *Alternative Investments—Audit Considerations*. That practice aid, which was developed and issued by the Alternative Investments Task Force, is available by following the practice aids and tools link of the audit and attest standards at www.aicpa.org/Professional+Resources. In circumstances in which the auditor is unable to audit the existence or measurement of interests in investments in securities at the financial statement date, the auditor should consider whether that scope limitation requires the auditor to either qualify his or her opinion or to disclaim an opinion, as discussed in paragraphs .22–.26 of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1).

## Net Appreciation on Endowment Funds

**8.34** As discussed in this chapter, net appreciation on donor-restricted endowment funds should be reported as a change in unrestricted net assets unless the appreciation is temporarily or permanently restricted by explicit donor-imposed stipulations or by law. Laws concerning net appreciation of donor-restricted endowment funds may vary from jurisdiction to jurisdiction. For example, some jurisdictions follow trust law, some follow the Uniform Management of Institutional Funds Act (UMIFA), some follow modifications of UMIFA, and some follow interpretations of those laws issued by state Attorneys General. In July 2006, the National Conference of Commissioners on Uniform State Laws issued the Uniform Prudent Management of Institutional Funds Act (UPMIFA) as model legislation to be adopted, in whole or in part, by the individual states as a replacement for UMIFA.[12] Generally, in jurisdictions following trust law,

---

[12] A few states have adopted the provisions of Uniform Prudent Management of Institutional Funds Act (UPMIFA) (in whole or in part), and additional states have introduced legislation to change their laws. Readers should be alert to changes in their state law and the possible effects of those changes on classification of net assets. UPMIFA prescribes new guidelines for expenditure of a donor-restricted endowment fund (in the absence of overriding, explicit donor stipulations) that focus on the entirety of a donor-restricted endowment fund, that is, both original gift amount(s) and net appreciation. UPMIFA eliminates Uniform Management of Institutional Funds Act (UMIFA) *bright-line historic-dollar-value* threshold, an amount below which an organization could not spend from the fund, in favor of a more robust set of guidelines about what constitutes prudent spending. Questions have arisen about whether UPMIFA's shift in focus affects the net asset classification of a donor-restricted

*(continued)*

net appreciation is not spendable and therefore should be added to permanently restricted net assets. Also, it has generally been interpreted that, absent donor restrictions, net appreciation is spendable under UMIFA and therefore should be added to unrestricted net assets.[13] Auditors may find information available from State Societies of Certified Public Accountants, state Attorneys General, and industry publications useful in obtaining an understanding of these issues. As discussed in paragraph .07 of AU section 333, *Management Representations* (AICPA, *Professional Standards*, vol. 1), the representation letter ordinarily should be tailored to include additional appropriate representations, an example being where the representations from management about any interpretations made by the organization's governing board concerning whether laws limit the amount of net appreciation of donor-restricted endowment funds that may be spent. However, for organizations operating in jurisdictions in which there may be questions concerning interpretations of the applicable laws or in which there are conflicting interpretations by various legal counsel, auditors may find it helpful to request that the organization obtain a specific opinion from legal counsel concerning interpretation of the legal requirements. (AU section 336, *Using the Work of a Specialist* [AICPA, *Professional Standards*, vol. 1], provides guidance concerning circumstances in which the auditor relies on the representations or work of an attorney for other than litigation, claims, and assessments as addressed in AU section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* [AICPA, *Professional Standards*, vol. 1].)

**8.35** The following table illustrates the use of assertions in developing audit objectives and designing substantive tests. The examples are not intended to be all-inclusive nor is it expected that all the procedures would necessarily be applied in an audit. The auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure to obtain sufficient appropriate audit evidence. The use of assertions in assessing risks and designing appropriate audit procedures to obtain audit evidence is described in paragraphs .14–.26 of AU section 326, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1). Various audit procedures and the purposes for which they may be performed are described in paragraphs .27–.41 of AU section 326.

---

*(footnote continued)*

endowment fund. In February 2008, FASB issued proposed FSP FAS 117-a, *Endowments of Not-for-Profit Organizations: Net Asset Classification of Funds Subject to an Enacted Version of the Uniform Prudent Management of Institutional Funds Act, and Enhanced Disclosures*, with guidance concerning the potential effect of the adoption of the model UPMIFA on the classification of net assets related to donor-restricted endowment funds. Readers in jurisdictions subject to UPMIFA-based laws should be alert to the issuance of the final standards.

[13] Paragraphs 8.16–.18 provide further guidance about classification of net appreciation of endowment funds.

## Auditing Considerations

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| ***Presentation and Disclosure*** | | | |
| *Contributed Investments, Investment Income, Gains, and Losses* | | | |
| Rights and obligations; Classification | Restrictions on contributed investments are reflected in the classification of net assets. | Contributions of investments and investment income, gains, and losses are reviewed for restrictions and management monitors compliance with restrictions. | Review donor correspondence to determine the existence of restrictions on, and classification of, investments and related income, gains, and losses. |
| | Restrictions on investment income, net realized gains, and net recognized unrealized gains that are imposed by donors or by law are reflected in the classification of revenue and gains. | | Review minutes of governing board and governing board committee meetings for evidence of donor or statutory restrictions on, and classification of, investments and related income, gains, and losses. |
| | | | If specific investments are restricted, review investment transactions for the propriety of dispositions. |
| *Reclassification of Restricted Net Assets* | | | |
| Occurrence/ Existence; Classification | Restricted net assets are reclassified as unrestricted net assets in the statement of activities when restrictions are met on investment income or net appreciation restricted for support of donor-specified programs. | | Determine that appropriate reclassifications are made in the statement of activities when restrictions are met on investment income or net appreciation restricted for donor-specified programs. |

8.36

# Appendix A — Measuring Other Investments

## FASB Staff Positions

**A.1** Financial Accounting Standard Board (FASB) Staff Position (FSP) FAS 115-1 and 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, (FSP 124-1) provides guidance about the meaning of other-than-temporary impairment and its application to certain debt and equity securities. When applied by not-for-profit organizations, it provides guidance for reporting equity securities whose fair value is not readily determinable (that is, equity securities that are outside the scope of FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*) if those securities are not reported at the equity method (that is, reported at cost in conformity with the guidance in paragraphs A.10–A.13). FSP 124-1 refers to those equity securities as cost-method investments.

**A.2** Impairment of cost-method investments is assessed at the individual security level, which means at the level and method of aggregation used by the organization to measure realized and unrealized gains and losses on its equity securities. An investment is impaired if the fair value of the investment is less than its cost. Because the fair value of a cost-method investment is not readily determinable, the evaluation of whether an investment is impaired should be determined as follows.

*a.* If the organization has determined the fair value of a cost-method investment (for example, for disclosure under FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*), that estimate should be used to determine if an investment is impaired.

*b.* If the organization has not estimated the fair value of a cost-method investment (for example, because the organization is exempt from providing fair value disclosures under FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities—an amendment to FASB Statement No. 107*), the organization should evaluate whether an event or change in circumstances has occurred in the period that might have a significant adverse effect on the fair value of the investment (an impairment indicator). If an impairment indicator is present, the investor should estimate the fair value of the investment. Impairment indicators include, but are not limited to the following:

- A significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee
- A significant adverse change in the regulatory, economic, or technological environment of the investee
- A significant adverse change in the general market condition of either the geographic area or the industry in which the investee operates
- A bona fide offer to purchase (whether solicited or unsolicited), an offer by the investee to sell, or a completed

auction process for the same or similar security for an amount less than the cost of the investment

- Factors that raise significant concerns about the investee's ability to continue as a going concern, such as negative cash flows from operations, working capital deficiencies, or noncompliance with statutory capital requirements or debt covenants.

In addition, if an investment was previously tested for impairment pursuant to paragraph A.3 and the organization concluded that the investment was not other-than-temporarily impaired, the organization should continue to evaluate whether the investment is impaired (that is, estimate the fair value of the investment) in each subsequent reported period until either (*a*) the investment experiences a recovery of fair value up to (or beyond) its cost or (*b*) the organization recognizes an other-than-temporary impairment.

**A.3** When the fair value of an investment is less than its cost at the balance sheet date of the reporting period for which impairment is assessed, the impairment is either temporary or other than temporary. (Other than temporary does not mean permanent.) An organization should apply other guidance that is pertinent to the determination of whether an impairment is other than temporary, such as Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) Topic 5M, *Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities*, paragraph 6 of Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*. In applying that guidance, an investor shall recognize an impairment loss when the impairment is deemed other than temporary even if a decision to sell has not been made. However, when an organization has decided to sell an impaired security and the organization does not expect the fair value of the security to fully recover prior to the expected time of sale, the security should be deemed other-than-temporarily impaired in the period in which the decision to sell is made.

**A.4** If the impairment is other than temporary, then an impairment loss should be recognized equal to the entire difference between the investment's cost and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment should not include partial recoveries subsequent to the balance sheet date. The fair value of the investment would then become the new cost basis of the investment and should not be adjusted for subsequent recoveries in fair value.

**A.5** For all cost-method investments that are in an unrealized loss position for which impairment losses have not been recognized, the organization should include the following information as of *each* date for which a statement of financial position is presented in its annual financial statements:

(1) The aggregate amount of unrealized losses (that is, the amount by which cost or amortized cost exceeds fair value)

(2) The aggregate related fair value of investments with unrealized losses

The information in (1) and (2) should be presented in tabular form, aggregated by each category of investment that the organization discloses in accordance with FASB Statement No. 124 for its cost-method investments. The table

should be segregated by those investments that have been in a continuous unrealized loss position for less than twelve months and those that have been in a continuous unrealized loss position for twelve months or longer. The reference point for determining how long an investment has been in a continuous unrealized loss position is the balance sheet date of the period in which the impairment is identified (if only annual financial statements are prepared, the reference point would be the annual balance sheet date of the period during which the impairment was identified). The continuous unrealized loss position ceases upon either (*a*) the recognition of an other-than-temporary impairment or (*b*) the recovery of fair value up to (or beyond) the cost of the investment.

**A.6** In addition, for all cost-method investments that are in an unrealized loss position for which impairment losses have not been recognized, the organization should explain as of the date of the *most recent* statement of financial position included in its annual financial statements why it concluded that the impairment was not other-than-temporary. That information could include:

- The nature of the investment(s)
- The cause(s) of the impairment(s)
- The number of investment positions that are in an unrealized loss position
- The severity and duration of the impairment(s)
- The evidence (both positive and negative) considered by the organization in reaching its conclusion that the investment is not other-than-temporarily impaired, including, for example, industry analyst reports, sector credit ratings, volatility of the security's fair value, and/or any other information that the organization considers relevant

**A.7** As of each date for which a statement of financial position is presented in its annual financial statements, FSP 124-1 requires the organization to disclose (if applicable)

*a.* The aggregate carrying amount of all cost-method investments,

*b.* The aggregate carrying amount of cost-method investments that the organization did not evaluate for impairment (for example, because estimated fair value was greater than cost or because no impairment indicator was present),

*c.* The fact that the fair value of a cost-method investment is not estimated if there are no identified events or changes in circumstances that may have a significant adverse effect on the fair value of the investment, and that

(1) The organization determined, in accordance with paragraphs 14–15 of FASB Statement No. 107 that it is not practicable to estimate the fair value of the investment, or

(2) The organization is exempt from estimating fair value under FASB Statement No 126.

## EITF Consensus Opinions*

**A.8** Emerging Issue Task Force (EITF) Consensus Opinions are category (c) generally accepted accounting principles (GAAP) as described in AU section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles (AICPA, *Professional Standards*, vol. 1). Including the EITF Consensus Opinions within this guide, which is category (b) GAAP, does not change their position in the GAAP hierarchy. The guidance in these consensus opinions should be considered in conjunction with the guidance brought forward from the superseded guides (paragraphs A.10–A.13) and the guidance in AICPA Statement of Position 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*. Thus, these consensus opinions do not apply to investments that are held in portfolios that are reported at current market value or fair value.

### *Equity Interests That Should Not Be Accounted for Under the Equity Method*

**A.9** The consensus opinion reached in EITF Issue No. 02-14, "Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock," which was ratified by the FASB in July 2004 and EITF Issue No. 04-5, "Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights," limit the use of the equity method to the following:

- Investment(s) in common stock
- Investment(s) in-substance common stock, as that type of investment is defined in the consensus opinion
- Investment(s) by a general partner in a limited partnership or similar entity when the general partner(s) do not control the partnership, as discussed in EITF Issue No. 04-5

EITF Issue No. 02-14 does not change the application of the equity method for

- Investments in noncorporate entities accounted for under AICPA Statement of Position 78-9, *Accounting for Investments in Real Estate Ventures*;
- Investments in limited liability companies that maintain "specific ownership accounts" for each investor as discussed in EITF Issue No. 03-16, "Accounting for Investments in Limited Liability Companies"; and

---

* On September 27, 2007, the FASB issued an exposure draft, *Proposed FSP SOP 94-3-a and AAG-HCO-a, Omnibus Changes to Consolidation and Equity Method Guidance for Not-for-Profit Organizations*, which would address the application by not-for-profit organizations of the following four Emerging Issues Task Force (EITF) Consensus No. 90-15, "Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions"; No. 96-21, "Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities"; No. 97-1, "Implementation Issues in Accounting for Lease Transactions, including Those involving Special-Purpose Entities"; and No. 03-16, "Accounting for Investments in Limited Liability Companies." In addition, the proposed FSP would make several changes to the guidance on consolidation and the equity method of accounting in AICPA Statement of Position (SOP) 94-3, *Reporting of Related Entities by Not-for-Profit Organizations* (AICPA, *Technical Practice Aids*, ACC sec. 10,610), and would require that not-for-profit organizations apply the guidance in SOP 78-9, *Accounting for Investments in Real Estate Ventures* (AICPA, *Technical Practice Aids*, ACC sec. 10,240). Readers should be alert to the issuance of a final standard.

- Beneficial interests in trusts as required by FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others.*

"The Significant Matters Since the Issuance of This SOP" of SOP 94-3 [paragraph 8.36] provides more information about EITF Issue No. 02-14, including how to discontinue use of the equity method if it is being used for investments that are not in the preceding list, and about EITF Issue No. 04-5. Further, EITF Issue No. 07-1, "Accounting for Collaborative Arrangements,"† states that the equity method of accounting should not be used for a collaborative arrangement (collaborative arrangements are discussed in chapter 3 of this guide), which is defined in the consensus as a contractual arrangement for a joint operating activity that involves two (or more) parties who are both (*a*) active participants in the activity and (*b*) exposed to significant risks and rewards dependent on the commercial success of the activity and that does not involve the formation of a separate legal entity. The consensus includes indicators to help in applying that definition. The guidance in the consensus does not apply to arrangements for which the accounting is specifically addressed within the scope of other authoritative accounting literature.

## Guidance Brought Forward From Superseded Guides

**A.10** The following guidance is based on the AICPA Industry Audit Guides, Audit and Accounting Guides, and SOPs that are superseded by this guide. To the extent that the guidance in those AICPA publications required all investments to be measured using the same measurement attribute, the guidance in paragraphs A.11–A.13 has been conformed to FASB Statement No. 124 and subsequently issued standards. For example, if an AICPA publication that is superseded by this guide permitted investments to be carried at either cost or fair value, provided that the same attribute is used for all investments, and if equity securities with a readily determinable fair value are carried at fair value in conformity with the guidance in FASB Statement No. 124, other investments are permitted to be carried at either cost or fair value, provided that the same attribute is used for all other investments. Similarly, if an organization elects the fair value option pursuant to FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*, or No. 159, *The Fair Value Option for Financial Assets and Liabilities—Including an amendment of FASB Statement No. 115*, only other investments for which the election was not made are required to be measured using the same attribute. In other words, the guidance is intended to maintain the status quo for other investments held by each kind of not-for-profit organization covered by that literature until it is changed by the FASB or by AcSEC.

**A.11** Other investments of institutions of higher education, including colleges, universities, and community or junior colleges that were acquired by

† EITF Issue 07-1 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. The guidance should be applied retrospectively to all prior periods presented for all collaborative arrangements existing as of the effective date. The guidance should be applied retrospectively to all prior periods presented for all collaborative arrangements existing as of the effective date.

purchase may be reported at cost and contributed other investments may be reported at their fair market value or appraised value at the date of the gift, unless there has been an impairment of value that is not considered to be temporary. If other investments are equity securities that are reported at cost, the institution should apply FSP FAS 124-1, which is discussed in paragraphs A.1–A.7 of this appendix, to determine if an impairment loss must be recognized. Other investments may also be reported at current market value or fair value. The same measurement attribute should be used for all other investments excluding those for which the institution chose, at a specified election date, to measure at fair value pursuant to FASB Statement No. 155 or FASB Statement No. 159,[‡] (which are described in paragraphs 3.44–.46 of this guide). (Investments in wasting assets are usually reported net of an allowance for depreciation or depletion.) The financial statements or notes should set forth the total performance (that is, investment income and realized and unrealized gains and losses) of the other investment portfolio.

**A.12** Voluntary health and welfare organizations should report other investments at cost if purchased and at fair market value at the date of the contribution if contributed. If other investments are equity securities that are reported at cost, the organization should apply FSP FAS 124-1, which is discussed in paragraphs A.1–A.7 of this appendix, to determine if an impairment loss must be recognized. If other investments are not equity securities and the market value of the portfolio of those investments is below the recorded amount, it may be necessary to reduce the carrying amount of the portfolio to market or to provide an allowance for decline in market value. If it can reasonably be expected that the organization will suffer a loss on the disposition of an investment, an impairment loss should be recognized in the period in which the decline in value occurs. Carrying other investments at market value is also acceptable. The same measurement attribute should be used for all other investments excluding those for which the organization chose, at a specified election date, to measure at fair value pursuant to FASB Statement No. 155[‡] (which are described in paragraphs 3.44–.46 of this guide). The measurement attribute(s) for other investments should be disclosed.

**A.13** Not-for-profit organizations that are not colleges, universities, or voluntary health and welfare organizations (that is, those that were included in the Statement of Position 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*)[||] should report other investments at either fair value or the lower of cost or fair value. The same measurement attribute should be used for all other investments excluding those for which the organization chose, at a specified election date, to measure at fair value pursuant to FASB Statement Nos. 155 or 159[‡] (which are described in paragraphs 3.44–.46 of this guide). If other investments are securities that are reported at cost, the organization should apply FSP FAS 124-1, which is discussed in paragraphs A.1–A.7 of this appendix, to determine if an impairment loss must be

[‡] FASB Statement No. 159, *The Fair Value Option for Financial Assets and Liabilities—Including an amendment of FASB Statement No. 115*, is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the entity also elects to apply the provisions of FASB Statement No. 157, *Fair Value Measurements*.

[||] This publication has been superseded by the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.

recognized. If other investments are not equity securities and are carried at the lower of cost or market value, declines in the value of those investments should be recognized when their aggregate market value is less than their carrying amount, recoveries of aggregate market value in subsequent periods should be recorded in those periods subject only to the limitation that the carrying amount should not exceed the original cost.

8.37

# Appendix B—Statement of Position 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*

> **NOTE**
>
> Statements of Position of the Accounting Standards Division present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

## SIGNIFICANT MATTERS SINCE THE ISSUANCE OF THIS SOP

In August 1996, the AICPA issued an Audit and Accounting Guide *Not-for-Profit Organizations* (the New Guide) which superseded the following AICPA Audit and Accounting Guides:

- Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations*
- Industry Audit Guide *Audits of Colleges and Universities*
- Audit and Accounting Guide *Audits of Certain Nonprofit Organizations*

It also superseded the following AICPA Statements of Position (SOPs):

- SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*
- SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*
- SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*

- SOP 94-2, *The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations*

The New Guide is effective for financial statements for fiscal years ending on or after December 31, 1996. Earlier application is permitted.

This SOP applies to entities following the New Guide.

Readers should note the following matters:

- In July 1996, the AICPA issued an Audit and Accounting Guide *Health Care Organizations* that superseded the Audit and Accounting Guide *Audits of Providers of Health Care Services*. This SOP does not apply to entities following *Health Care Organizations*, just as it did not apply to entities following *Audits of Providers of Health Care Services*.

- References to pronouncements and guidance that are superseded have been shaded.

- In applying the guidance in paragraph .07, readers should refer to Chapter 8, "Investments," of the New Guide. Not-for-profit organizations that choose to report investments at market value in conformity with the New Guide may do so instead of reporting those investments by the equity method, which otherwise would be required by this SOP.

  — Although the New Guide superseded SOP 78-10, it did not supersede the guidance in paragraph .13 of this SOP that "[e]ntities that otherwise would be prohibited from presenting consolidated financial statements under the provisions of this SOP, but that currently present consolidated financial statements in conformity with the guidance in SOP 78-10, may continue to do so." Organizations that presented consolidated financial statements in conformity with the guidance in SOP 78-10 may continue to do so.

- In applying the definition of "economic interest" in the Glossary, readers should refer also to paragraph 3.22 of the New Guide.

- Paragraph C2 of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, amends the last sentence of paragraph 2 of ARB No. 51, *Consolidated Financial Statements*, by deleting the phrase "is likely to be temporary or if it" from that sentence. The amended sentence in paragraph 2 therefore reads as follows:

  "A majority-owned subsidiary shall not be consolidated if control ~~is likely to be temporary or if it~~ does not rest with the majority owner. . ."

This SOP has been conformed to FASB Statement No. 144 to eliminate the exception to consolidation for a temporarily controlled subsidiary in circumstances in which this SOP requires consolidation based on a controlling financial interest through direct or indirect ownership of a majority voting interest (paragraphs .05 and .10 of this SOP). No such conforming change to this SOP is appropriate in circumstances in which consolidation is required or permitted based on control through other than a controlling financial interest through direct or indirect ownership of a majority voting interest (Paragraphs .11 and .12 of this SOP). Accordingly, this SOP retains the exception to consolidation for a temporarily controlled subsidiary in circumstances in which consolidation is required or permitted based on control through other than a controlling financial interest through direct or indirect ownership of a majority voting interest.

- In July 2004, the FASB ratified conclusions reached by the Emerging Issues Task Force in EITF Issue No. 02-14, *Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock*. Accordingly, this SOP has been conformed to include the guidance in EITF Issue No. 02-14. The consensus opinion reached in EITF Issue No. 02-14 expands the use of the equity method of accounting described in APB Opinion No. 18 to certain investments that are deemed "in-substance common stock" (as defined in the consensus opinion).[†] It requires an investor that has the ability to exercise significant influence over the operating and financial policies of an investee to apply the equity method of accounting only when it has an investment(s) in common stock and/or an investment that is in-substance common stock. The consensus opinion does not apply to investments accounted for under FASB Statement No. 133, non-corporate entities accounted for under AICPA Statement of Position No. 78-9, *Accounting for Investments in Real Estate Ventures*, or to LLCs accounted for under EITF Issue No. 03-16.

Also, in accordance with paragraph .07 of this SOP, EITF Issue No. 02-14 does not apply to investments that are reported at current market value or fair value. (Paragraphs A.10–A.13 of Appendix A of Chapter 8 of this Guide discuss the circumstances in which an investment may be reported at current market value or fair value.) When applied by a not-for-profit organization, EITF Issue No. 02-14 requires that an organization with the ability to exercise significant influence over the operating and financial policies of a for-profit entity apply APB Opinion No. 18 if that investment is common stock or "in-substance common stock." [Revised, May 2007, to reflect conforming changes necessary due to the issuance of FASB Statement No. 159.]

In-substance common stock is an investment in a for-profit investee that has risk and reward characteristics that are substantially similar to that entity's common stock. It might be an investment in a

† [Footnote deleted, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5.]

different class of stock or in an in-the-money warrant or option. An organization should consider three characteristics when determining whether an investment in a for-profit entity is substantially similar to an investment in that entity's common stock: subordination, risks and rewards of ownership, and obligation to transfer value. All three of the characteristics must be substantially similar to an investment in the entity's common stock for the organization to conclude that the investment is in-substance common stock. EITF Issue No. 02-14 provides numerous factors that should be considered when determining whether the three characteristics are substantially similar. It also provides examples that illustrate the application of the characteristics to various investments. The initial determination of whether an investment is substantially similar to common stock should be made on the date on which the investor obtains the investment if the investor has the ability to exercise significant influence over the operating and financial policies of the investee. That determination should be reconsidered upon the occurrence of one or more of the triggers described in the consensus opinion.

The use of the equity method of accounting is effectively limited to investment(s) in common stock, in-substance common stock, noncorporate entities accounted for under AICPA Statement of Position 78-9, *Accounting for Investments in Real Estate Ventures*, limited liability companies that maintain "specific ownership accounts" for each investor as discussed in EITF Issue No. 03-16, *Accounting for Investments in Limited Liability Companies* and investments by a general partner in a limited partnership or similar entity when the general partner(s) do not control the partnership, as discussed in EITF Issue No. 04-5, *Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights*. If a not-for-profit organization uses the equity method of accounting to account for investments in for-profit entities that are not included in that list, the equity method of accounting should be discontinued.[‡] The organization should evaluate whether the investment should be prospectively accounted for under FASB Statement 124 or accounted for as described in Appendix A. The accounting for beneficial interests in trusts as required by FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, does not change as a result of EITF Issue No. 02-14. [Revised, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5.]

- In June 2005, the FASB ratified conclusions reached by the Emerging Issues Task Force in EITF Issue No. 04-5, *Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights.* Accordingly, this SOP has been

[‡] Previously recognized equity method earnings and losses should not be reversed when the equity method of accounting is discontinued. [Footnote revised, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5.]

conformed to include the guidance in EITF Issue No. 04-5. The consensus opinion reached in EITF Issue No. 04-5 provides a framework to determine if a general partner, or the general partners as a group, controls a limited partnership or similar entity when the limited partners have certain rights. For not-for-profit organizations, the consensus opinion applies to limited partnerships or similar entities (such as limited liability companies that have governing provisions that are the functional equivalent of a limited partnership) unless, in conformity with GAAP, the interests in those entities are reported at fair value with changes in fair value reported in a statement of operations or financial performance. That is, if an organization is required to apply the consolidation guidance included in ARB 51 and FASB Statement No. 94 to its to its investment in a limited partnership, it is within the scope of EITF Issue No. 04-5. The consensus opinion need not be applied in circumstances in which no single general partner in a group of general partners controls the limited partnership. Guidance on determining which general partner in a group of general partners should consolidate the partnership is beyond the scope of this EITF Issue. [Added, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5. Revised, May 2007, to reflect conforming changes necessary due to the issuance of FASB Statement No. 159.]

The general partners in a limited partnership are presumed to control that limited partnership regardless of the extent of the general partners' ownership interest in the limited partnership. The assessment of whether the rights of the limited partners should overcome the presumption of control by the general partners is a matter of judgment that depends on facts and circumstances. [Added, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5.]

The general partners do not control the limited partnership if the limited partners have either (*a*) the substantive ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause (referred to as kick-out rights) or (*b*) substantive participating rights. Substantive participating rights provide the limited partners with the ability to effectively participate in significant decisions that would be expected to be made in the ordinary course of the limited partnership's business. Limited partners' rights that are only protective in nature (referred to as "protective rights") do not overcome the presumption that the general partners control the limited partnership. Guidance on how to determine if the limited partners have these characteristics is provided by paragraphs 7 to 19 of EITF Issue No. 04-5 and examples in Exhibit 04-5A of the Issue abstract. [Added, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5.]

If the limited partners possess substantive kick-out rights or if the limited partners have substantive participating rights, presumption of control by the general partners would be overcome, and each of the general partners should account for its investment in the limited partnership using the equity method of accounting. [Added, May 2006,

to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5.]

The assessment of limited partners' rights and their impact on the presumption of control of the limited partnership by the general partners should be made when an investor(s) first becomes a general partner(s) and should be reassessed at each reporting period thereafter for which financial statements of the general partner(s) are prepared. [Added, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5.]

- In February 2007, the FASB issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which creates an option under which an organization may irrevocably elect fair value as the initial and subsequent measure for many financial instruments and certain other items, with changes in fair value recognized in the statement of activities as those changes occur.[||] An election is made on a instrument-by-instrument basis (with certain exceptions), generally when an instrument is initially recognized in the financial statements. Not-for-profit organizations that choose to report investments at fair value in conformity with this Statement may do so instead of reporting those investments by the equity method, even if that method otherwise would be required by this SOP. [Added, May 2007, to reflect conforming changes necessary due to the issuance of FASB Statement No. 159.]
- In June 2007, the AICPA issued Statement of Position No. 07-1, *Clarification of the Scope of the Audit and Accounting Guide*, Audits of Investment Companies, *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*. SOP 07-1 amended paragraph .07 of SOP 94-3 and added to it footnotes 6 and 8. Subsequently, the FASB issued FSP SOP 07-1-1, *Effective Date of AICPA Statement of Position 07-1*, to delay indefinitely the effective date of the SOP and to prohibit adoption of the SOP by an entity that has not early adopted the SOP before issuance of the FSP. Therefore, the changes made by SOP 07-1 are not reflected in this Appendix. A not-for-profit organization that early adopts SOP 07-1 before issuance of the final FSP would be permitted but not required to continue to apply the provisions of the SOP; those organizations should refer to SOP 07-1 for the amendments. [Revised, March 2008, to reflect the issuance of SOP 07-1.]
- On September 27, 2007, the FASB issued an exposure draft, *Proposed FSP SOP 94-3-a and AAG-HCO-a, Omnibus Changes to Consolidation and Equity Method Guidance for Not-for-Profit Organizations*, which would make several changes to the guidance on consolidation and the equity method of accounting in SOP 94-3. It would amend paragraphs 3, 7, 10, 11, 12, and 20 and footnotes

---

[||] FASB Statement No. 159 is effective as of the beginning of the first fiscal year that begins after November 15, 2007. Earlier adoption is permitted if certain conditions described in paragraph 30 of the Statement are met. [Footnote added, May 2007, to reflect conforming changes necessary due to the issuance of FASB Statement No. 159.]

4, 10, 11, and 13. It also would add a new paragraph (6A) about investments in for-profit partnerships, limited liability companies, and similar entities in which the not-for-profit organization has more than a minor interest. Readers should be alert to the issuance of a final standard. [Added, March 2008, to reflect the issuance of proposed exposure draft, *Proposed FSP SOP 94-3-a and AAG-HCO-a*.]

## TABLE OF CONTENTS

| | *Paragraph* |
|---|---|
| Summary | |
| Introduction | 1 |
| Scope | 2 |
| Conclusions | 3-4 |
| Investments in For-Profit Majority-Owned Subsidiaries | *5* |
| Investments in Common Stock of For-Profit Entities Wherein the Not-for-Profit Organization Has a 50 Percent or Less Voting Interest | *6-7* |
| Financially Interrelated Not-forProfit Organizations | 8-14 |
| Effective Date and Transition | 15 |
| Appendix A—Background Information and Discussion of Conclusions | |
| Appendix B—Other Financial Reporting Literature | |
| Appendix C—Other Projects Related to This SOP | |
| Appendix D—Flowcharts and Decision Trees | |
| Glossary | |

**SUMMARY**

This statement of position (SOP) amends and makes uniform the guidance concerning reporting related entities in the following AICPA publications:

- Industry Audit Guides *Audits of Voluntary Health and Welfare Organizations*# and *Audits of Colleges and Universities*#
- Audit and Accounting Guide *Audits of Certain Nonprofit Organizations*#
- SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*#

The conclusions in this SOP are based on the premise that (1) whether the financial statements of a reporting not-for-profit organization and those of one or more other not-for-profit or for-profit entities should be consolidated and (2) the extent of disclosure that should be required, if any, if consolidated financial statements are not presented should be based on the nature of the relationship between the entities.

The guidance in this SOP focuses on (1) investments in for-profit entities and (2) financially interrelated not-for-profit organizations. That guidance includes the following:

**Investments in For-Profit Entities**

- A reporting not-for-profit organization should consolidate a for-profit entity in which it has a controlling financial interest through direct or indirect ownership of a majority voting interest if the guidance in Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, as amended by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards Nos. 94, *Consolidation of All Majority-Owned Subsidiaries* and 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, requires consolidation. The manner in which the for-profit entity's financial position, results of operations, and cash flows are presented in the reporting organization's financial statements depends on the nature of the activities of the for-profit entity.
- A reporting not-for-profit organization should use the equity method in conformity with Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, to report investments in common stock or "in substance common stock" of a for-profit entity if the guidance in that Opinion requires the use of the equity method.
- Not-for-profit organizations that choose to report at fair value their portfolio of other investments in conformity with paragraphs A.10–A.13 of Appendix A of Chapter 8 of the New Guide or that report investments in common stock or "in substance common stock" at fair value pursuant to FASB Statement No. 159, *The Fair Value*

# This publication has been superseded by the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*. [Footnote renumbered, June 2007.]

*Option for Financial Assets and Financial Liabilities,*[**] may do so instead of reporting those investments by the equity method, which otherwise would be required by this SOP. [Revised, May 2007, to reflect conforming changes necessary due to the issuance of FASB Statement No. 159.]

**Financially Interrelated Not-for-Profit Organizations**

- A not-for-profit organization should consolidate another not-for-profit organization in which it has a controlling financial interest through direct or indirect ownership of a majority voting interest, unless control does not rest with the majority owner, in which case consolidation is prohibited, as discussed in ARB No. 51, as amended by FASB Statement Nos. 94 and 144.
- A not-for-profit organization should consolidate another not-for-profit organization if the reporting not-for-profit organization has both control of the other not-for-profit organization, as evidenced by either majority ownership or a majority voting interest in the board of the other not-for-profit organization, and an economic interest in the other not-for-profit organization, unless control is likely to be temporary or does not rest with the majority owner, in which case consolidation is prohibited.
- A not-for-profit organization may exercise control of another not-for-profit organization in which it has an economic interest by means other than majority ownership or a majority voting interest in the board of the other not-for-profit organization. In such circumstances, the not-for-profit organization is permitted, but not required, to consolidate the other not-for-profit organization, unless control is likely to be temporary, in which case consolidation is prohibited. If a not-for-profit organization controls another organization in which it has an economic interest by means other than majority ownership or a majority voting interest in the board of the other not-for-profit organization and consolidated financial statements are not presented, the not-for-profit organization should make the financial statement disclosures specified in paragraph .12.
- If either (but not both) control or an economic interest exists, the financial statement disclosures required by FASB Statement No. 57, *Related Party Disclosures*, should be made.

The conclusions in this SOP will be reconsidered when the FASB completes its project on consolidations and related matters, which may affect the definition of control and other related matters. In January 2004, after the issuance of FASB Interpretation No. 46, Consolidation of Variable Interest Entities, the FASB moved its consolidations and related matters project from its technical agenda to its research project agenda. To date, no changes to the guidance in this SOP have resulted from the FASB's consolidations and related matters project.

---

[**] FASB Statement No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the entity also elects to apply the provisions of FASB Statement No. 157, *Fair Value Measurement*. [Footnote added, May 2007, to reflect conforming changes necessary due to the issuance of FASB Statement No. 159; Footnote renumbered, June 2007, to reflect conforming changes necessary due to the issuance of SOP 07-1.]

This SOP is effective for financial statements issued for fiscal years beginning after December 15, 1994, except for not-for-profit organizations that have less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date shall be for fiscal years beginning after December 15, 1995. Earlier application is permitted. For organizations that adopt FASB Statement No. 117, Financial Statements of Not-for-Profit Organizations, before its effective date, earlier application of this SOP is encouraged. Comparative financial statements for earlier periods included with those for the period in which this SOP is adopted should be restated.

**Changes Made to Reflect the Issuance of FASB Statement No. 144**

There have been conforming changes made to this SOP due to the issuance of FASB Statement No. 144. Paragraph C2 of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, amends the last sentence of paragraph 2 of ARB No. 51, *Consolidated Financial Statements*, by deleting the phrase "is likely to be temporary or if it" from that sentence. The following paragraphs of this SOP have changed and footnotes added: paragraph .05, footnote 4, paragraph .10, footnote 8, paragraph .11, footnote 11, and paragraph .12, footnote 12. Readers should be aware of the changes. [Revised, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5.]

**Changes Made to Reflect the Issuance of EITF Issue No. 02-14**

There have been conforming changes made to this SOP due to the issuance of EITF Issue No. 02-14, *Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock*. Paragraph .06, footnote 5 was added. Readers should be aware of the change.

**Changes Made to Reflect the Issuance of EITF Issue No. 04-5**

There have been conforming changes made to this SOP due to the issuance of EITF Issue No. 04-5, *Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights*. Paragraph 5, footnote 5 was added and subsequent footnotes were renumbered. Readers should be aware of the change. [Added, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5].

**Changes Made to Reflect the Issuance of FASB Statement No. 159**

There have been conforming changes made to this SOP due to the issuance of FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. Paragraph 7 has been changed by removing reference to the superseded AICPA audit guides and replacing it with references to paragraphs A.10–A.13 of Chapter 8 of the AICPA Audit and Accounting Guide, *Not-for-Profit Organizations* and FASB Statement No. 159. Readers should be aware of the change. [Added, May 2007, to reflect conforming changes necessary due to the issuance of FASB Statement No. 159.]

## Introduction

**.01** The purpose of this statement of position (SOP) is to provide guidance to users and preparers of not-for-profit organizations' financial statements that will produce greater uniformity and comparability in the reporting of investments in majority-owned for-profit subsidiaries, investments in less than 50-percent-owned for-profit entities, and related but separate not-for-profit organizations. This SOP does not address how to prepare consolidated financial statements,[1] nor does it address all the conceptual issues underlying the reporting of relationships not evidenced by ownership.[2]

## Scope

**.02** This SOP—

- Amends and makes uniform the guidance concerning the reporting of related entities in the following AICPA publications:
  - — Industry Audit Guides *Audits of Voluntary Health and Welfare Organizations*# and *Audits of Colleges and Universities*#
  - — Audit and Accounting Guide *Audits of Certain Nonprofit Organizations*#
  - — SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*[3]
- Does not apply to entities or activities that are covered by the AICPA Audit and Accounting Guide *Audits of Providers of Health Care Services*

## Conclusions

**.03** This SOP provides guidance for reporting (*a*) investments in for-profit majority-owned subsidiaries, (*b*) investments in common stock of for-profit entities wherein the not-for-profit organization has a 50 percent or less voting interest, and (*c*) financially interrelated not-for-profit organizations.

**.04** Whether the financial statements of a reporting not-for-profit organization and those of one or more other entities should be consolidated, whether those other entities should be reported using the equity method, and the extent of the disclosure that should be required, if any, should be based on the nature of the relationships between the entities.

---

[1] *Consolidation* of a parent and subsidiary organizations requires the presentation of a single set of amounts for the entire reporting entity. *Combination*, as discussed in paragraphs 22 and 23 of Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, refers to financial statements prepared for organizations among which common control exists but for which the parent-subsidiary relationship does not exist. Both consolidation and combination require elimination of interorganization transactions and balances. This SOP provides no guidance concerning commonly controlled not-for-profit organizations.

[2] As discussed in Appendix C [paragraph .18], the Financial Accounting Standards Board (FASB) has on its agenda a project on consolidations and related matters.

# See footnote # in paragraph 8.37.

[3] SOP 78-10 has no effective date. This SOP amends, but does not affect the status of, SOP 78-10.

## Investments in For-Profit Majority-Owned Subsidiaries

**.05** Not-for-profit organizations with a controlling financial interest in a for-profit entity through direct or indirect ownership of a majority voting interest in that entity should follow the guidance in ARB No. 51, as amended by FASB Statement Nos. 94, *Consolidation of All Majority-Owned Subsidiaries*, and 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*,[4,5] in determining whether the financial position, results of operations, and cash flows of the for-profit entity should be included in the not-for-profit organization's financial statements.[6]

## Investments in Common Stock of For-Profit Entities Wherein the Not-for-Profit Organization Has a 50 Percent or Less Voting Interest

**.06** Investments in common stock of for-profit entities wherein the not-for-profit organization has 50 percent or less of the voting stock in the investee should be reported under the equity method in conformity with Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, if the guidance in that Opinion requires use of

---

[4] Paragraph C2 of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, amends the last sentence of paragraph 2 of ARB No. 51, *Consolidated Financial Statements*, by deleting the phrase "is likely to be temporary or if it" from that sentence. The amended sentence in paragraph 2 therefore reads as follows:

> "A majority-owned subsidiary shall not be consolidated if control ~~is likely to be temporary or if it~~ does not rest with the majority owner..."

This SOP has been conformed to FASB Statement No. 144 to eliminate the exception to consolidation for a temporarily controlled subsidiary in circumstances in which this SOP requires consolidation based on a controlling financial interest (paragraphs .05 and .10 of this SOP). No such conforming change to this SOP is appropriate in circumstances in which consolidation is required or permitted based on control through other than a controlling financial interest (paragraphs .11 and .12 of this SOP). Accordingly, this SOP retains the exception to consolidation for a temporarily controlled subsidiary in circumstances in which consolidation is required or permitted based on control through other than a controlling financial interest.

[5] EITF Issue No. 04-5 requires consolidation by a general partner of limited partnerships or similar entities (such as limited liability companies that have governing provisions that are the functional equivalent of a limited partnership) unless the rights of the limited partners overcome a presumption that the general partner controls a limited partnership. Paragraphs 6–19 and the examples in Exhibit 04-5A of EITF Issue No. 04-5 provide a framework to determine if a general partner, or the general partners as a group, controls a limited partnership or similar entity when the limited partners have certain rights. If the presumption of control by the general partners is overcome, each of the general partners should account for its investment in the limited partnership using the equity method of accounting. The consensus does not apply to partnerships that are reported at fair value in conformity with paragraphs A.10–A.13 of this Guide. That is, if an organization is required to apply the consolidation guidance included in ARB No. 51 and FASB Statement No. 94 to its investment in a limited partnership, it is within the scope of EITF Issue No. 04-5. It also need not be applied in circumstances in which no single general partner in a group of general partners controls the limited partnership. The consensus opinion in this EITF Issue has been ratified by the FASB. EITF Consensus Opinions are category (c) GAAP as described in SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles. The accounting conclusions in this SOP are category (b) GAAP as described in SAS No. 69. Including the EITF Consensus Opinions within this SOP does not change their position in the GAAP hierarchy. However, the guidance in this consensus opinion may be relevant in applying the guidance in this SOP and should be considered in conjunction with it. A more detailed summary of this consensus opinion is provided in the "Summary" of "Significant Matters Since the Issuance of this SOP." [Footnote added, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5.]

[6] [Footnote removed, March 2008, due to indefinite deferral of effective date of SOP 07-1 by FSP SOP 07-1-1, *Effective Date of AICPA Statement of Position 07-1*.]

the equity method, subject to the exception in paragraph .07 of this SOP.[7,[8]] Also, not-for-profit organizations should make the financial statement disclosures required by APB Opinion No. 18 if the guidance in that Opinion requires them.

**.07** Some AICPA audit guides applicable to some not-for-profit organizations (as discussed in paragraphs A.10–A.13 of the appendix A of chapter 8 of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* permit investment portfolios to be reported at market value in certain circumstances. FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities,*[**] permits common stock and "in-substance common stock" to be reported at fair value. Not-for-profit organizations that choose to report investment portfolios at market value in conformity with the AICPA audit guides or that make an election to report investments in common stock or "in-substance common stock" at fair value pursuant to FASB Statement No. 159 may do so instead of applying the equity method of accounting to investments covered by paragraph .06 of this SOP. [Revised, May 2007, to reflect conforming changes necessary due to the issuance of FASB Statement No. 159; Revised, June 2007, to reflect conforming changes necessary due to the issuance of SOP 07-1; Revised, March 2008, to remove conforming changes made to reflect SOP 07-1 due to indefinite deferral of effective date of SOP 07-1 by FSP SOP 07-1-1, *Effective Date of AICPA Statement of Position 07-1.*]

## Financially Interrelated Not-for-Profit Organizations

**.08** Not-for-profit organizations may be related to one or more other not-for-profit organizations in numerous ways, including ownership, *control,*[9] and *economic interest.*

**.09** As discussed in paragraphs .10–.13, the various kinds and combinations of control and economic interest result in various financial reporting. Certain kinds of control result in consolidation (paragraph .10). Other kinds of control result in consolidation only if coupled with an economic interest (paragraph .11). Still other kinds of control result in consolidation being permitted but not required if coupled with an economic interest (paragraph .12). The existence of control or an economic interest, but not both, is discussed in paragraph .13.

---

[7] EITF Issue No. 02-14, *Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock,* requires use of the equity method for investments that are deemed "in-substance common stock" (as defined in the consensus opinion). The consensus opinion in this EITF Issue has been ratified by the FASB. EITF Consensus Opinions are category (c) GAAP as described in AU section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles. The accounting conclusions in this SOP are category (b) GAAP as described in AU section 411. Including the EITF Consensus Opinions within this SOP does not change their position in the GAAP hierarchy. However, the guidance in this consensus opinion may be relevant in applying the guidance in this SOP and should be considered in conjunction with it. A summary of this consensus opinion is provided in the "Summary" of "Significant Matters Since the Issuance of this SOP." [Footnote renumbered , May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue 04-5; Footnote further renumbered, June 2007, to reflect conforming changes necessary due to the issuance of SOP 07-1.]

[8] [Footnote removed, March 2008, due to indefinite deferral of effective date of SOP 07-1 by FSP SOP 07-1-1, *Effective Date of AICPA Statement of Position 07-1.*]

** See footnote ** in paragraph 8.37.

[9] Words or terms defined in the Glossary [paragraph .20] are in italicized type the first time they appear in this SOP. [Footnote renumbered, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue 04-5; Footnote further renumbered, June 2007, to reflect conforming changes necessary due to the issuance of SOP 07-1.]

**.10** Not-for-profit organizations with a controlling financial interest in another not-for-profit organization through direct or indirect ownership of a majority voting interest in that other not-for-profit organization should consolidate that other organization, unless control does not rest with the majority owner, in which case consolidation is prohibited, as discussed in ARB No. 51, as amended by FASB Statement Nos. 94 and 144.[10]

**.11** In the case of (*a*) control through a majority ownership interest[11] by other than ownership of a majority voting interest, as discussed in paragraph .10, or control through a *majority voting interest in the board of the other entity* and (*b*) an economic interest in other such organizations, consolidation is required, unless control is likely to be temporary or does not rest with the majority owner, in which case consolidation is prohibited.[12,13]

**.12** [10]Control of a separate not-for-profit organization in which the reporting organization has an economic interest may take forms other than majority ownership or voting interest; for example, control may be through contract or affiliation agreement. In circumstances such as these, consolidation is permitted but not required, unless control is likely to be temporary, in which case consolidation is prohibited. If the reporting organization controls a separate not-for-profit organization through a form other than majority ownership or voting interest and has an economic interest in that other organization, and consolidated financial statements are not presented, the notes to the financial statements should include the following disclosures:

- Identification of the other organization and the nature of its relationship with the reporting organization that results in control
- Summarized financial data of the other organization including—
  - Total assets, liabilities, net assets, revenue, and expenses
  - Resources that are held for the benefit of the reporting organization or that are under its control

---

[10] Footnote 4 to paragraph .05 of this SOP discusses the effect of FASB Statement No. 144 on the guidance in this SOP. [Footnote renumbered, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5; Footnote further renumbered, June 2007, to reflect conforming changes necessary due to the issuance of SOP 07-1.]

[11] Ownership of not-for-profit organizations may be evidenced in various ways because not-for-profit organizations may exist in various legal forms, such as corporations issuing stock, corporations issuing ownership certificates, membership corporations issuing membership certificates, joint ventures, and partnerships, among other forms. [Footnote renumbered, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5; Footnote further renumbered, June 2007, to reflect conforming changes necessary due to the issuance of SOP 07-1.]

[12] Interests by not-for-profit organizations in other not-for-profit organizations may be less than complete interests. For example, a not-for-profit organization may appoint 80 percent of the board of the other not-for-profit organization. If the conditions for consolidation in this SOP are met, the basis of that consolidation would not reflect a minority interest for the portion of the board that the reporting not-for-profit organization does not control, because there is no ownership interest other than the interest of the reporting not-for-profit organization. However, some not-for-profit organizations may enter into agreements with other entities, such as sharing revenue from fund-raising campaigns, resulting in liabilities to those other entities. In such circumstances, those liabilities should be reported. [Footnote renumbered, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5; Footnote further renumbered, June 2007, to reflect conforming changes necessary due to the issuance of SOP 07-1.]

[13] Footnote 4 to paragraph .05 of this SOP discusses the effect of FASB Statement No. 144 on the guidance in this SOP. [Footnote renumbered, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5; Footnote further renumbered, June 2007, to reflect conforming changes necessary due to the issuance of SOP 07-1.]

- The disclosures set forth in FASB Statement No. 57, *Related Party Disclosures*

**.13** In the case of control and an economic interest, the presentation of consolidated financial statements, as discussed in paragraph .11, or the disclosures, as discussed in paragraph .12, are required. The existence of control or an economic interest, but not both, precludes consolidation, except as stated in the next sentence, but requires the disclosures set forth in FASB Statement No. 57.[14] Entities that otherwise would be prohibited from presenting consolidated financial statements under the provisions of this SOP, but that currently present consolidated financial statements in conformity with the guidance in SOP 78-10, may continue to do so.

**.14** If consolidated financial statements are presented, they should disclose any restrictions made by entities outside of the reporting entity on distributions from the controlled not-for-profit organization to the reporting organization and any resulting unavailability of the net assets of the controlled not-for-profit organization for use by the reporting organization.

## Effective Date and Transition

**.15** This SOP is effective for financial statements issued for fiscal years beginning after December 15, 1994, except for not-for-profit organizations that have less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date shall be for fiscal years beginning after December 15, 1995. Earlier application is permitted. For organizations that adopt FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, prior to its effective date, earlier application of this SOP is encouraged. Comparative financial statements for earlier periods included with those for the period in which this SOP is adopted should be restated.

---

[14] The existence of an economic interest does not necessarily cause the entities to be related parties, as defined in FASB Statement No. 57. However, the disclosures required by that Statement also are required under this SOP if an economic interest exists. [Footnote renumbered, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5; Footnote further renumbered, June 2007, to reflect conforming changes necessary due to the issuance of SOP 07-1.]

.16

# Appendix A

## Background Information and Discussion of Conclusions

**A-1.** This Appendix discusses considerations that were deemed significant by members of AcSEC in reaching the conclusions in this SOP. It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

## Background

### *Characteristics and Objectives of Financial Reporting*

**A-2.** FASB Statement of Financial Accounting Concepts No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, states, among other things, that financial reporting by not-for-profit organizations should provide information—

> . . . that is useful to . . . resource providers . . . in making rational decisions about the allocation of resources to those organizations. (paragraph 35)

and that is

> . . . about the economic resources, obligations, and net resources of an organization and the effects of transactions . . . that change resources and interests in those resources. (paragraph 43)

**A-3.** FFASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, as amended by FASB Concepts Statement No. 6, *Elements of Financial Statements*, examines the characteristics that make accounting information useful. The Statement sets forth a hierarchy of qualities, with usefulness for decision making being most important. The two primary characteristics that make accounting information useful are relevance and reliability. Comparability, which includes consistency, interacts with relevance and reliability to increase the usefulness of information.

**A-4.** Information about the nature of relationships and forms of control among not-for-profit organizations and between not-for-profit organizations and for-profit entities should contribute to the objectives set forth in FASB Concepts Statement No. 4, as well as meet the criteria for accounting information set forth in Concepts Statement No. 2. As indicated in paragraphs A-11 and A-12 of this SOP, the information currently presented in not-for-profit organizations' financial statements may not meet the objectives set forth in Concepts Statement No. 4.

**A-5.** Related but separate not-for-profit organizations and for-profit entities result from the following:

- *a.* The decision of not-for-profit organizations to structure their operations in a manner that helps them achieve their mission
- *b.* Investments by not-for-profit organizations in for-profit entities

### *Structure of Not-for-Profit Organizations*

**A-6.** Not-for-profit organizations conduct their operations through a variety of organizational structures. *The Not-For-Profit Organization Reporting Entity* (the Holder Report), a 1986 research report by William W. Holder, identifies three basic kinds of organizational structure:

*a.* *Simple structures*, consisting of a single entity that conducts all operations and activities of the organization

*b.* *Separate entities*, conducting individual program activities

*c.* *Single entity and separate entities*, conducting, respectively, program activities and support and other noncentral activities, such as fund-raising

### Relationship of Separate Entities to Each Other

**A-7.** The Holder Report, as well as other studies, identified a variety of relationships that could indicate that the resources and activities of an entity are controlled by another entity. Among the most widespread are the following:

- *Ownership*—One entity is the legal owner of another entity, either through stock ownership or some other means, such as membership in a membership corporation.
- *Board membership*—(*a*) One entity has the ability to appoint or elect a voting majority of the board of directors of another entity or (*b*) a voting majority of one entity's board, as a result of its charter or bylaws, is also a voting majority of the board of another entity.
- *Charter or bylaws*—The corporate charter or bylaws of an entity limits its activities to those that are beneficial to another entity.
- *Oversight relationship*—A national charter establishes conditions, such as financial relationships or an accreditation process, for a separate entity's use of a national name or participation in the activities of a national organization.
- *Contract*—The relationship between separate entities is spelled out in a written contract.

### Factors Influencing Relationships of Separate Entities to Each Other

**A-8.** According to the Holder Report, the most common reasons for establishing separate entities are the following:

- *Taxes*—To ensure the income tax deductibility of contributions by donors and to avoid problems of unrelated business income for taxation purposes
- *Legal*—To limit legal liability; protect funding sources; and avoid laws, rules, and regulations perceived to be overly restrictive
- *Organization*—To establish clear-cut organizational limits of authority and autonomy for various activities
- *Public identity*—To create a separate, distinct public identity for the specific activity in question

Generally, entities that are established for these reasons are not-for-profit organizations; however, they also may be for-profit entities, principally for tax reasons.

### Not-for-Profit Organization Investment Portfolio Relationships

**A-9.** Not-for-profit organizations' investment portfolios may include ownership interests in for-profit entities. Such investments generally are made to earn returns on assets rather than to conduct operating activities and frequently are held for long-term investment purposes. Some not-for-profit organizations

holding such investments own more than 20 percent interests in these for-profit organizations; for example—

- A federated fund-raising organization may hold a majority interest in an oil company.
- A not-for-profit organization's endowment fund may include controlling interests in shopping malls, commercial buildings, and venture capital funds.

Current practice for reporting such investments is diverse, including cost, lower of cost or market, fair market value, and the equity method. Such investments generally are not reported by consolidating their financial statements with the financial statements of the reporting not-for-profit organizations.

### *Current Authoritative Literature*

**A-10.** Current authoritative literature on reporting the resources and activities of related entities of which one or more is a not-for-profit organization is inconsistent. Two noteworthy instances are the following:

- Appendix B [paragraph .17] discusses the inconsistencies in the AICPA audit and accounting guides and the SOP listed in paragraph .02 of this SOP. Efforts to correct or address these inconsistencies will take a long time, and no immediate guidance is anticipated other than this SOP.
- There has been uncertainty in practice over whether and to what extent certain pronouncements of the FASB—for example, FASB Statement No. 94—apply to not-for-profit organizations. In September 1994, the AICPA Accounting Standards Executive Committee (AcSEC) issued SOP 94-2, *The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations* [section 10,600], which provides that not-for-profit organizations should follow the guidance in effective provisions of ARBs, APB Opinions, and FASB Statements and Interpretations except for specific pronouncements that explicitly exempt not-for-profit organizations.

Appendix C [paragraph .18] summarizes other projects related to this SOP and their current status.

### *Needs of Financial Statement Users*

**A-11.** Because of the variety of organizational structures, the nature of the relationships among separate entities, and the inconsistency of the guidance in the current authoritative accounting literature, the needs of users of not-for-profit organizations' financial reports described in FASB Concepts Statement Nos. 2 and 4 may not be met.

**A-12.** Among the deficiencies noted by creditors, identified in the Holder Report, are the following:

- Relationships with and among affiliated entities and other related parties are not always clear and readily understandable in an organization's financial reports.

- Creditors sometimes are unable to understand the scope of activities and range of entities that make up the reporting entity simply by reading the financial reports.
- Substantially different reporting practices exist for similar economic circumstances.

Among the deficiencies noted by grantors and contributors, also identified in the Holder Report, are the following:

- Reporting for fund-raising and administrative activities sometimes is fragmented into more than one set of financial statements.
- The level of disclosure in financial statements about the kinds of activities conducted and the existence and inclusion of related entities is inadequate. Of specific concern is whether all the resources controlled and all the activities conducted by a not-for-profit organization are included in its financial statements.

### Reporting and Disclosures

**A-13.** Relationships between not-for-profit organizations and other entities range from complete control of the other entities by a central organization to a loose association. These relationships have resulted in the following eight financial reporting alternatives:

*a.* Consolidation or combination under the guidelines in ARB 51, FASB Statement No. 94, and SOP 78-10#

*b.* Reporting the investment under the equity method of accounting for investments

*c.* Reporting the investment at cost

*d.* Reporting the investment at market

*e.* Reporting the investment at the lower of cost or market

*f.* Disclosures similar to those under the AICPA Audit and Accounting Guide *Audits of Providers of Health Care Services*

*g.* Related-party disclosures under the guidelines of FASB Statement No. 57

*h.* No reporting or disclosures

### Consolidation and Combination

**A-14.** Drawing on ARB 51, FASB Statement No. 94, paragraph 1, states:

> The purpose of consolidated statements is to present, primarily for the benefit of the shareholders and creditors of the parent company, the results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single company with one or more branches or divisions.

**A-15.** SOP 78-10,# which is included in the AICPA Audit and Accounting Guide *Audits of Certain Nonprofit Organizations* # and which predates FASB Statement No. 94, states in paragraphs 42 and 43:

---

# See footnote # in paragraph 8.37.

For a reporting organization that controls another organization having a compatible purpose, it is presumed that combined or combining financial statements are more meaningful than separate statements and are usually necessary for a fair presentation in conformity with generally accepted accounting principles. *Control* means the direct or indirect ability to determine the direction of the management and policies through ownership, by contract, or otherwise.

The accounting standards division has considered the foregoing definition in relation to the nonprofit organizations covered by this statement of position and has concluded that it may be construed by some to be so broad, considering the structure of some nonprofit organizations, that presentation of combined financial statements might have relatively little value to users of such combined statements, particularly in relation to the cost of their preparation.

SOP 78-10, paragraph 44, states, in part:

> . . . combined financial statements should be presented if (1) control exists as defined in paragraph 42 and (2) any of the following circumstances exists:
>
> *a.* Separate entities solicit funds in the name of and with the expressed or implied approval of the reporting organization, and substantially all of the funds solicited are intended by the contributor or are otherwise required to be transferred to the reporting organization or used at its discretion or direction.
>
> *b.* A reporting organization transfers some of its resources to another separate entity whose resources are held for the benefit of the reporting organization.
>
> *c.* A reporting organization assigns functions to a controlled entity whose funding is primarily derived from sources other than public contributions.

### Equity Method

**A-16.** APB Opinion 18 states in paragraph 17:

> . . . the equity method of accounting for an investment in common stock should . . . be followed by an investor whose investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee even though the investor holds 50% or less of the voting stock. Ability to exercise that influence may be indicated in several ways, such as representation on the board of directors, participation in policy making processes, material intercompany transactions, interchange of managerial personnel, or technological dependency.

### Disclosures

**A-17.** Paragraph 13.04 of *Audits of Providers of Health Care Services* suggests presenting "summarized information about the assets, liabilities, results of operations, and changes in fund balances of related organizations" that "describe the nature of the relationships between . . . the related organizations."

**A-18.** FASB Statement No. 57 requires the following disclosures for material related-party transactions:

- The existence and nature of the relationship
- A description of the transactions between the entities, summarized if appropriate, for the period reported on, including amounts, if any, and any other information deemed necessary to an understanding of the effects of those transactions on the reporting organization's financial statements
- The dollar volume of transactions between the entities and the effects of any changes in the method of establishing their terms from the preceding period
- Amounts due from or to the related entities, and, if not otherwise apparent, the terms and manner of settlement

## Discussion of Conclusions

### *Scope*

**A-19.** Consistent with the May 19, 1993, exposure draft of this SOP, this SOP does not apply to entities that are included in the scope of *Audits of Providers of Health Care Services*. AcSEC considered including those entities in the scope of this SOP but exempted them for practical purposes. The ways those entities are related to each other are evolving and may not be contemplated by this SOP. For example, many of those entities are affiliated based on participation in networks of health care providers, with complex contractual agreements that make it difficult to determine whether control and economic interest exist based on the definitions in this SOP. While AcSEC believes the basic principles in this SOP also may apply to those entities, further study and deliberation are necessary to determine whether this SOP would require clarification for it to be made operational for those entities. Further, AcSEC believes (*a*) there is a need for guidance now for entities included in the scope of this SOP and (*b*) including entities covered by *Audits of Providers of Health Care Services* in the scope of this SOP likely would delay its issuance. Accordingly, AcSEC concluded it should exclude entities that are required to follow *Audits of Providers of Health Care Services* from the scope of this SOP. Guidance for reporting related entities for entities covered by *Audits of Providers of Health Care Services* is expected to be included as part of the current project to revise that guide.

### *Underlying Principles*

**A-20.** The conclusions in this SOP are based on the premise that (*a*) whether the financial statements of a reporting not-for-profit organization and those of one or more other entities (either a not-for-profit organization or a for-profit entity) should be consolidated and (*b*) the extent of disclosure that should be required, if any, if consolidated financial statements are not presented should be based on the nature of the relationship between the entities.

### *Control*

**A-21.** This SOP does not develop new concepts concerning the definition of control. Because the FASB currently has on its agenda a project on

consolidations and related matters that may result in a definition of control different from that contained in SOP 78-10, AcSEC concluded that it should not revise the definition of control at this time.[15]

### *Relation to Other Guidance*

**A-22.** This SOP makes uniform the application of APB Opinion 18 and FASB Statement No. 94 for not-for-profit organizations with the following exception: This SOP permits not-for-profit organizations that otherwise would report their investment portfolios at market value in conformity with guidance in the not-for-profit audit guides to do so instead of adopting the equity method for unconsolidated subsidiaries and 50 percent or less owned entities. AcSEC permitted this exception because it believes uniform guidance will be issued by the FASB on reporting the overall investment activities of not-for-profit organizations as part of the FASB's project on not-for-profit organizations.

**A-23.** The conclusions in this SOP evolve from and consider the conclusions of SOP 78-10 and *Audits of Providers of Health Care Services* to provide uniform criteria for consolidation. They provide for financial statement disclosures that can be applied objectively and that can curb potential abuses in not reporting (*a*) the results of separate but related entities established by a not-for-profit organization to raise funds on its own behalf and (*b*) assets controlled by another not-for-profit organization. (This SOP does not revise *Audits of Providers of Health Care Services*.)

**A-24.** This SOP requires consolidation if there is an economic interest and control by either a majority voting interest in the board of the other entity or the ability to appoint a majority of its board members. Some not-for-profit organizations are related to each other in ways that would meet the definition of control under this SOP. However, in the case of some of the organizations, no such economic interest exists. In circumstances of control other than a controlling financial interest in another not-for-profit organization through direct or indirect ownership of a majority voting interest, this SOP requires the existence of an economic interest for consolidation to be required or permitted. That provision is included in order to preclude the reporting of misleading information about the assets, liabilities, results of operations, and cash flows of the reporting organization.

### *Economic Interest*

**A-25.** The Glossary [paragraph .20] of this SOP states that "[a]n *economic interest* in another entity exists if (*a*) the other entity holds or utilizes significant resources that must be used for the unrestricted or restricted purposes of the not-for-profit organization, either directly or indirectly by producing income or providing services, or (*b*) the reporting organization is responsible for the liabilities of the other organization." The Glossary [paragraph .20] includes examples of circumstances that result in economic interests, including a reporting organization assigning certain of its functions to another entity. For example, an educational institution assigning its research functions to a research corporation that holds significant resources that must be used for the unrestricted or

---

[15] In January 2004, after the issuance of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, the FASB moved its consolidations and related matters project from its technical agenda to its research project agenda. To date, no changes to the guidance in this SOP have resulted from the FASB's consolidations and related matters project. [Footnote renumbered, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5; Footnote further renumbered, June 2007, to reflect conforming changes necessary due to the issuance of SOP 07-1.]

restricted purposes of the reporting organization, either directly or indirectly, results in an economic interest in that research corporation. Also, an organization may have an economic interest in a lobbying organization if that lobbying organization conducts any of the organization's lobbying functions and uses significant resources that must be used for the unrestricted or restricted purposes of the reporting organization, either directly or indirectly.

### *Circumstances Permitting but Not Requiring Consolidation*

**A-26.** Paragraph .12 of this SOP permits but does not require consolidation if the reporting not-for-profit organization controls a separate not-for-profit organization in which it has an economic interest and that control is achieved other than control through—

*a.* A controlling financial interest in the other not-for-profit organization through direct or indirect ownership of a majority voting interest or

*b.* A majority voting interest in the board of the other entity.

AcSEC considered requiring consolidation in all circumstances in which the reporting not-for-profit organization controls and has an economic interest in another not-for-profit organization. However, AcSEC believes consolidation may not be meaningful in all situations in which there is control and an economic interest. For example, some national organizations may control local chapters through affiliation agreements and receive funds from those local chapters. In such circumstances, both control and an economic interest exist. However, consolidation may not be meaningful. AcSEC encourages consolidation if—

*a.* The reporting not-for-profit organization controls a separate not-for-profit organization in which it has an economic interest and that control is other than control through—

  i. A controlling financial interest in the other not-for-profit organization through direct or indirect ownership of a majority voting interest or

  ii. A majority voting interest in the board of the other entity and

*b.* Consolidation would be meaningful.

### *Disclosures*

**A-27.** AcSEC believes the disclosures required by this SOP in circumstances in which control exists by contract, agreement, or otherwise provide financial statement users with information that is more meaningful than the information they now receive under the existing not-for-profit audit guides. The disclosure requirements in this SOP are an interim step until the FASB completes its consolidations and related matters project.[16]

### *Combined Financial Statements*

**A-28.** This SOP provides guidance concerning consolidated financial statements. As discussed in footnote 1, ARB 51 provides guidance concerning combined financial statements. Paragraph 22 of ARB 51 states that "there are circumstances, however, where combined financial statements (as distinguished from consolidated statements) of commonly controlled companies are likely to

---

[16] See footnote 15. [Footnote renumbered, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5; Footnote revised and further renumbered, June 2007, to reflect conforming changes necessary due to the issuance of SOP 07-1.]

be more meaningful than their separate statements." This SOP prohibits consolidated financial statements in certain circumstances. However, it provides no guidance concerning combined financial statements of commonly controlled not-for-profit organizations, which may be presented, in certain circumstances, in conformity with the guidance in ARB 51.

### *Parent or Subsidiary-Only Financial Statements*

**A-29.** This SOP provides no guidance concerning parent-entity-only or subsidiary-entity-only financial statements. Paragraph 15 of FASB Statement No. 94 precludes the use of parent-company financial statements for use as the general-purpose financial statements of the primary reporting entity. However, that Statement is silent concerning parent-company financial statements as other than general-purpose financial statements for the primary reporting entity. Generally accepted accounting principles do not preclude the issuance of subsidiary-only financial statements. However, care should be taken to include all disclosures required by FASB Statement No. 57 and other relevant pronouncements.

.17

# Appendix B

## Other Financial Reporting Literature

**B-1.** The following discusses the authoritative and other financial reporting literature that is relevant to AcSEC's consideration of consolidated financial statements involving not-for-profit organizations. All references and discussion pertain to literature as it exists prior to being revised by this SOP. As discussed in paragraph .02, this SOP revises certain AICPA literature.

## SOP 78-10

**B-2.** SOP 78-10,[#] *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, is discussed in paragraph A-15 of this SOP. (As discussed in paragraph .02 of this SOP, this SOP amends SOP 78-10.)

## Audits of Providers of Health Care Services

**B-3.** The AICPA Audit and Accounting Guide *Audits of Providers of Health Care Services*, paragraph 13.02, recommends consolidation or combination of organizations related to health care entities by direct or common ownership in accordance with the provisions of ARB 51. In cases in which related organizations are controlled through means other than direct or common ownership and ARB 51 does not require consolidation, *Audits of Providers of Health Care Services* does not recommend consolidation or combination.

**B-4.** In circumstances in which *Audits of Providers of Health Care Services* does not recommend consolidation or combination, paragraph 13.04 of that guide requires disclosure of certain summarized information concerning the related organizations if control and at least one of the following circumstances exist:

*a.* The organization has solicited funds in the name of the health care entity and with the expressed or implied approval of the health care entity, and substantially all the funds solicited by the organization were intended by the contributor, or were otherwise required, to be transferred to the health care entity or used at its discretion or direction.

*b.* The health care entity has transferred some of its resources to the organization, and substantially all of the organization's resources are held for the benefit of the health care entity.

*c.* The health care entity has assigned certain of its functions (such as the operation of a dormitory) to the organization, which is acting primarily for the benefit of the health care entity.

(As discussed in paragraph .02 of this SOP, this SOP does not amend *Audits of Providers of Health Care Services*.)

## Audits of Colleges and Universities

**B-5.** *The AICPA Industry Audit Guide Audits of Colleges and Universities,* [#] paragraph 11.09, states:

---

[#] See footnote # in paragraph 8.37.

> For adequate disclosure, all separately incorporated but related units for which the reporting institution is fiscally responsible, such as university presses, intercollegiate athletics, and research foundations, should be (1) included in the financial statements, (2) adequately disclosed by notes, or (3) presented in separate financial statements accompanied by and cross-referenced in the basic financial statements of the institution.

(As discussed in paragraph .02 of this SOP, this SOP amends *Audits of Colleges and Universities*.)[#]

## Audits of Voluntary Health and Welfare Organizations

**B-6.** The AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* provides no guidance on whether consolidated financial statements should be presented. However, paragraphs 7.08 and 7.09 provide guidance for determining whether auditors should audit the financial statements of organizations associated with the reporting not-for-profit organization. (As discussed in paragraph .02 of this SOP, this SOP amends *Audits of Voluntary Health and Welfare Organizations.*)

---

[#] See footnote # in paragraph 8.37.

.18

# Appendix C

## Other Projects Related to This SOP

### FASB Project on Consolidations and Related Matters

**C-1.** This project is addressing various issues concerning the reporting entity, including those relating specifically to not-for-profit organizations. The FASB issued its September 10, 1991, Discussion Memorandum, *Consolidation Policies and Procedures.* The conclusions in this SOP will be reconsidered when the FASB completes its project on consolidations and related matters, which may affect the definition of control and other related matters. In January 2004, after the issuance of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, the FASB moved its consolidations and related matters project from its technical agenda to its research project agenda. To date, no changes to the guidance in this SOP have resulted from the FASB's consolidations and related matters project.

### FASB Project on Investments

**C-2.** This project is addressing various issues concerning investments held by not-for-profit organizations. The project is in the preliminary stages. The conclusions in this SOP will be reconsidered when the FASB completes its project on investments, which may affect the conclusions concerning investments in common stock of for-profit entities wherein the not-for-profit organization has a 50 percent or less voting interest and other related matters. [*In November 1995, the FASB issued FASB Statement No. 124,* Accounting for Certain Investments Held by Not-for-Profit Organizations, *which does not effect the conclusions of this SOP.*]

### AICPA Project on the Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations

**C-3.** In September 1994, AcSEC issued SOP 94-2, *The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations* [section 10,600], which provides that not-for-profit organizations should follow the guidance in effective provisions of ARBs, APB Opinions, and FASB Statements and Interpretations except for specific pronouncements that explicitly exempt not-for-profit organizations.

### AICPA Accounting and Audit Guide Revisions

**C-4.** The AICPA will revise the existing audit and accounting guides for not-for-profit organizations and colleges and universities to reflect the accounting

and reporting requirements of FASB Statement Nos. 116, *Accounting for Contributions Received and Contributions Made*, and 117, *Financial Statements of Not-for-Profit Organizations*, among other things.[17]

---

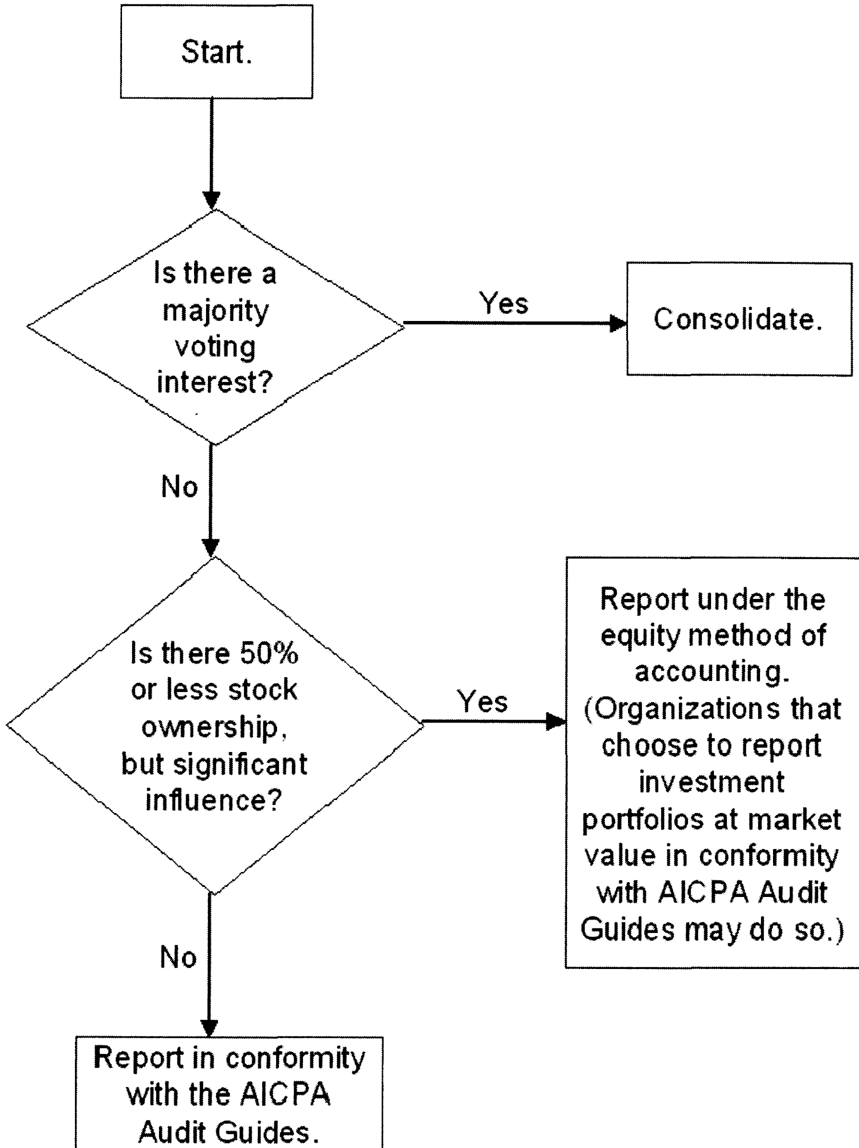
[17] In 1996, the AICPA issued the Audit and Accounting Guide *Not-for-Profit Organizations*, to reflect the accounting and reporting requirements of FASB Statement Nos. 116 and 117, among other things. [Footnote renumbered, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5; Footnote further renumbered, June 2007, to reflect conforming changes necessary due to the issuance of SOP 07-1.]

.19

## Appendix D

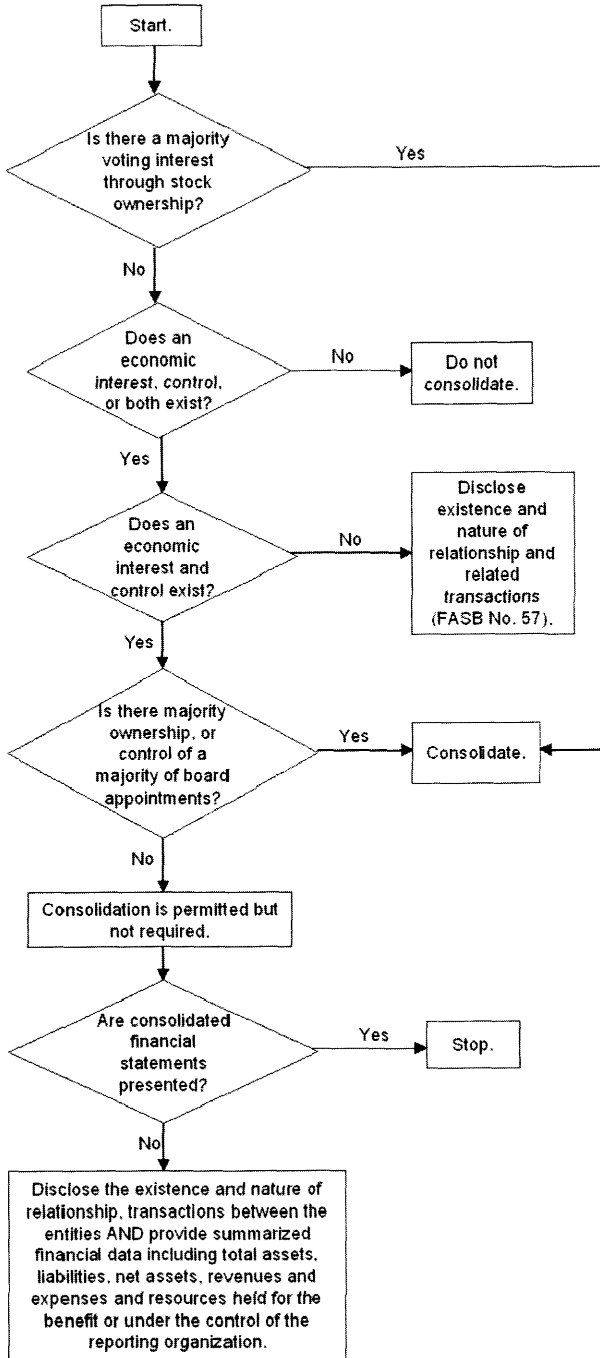
## Flowcharts and Decision Trees[18]

### Ownership of a For-Profit Entity




[18] The flowcharts and decision trees summarize certain guidance in this SOP and are not intended as substitutes for the SOP. [Footnote renumbered, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5; Footnote further renumbered, June 2007, to reflect conforming changes necessary due to the issuance of SOP 07-1.]

## Relationship With Another Not-for-Profit Organization



.20

## Glossary

**Control.** The direct or indirect ability to determine the direction of management and policies through ownership, contract, or otherwise.

**Economic interest.** An interest in another entity that exists if (*a*) the other entity holds or utilizes significant resources that must be used for the unrestricted or restricted purposes of the not-for-profit organization, either directly or indirectly by producing income or providing services, or (*b*) the reporting organization is responsible for the liabilities of the other entity. The following are examples of economic interests:

- Other entities solicit funds in the name of and with the expressed or implied approval of the reporting organization, and substantially all of the funds solicited are intended by the contributor or are otherwise required to be transferred to the reporting organization or used at its discretion or direction.
- A reporting organization transfers significant resources to another entity whose resources are held for the benefit of the reporting organization.
- A reporting organization assigns certain significant functions to another entity.
- A reporting organization provides or is committed to provide funds for another entity or guarantees significant debt of another entity.

**Majority voting interest in the board of another entity.** For purposes of this SOP, a majority voting interest in the board of another entity is illustrated by the following example. Entity B has a five-member board, and a simple voting majority is required to approve board actions. Entity A will have a majority voting interest in the board of entity B if three or more entity A board members, officers, or employees serve on or may be appointed at entity A's discretion to the board of entity B. However, if three of entity A's board members serve on the board of entity B but entity A does not have the ability to require that those members serve on the entity B board, entity A does not have a majority voting interest in the board of entity B.

**Accounting Standards Executive Committee (1993–1994)**

NORMAN N. STRAUSS, *Chair*
PHILIP D. AMEEN
ERNEST F. BAUGH, JR.
G. MICHAEL CROOCH
H. JOHN DIRKS
GEORGE P. FRITZ
STUART H. HARDEN
JAMES E. HEALEY
SALLY L. HOFFMAN
JAMES A. JOHNSON
KRISTA M. KALAND
ROBERT S. KAY
ARAM G. KOSTOGLIAN
JAMES T. PARKS
EDWARD W. TROTT

**Not-for-Profit Organizations Committee (1993–1994)**

KENNETH D. WILLIAMS, *Chair*
MARTHA L. BENSON
ESPY BROWNING, JR.
ROGER S. BRUTTOMESSO
GEORGIA G. CHANGARIS
LAWRENCE A. DOLLINGER
JOHN HERBERT FISHER
TERRY FRASER
MARK GORMAN
GREGORY D. KIRK
ARLENE J. LURIE
TONI R. MCKINLEY
JOHN E. SCHLITT
JOSEPH SEBEK
DAVID M. ZIEFF

**AICPA Staff**

JOHN F. HUDSON
*Vice President*
*Technical Standards and Services*

ARLEEN RODDA THOMAS
*Director*
*Accounting Standards*

JOEL TANENBAUM
*Technical Manager*
*Accounting Standards*

The committees gratefully acknowledge the significant contributions of Mary F. Foster and Richard F. Larkin.

# Chapter 9

# *Property and Equipment*

## Introduction

**9.01** Not-for-profit organizations use various kinds of property and equipment to provide goods and services to beneficiaries, customers, and members. Property and equipment include all long-lived tangible assets held by not-for-profit organizations, except collection items[1] and assets held for investment purposes.

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

- Land used as a building site not subject to depreciation
- Land improvements, buildings and building improvements, equipment, furniture and office equipment, library books, motor vehicles, and similar depreciable assets
- Leased property and equipment (capitalized in conformity with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 13, *Accounting for Leases*)
- Improvements to leased property
- Construction in process
- Contributed use of facilities and equipment (recognized in conformity with FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*)

## Recognition and Measurement Principles

**9.03** Not-for-profit organizations acquire the use of property and equipment through purchases, trade-ins, self-construction, leases, and contributions. Except as discussed in this chapter, the recognition and measurement principles for property and equipment acquired by not-for-profit organizations in exchange transactions are similar to those used by business organizations. For example, FASB Staff Position (FSP) AUG AIR-1, *Accounting for Planned Major Maintenance Activities*, discusses accounting for planned activities that improve the operating efficiency of an asset, comply with regulatory operating guidelines, or extend the useful life of the asset. In compliance with that FSP, not-for-profit organizations should not use an accrue-in-advance method of accounting for those planned major maintenance activities because they do not embody a present duty or responsibility of the entity until the obligating transaction or event occurs.[*]

**9.04** Property and equipment used in exchange transactions (other than lease transactions), such as federal contracts, in which the resource provider

---

[1] Because of their unique nature, collection items are reported differently from how other long-lived tangible assets are reported. Chapter 7, "Other Assets," of this Audit and Accounting Guide (guide), discusses accounting for collection items.

[*] Financial Accounting Standards Board (FASB) Staff Position (FSP) AUG AIR-1, *Accounting for Planned Major Maintenance Activities*, is effective for the first fiscal year beginning after December 15, 2006. Earlier adoption is permitted as of the beginning of an entity's fiscal year.

retains legal title during the term of the arrangement should be reported as a contribution at fair value at the date received by the not-for-profit organization only if it is probable that the organization will be permitted to keep the assets when the arrangement terminates. The terms of such arrangements should be disclosed in notes to the financial statements.

## Contributed Property and Equipment

**9.05** Contributions of property and equipment (including unconditional promises to give property and equipment) should be recognized at fair value[2] at the date of contribution and, depending on donor restrictions and the organization's accounting policy, should be included in permanently restricted,[3] temporarily restricted, or unrestricted net assets. If the donors stipulate how or how long contributed property and equipment must be used by the organization, the contribution should be reported as restricted support. If the donors do not specify such restrictions, the contribution should be reported as restricted support if the organization has adopted an accounting policy of implying a time restriction on the use of such assets that expires over the assets' useful lives. In the absence of donor restrictions or an organization's policy of implying time restrictions, contributions of long-lived assets should be reported as unrestricted support. Unconditional promises to give property and equipment should be recognized as receivables in conformity with FASB Statement No. 116 and with chapter 5 of this guide. Contributions of the use of property and equipment in which the donor retains legal title to the assets are discussed in paragraphs 5.57–.58.

**9.06** Similar to items acquired in exchange transactions, the amount initially recognized for contributed property and equipment should include all the costs incurred by the organization to place those assets in use. Examples of such costs include the freight and installation costs of contributed equipment and cataloging costs for contributed library books.

## Depreciation

**9.07** Paragraph 149 of FASB Concepts Statement No. 6, *Elements of Financial Statements—a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2)* , describes depreciation as a "systematic and rational" process for allocating the cost of using up assets' service potential or economic benefit over the assets' useful economic lives. FASB Statement No. 93, *Recognition of Depreciation by Not-for-Profit Organizations*, requires all not-for-profit organizations to recognize depreciation for all property and equipment except land used as a building site and similar

---

[2] FASB Statement No. 157, *Fair Value Measurements*, defines fair value and establishes a framework for measuring fair value. Paragraphs 3.24–.43 discuss those standards, which are effective for financial statements issued for fiscal years beginning after November 15, 2007. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year or its interim periods. However, FSP FAS 157-2, *Effective Date of FASB Statement No. 157*, delays the effective date of FASB Statement No. 157 until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for fair value measurements of all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). See footnote † to paragraph 3.25 for more information about the types of assets and liabilities to which the deferral applies. In addition, chapter 5, "Contributions Received and Agency Transactions," of this guide, discusses measuring the fair value of contributed assets.

[3] In practice, contributions of depreciable assets generally are not permanently restricted.

assets and collections.[4] Depreciation should be recognized for contributed property and equipment as well as for plant and equipment acquired in exchange transactions.

**9.08** Depreciation expense should be reported in a statement of activities as a decrease in unrestricted net assets. If the property and equipment being depreciated have been contributed to the organization with donor-imposed restrictions on the item's use, temporarily restricted net assets should, over time, be reclassified as unrestricted net assets in a statement of activities as those restrictions expire. The amount reclassified may or may not be equal to the amount of the related depreciation. The amount to be reclassified should be based on the length of time indicated by the donor-imposed restrictions while the amount of depreciation should be based on the useful economic life of the asset. For example, a computer with an estimated useful economic life of five years may be contributed by a donor and restricted for a specific use by the organization for three years. Reclassifications are also necessary if the not-for-profit organization has adopted an accounting policy that implies a time restriction on contributions of property and equipment that expires over the useful life of the contributed assets. Reclassifications should be included as "Net Assets Released from Restrictions" in a statement of activities.

## Impairment or Disposal of Long-Lived Assets

**9.09** Whenever events or changes in circumstances indicate that the carrying amount of a long-lived asset (or asset group[5]) may not be recoverable, the asset (asset group) should be tested for impairment in conformity with FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. If the carrying amount of the long-lived asset (or asset group) exceeds its fair value and the carrying amount is not recoverable, an impairment loss is recognized. The carrying amount is not recoverable if it exceeds the sum of (*a*) the undiscounted cash flows expected to result from use, such as fees or contributions, and (*b*) the eventual disposition of the asset (asset group). An impairment loss is measured as the amount by which the carrying amount of the long-lived asset (asset group) exceeds its fair value. Paragraphs 25–26 of FASB Statement No. 144 prescribe the reporting and disclosure requirements for assets held and used.

**9.10** A long-lived asset is classified as held and used until (*a*) it ceases to be used, (*b*) it is exchanged in a transaction measured based on the recorded amount of the nonmonetary asset relinquished, or (*c*) it is held for sale. An

---

[4] The terms of certain grants and reimbursements from other organizations may specify whether depreciation or the entire cost of the asset in the year of acquisition should be included as a cost of activities associated with those grants or reimbursements for contractual purposes (sometimes referred to as *allowable costs*). Those terms should not affect the recognition and measurement of depreciation for financial reporting purposes.

[5] An asset group is the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities. For long-lived assets to be disposed of by sale or otherwise, that group represents assets to be disposed of together as a group in a single transaction and liabilities directly associated with those assets that will be transferred in the transaction. (Examples of such liabilities include environmental obligations and warranty obligations related to an acquired customer base.) In limited circumstances, a long-lived asset may not have identifiable cash flows that are largely independent of the cash flows of other assets and liabilities and other groups. In those circumstances the asset group for that long-lived asset should include all assets and liabilities of the organization.

asset (disposal group) is classified as held for sale in the period in which all of the criteria in paragraph 30 of FASB Statement No. 144 are met. If at any time afterwards the criteria are no longer met (except in certain limited circumstances beyond the organization's control, as discussed in paragraph 31 of FASB Statement No. 144), the asset (disposal group) should be reclassified as held and used. Further, if the criteria in paragraph 30 are met after the date of the statement of financial position, but before the issuance of the financial statements, a long-lived asset (disposal group) should be classified as held and used in the financial statements when issued and certain disclosures are required. A long-lived asset (disposal group) that is held for sale is measured at the lower of its carrying amount or fair value less cost to sell. The asset (disposal group) should not be depreciated (amortized) while it is classified as held for sale. (However, interest and other expenses attributable to the liabilities of a disposal group held for sale would continue to be accrued.) Paragraphs 27–48 of Statement No. 144 prescribe the reporting and disclosure requirements for assets to be disposed of by sale or otherwise. EITF Issue No. 03-13, "Applying the Conditions in Paragraph 42 of FASB Statement No. 144 in Determining Whether to Report Discontinued Operations," which was ratified by the FASB in November 2004, provides guidance for determining whether transactions of components that have been disposed of or are held for sale should be reported in a separate section of the statement of activities entitled "discontinued operations."

## Asset Retirement Obligations

**9.11** FASB Statement No. 143, *Accounting for Asset Retirement Obligations*, addresses financial accounting and reporting for obligations associated with the retirement (sale, abandonment, recycling, disposal, or other other-than-temporary idling) of tangible long-lived assets and the associated asset retirement costs. It applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and (or) the normal operation of a long-lived asset, except for certain obligations of lessees. For example, an organization would have an asset retirement obligation if it accepted a gift of a building and with the stipulation that in 10 years the building would be destroyed and the land converted to a garden that would be open to the public. FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*, clarifies that an entity is required to recognize a liability if the obligation to perform the asset retirement activity is unconditional, even though the timing and (or) method of settlement may be uncertain. FASB Statement No. 143 requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The associated asset retirement costs should be capitalized as part of the carrying amount of the long-lived asset.

## Gains and Losses

**9.12** Gains and losses recognized on property and equipment, including impairment losses recognized in conformity with FASB Statement No. 144, should be classified in a statement of activities as changes in unrestricted net assets unless explicit donor stipulations or law require their use to be restricted. In those situations, gains or losses should be classified as increases or decreases in temporarily restricted or permanently restricted net assets, as appropriate.

## Financial Statement Presentation

**9.13** A statement of financial position or related notes should include the balances of each major class of property and equipment. The basis of valuation—for example, cost for purchased items and fair value for contributed items—should also be disclosed. Separate disclosure should also be made of the following items:

- Nondepreciable assets
- Property and equipment not held for use in operations, for example, items held for sale or for investment purposes or construction in process
- Assets restricted by donors to investment in property and equipment
- Improvements to leased facilities and equipment[6]
- Assets (and related obligations) recognized under capital leases (in conformity with FASB Statement No. 13)
- Capitalized interest (in conformity with FASB Statement Nos. 34, *Capitalization of Interest Cost*, and 62, *Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants*)[7]
- Disclosures required by FASB Statement No. 144, if applicable
- Significant accounting policies concerning property and equipment, such as the following:
    - The capitalization policy adopted
    - Whether time restrictions are implied on the use of contributed long-lived assets (and contributions of assets restricted to purchase them) received without donor stipulations concerning how long the contributed assets must be used[8]
    - Whether donor-restricted contributions of long-lived assets are reported as unrestricted or restricted support when restrictions are satisfied in the same reporting period in which the contributions are received[9]

**9.14** Accumulated depreciation, either for each major class of property and equipment or in total, should be disclosed (*a*) as a deduction or parenthetically

---

[6] Emerging Issues Task Force (EITF) Issue No. 05-6, "Determining the Amortization Period for Leasehold Improvements Purchased after Lease Inception or Acquired in a Business Combination," addresses the amortization period for leasehold improvements that are placed in service significantly after the beginning of the initial term of an operating lease and not contemplated at or near the beginning of that lease term. Those improvements should be amortized over the shorter of (*a*) the useful life of the leasehold improvements or (*b*) a term that includes required lease periods and renewals that are deemed to be reasonably assured (as defined in paragraph 5 of FASB Statement No. 13, *Accounting for Leases*) at the date the leasehold improvements are purchased.

[7] EITF Issue No. 99-9, "Effect of Derivative Gains and Losses on the Capitalization of Interest," states that the interest rate used in capitalizing interest as a part of the historical cost of acquiring certain assets under FASB Statement No. 34, *Capitalization of Interest Cost*, and No. 62, *Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants—an amendment of FASB Statement No. 34*, should include gains and losses on the effective portion of a fair value hedge of the fixed interest-rate debt.

[8] Paragraph 5.81 includes examples of how these alternative policies might be disclosed in notes to the financial statements.

[9] See footnote 7.

in a statement of financial position or (*b*) in the notes to the financial statements. The amount of depreciation expense for the period and the method or methods used to compute depreciation for the major classes of property and equipment should also be disclosed.

**9.15** The notes to the financial statements should also include disclosures concerning the liquidity of the organization's property and equipment, including information about limitations on their use. For example, information should be provided about

- Property and equipment pledged as collateral or otherwise subject to lien
- Property and equipment acquired with restricted assets where title may revert to another party, such as a resource provider
- Donor or legal limitations on the use of or proceeds from the disposal of property and equipment
- Impaired long-lived assets reported at fair value, in conformity with paragraph 33 of FASB Statement No. 157, *Fair Value Measurements*

## Auditing

**9.16** As discussed in chapter 5 of this guide, a not-for-profit organization may have access to the use of property or equipment that is neither owned nor leased. For example, property or equipment may be provided by a related organization (such as a religious order), by unrelated organizations under affiliation programs, or by a governmental agency or unit. The auditor should inquire into, and the financial statements should disclose, the nature of any relationship between the organization and the owners of the property or equipment. Contribution of property or its use received by the organization are measured at fair value. AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), addresses audit considerations relating to the measurement and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements.

**9.17** Many audit objectives, controls, and auditing procedures for property and equipment of not-for-profit organizations are similar to those of other organizations. In addition, the auditor may need to consider the following specific audit objectives, selected controls, and auditing procedures that are unique to not-for-profit organizations.

**9.18** The following table illustrates the use of assertions in developing audit objectives and designing substantive tests. The examples are not intended to be all-inclusive nor is it expected that all the procedures would necessarily be applied in an audit. The auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure to obtain sufficient appropriate audit evidence. The use of assertions in assessing risks and designing appropriate audit procedures to obtain audit evidence is described in paragraphs .14–.26 of AU section 326, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1). Various audit procedures and the purposes for which they may be performed are described in paragraphs .27–.41 of AU section 326.

## Auditing Considerations

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| | | ***Transactions*** | |
| *Contributed Property and Equipment* | | | |
| Valuation and allocation | Contributed property and equipment is reported at fair value at the date of contribution. | Controls ensure that contributions of property and equipment are known and recorded and that documentation supports the determination of their fair value. | Review documentation supporting the determination of fair value. |
| *Property and Equipment Additions* | | | |
| Rights and obligations | Appropriate resource provider approvals, if required, have been obtained for property and equipment additions. | Management monitors compliance with resource provider regulations related to additions to property and equipment.<br><br>Additions are authorized in the capital budget. | Determine compliance with resource provider requirements. |
| | | ***Presentation and Disclosures*** | |
| Rights and obligations; Classification | Restrictions on contributed property and equipment are reflected in the classification of net assets. | Contributions of property and equipment are reviewed for restrictions and management monitors compliance with restrictions. | Review donor correspondence to determine the presence or absence of restrictions.<br>Review minutes of governing board and governing board committee meetings for evidence of donor restrictions. |

*(continued)*

**Auditing Considerations—continued**

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| | ***Presentation and Disclosures—continued*** | | |
| | | | If specific property or equipment is restricted, review contributed property and equipment transactions for propriety of use and dispositions. |
| Classification | Property and equipment is reported in the proper net asset class. | | Review documentation underlying contributions of property and equipment for propriety of classification. |
| *Property and Equipment Not Held for Use in Operations* | | | |
| Classification | Property and equipment not used in operations but held as an investment or for sale is separately reported. | Property records segregate property and equipment not used for operating purposes. | Determine that property and equipment not held for operating purposes is reported separately. |
| *Reclassification of Temporarily Restricted Net Assets* | | | |
| Occurrence/ Existence; Classification | Temporarily restricted net assets are reclassified as unrestricted net assets in the statement of activities over the term of the donor-imposed restrictions or when placed in service if the donor did not specify a term and one is not implied. | | Determine that appropriate reclassifications are made on the statement of activities over the term of the donor-imposed restrictions or when placed in service if the donor did not specify a term and one is not implied. |

# Chapter 10

# *Debt and Other Liabilities*

## Introduction

**10.01** Many obligations of not-for-profit organizations are similar to those of for-profit entities. This chapter considers debt and other liabilities that are not discussed elsewhere in this Audit and Accounting Guide (guide) and that present accounting and auditing issues unique to not-for-profit organizations.[1] As discussed in paragraphs 3.44–.46 of this guide, Financial Accounting Standards Board (FASB) Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*, permits an organization to irrevocably elect fair value as the initial and subsequent measure for certain financial liabilities, with changes in fair value recognized in the statement of activities as those changes occur.[*] The following liabilities that might exist for not-for-profit organizations are outside the scope of the statement and thus cannot be reported at fair value: employers' and plans' obligations for pension benefits, other postretirement benefits (including health care and life insurance benefits), postemployment benefits, deferred compensation arrangements, financial liabilities recognized under lease contracts, current and deferred tax assets and liabilities, and liabilities that require the organization to provide services, rather than cash or another financial asset, to the obligee.

## Tax-Exempt Financing

**10.02** Some not-for-profit organizations finance part of their activities from the proceeds of tax-exempt bonds and other obligations issued through state and local financing authorities. Because not-for-profit organizations are responsible for the repayment of those obligations, such financing should be reported as liabilities on their statements of financial position.

## Current and Deferred Tax Liabilities

**10.03** Although not-for-profit organizations are generally tax-exempt under various Internal Revenue Code (IRC) sections,[2] some may be subject to taxes

---

[1] Two consensuses reached by the Emerging Issues Task Force (EITF) describe the accounting for modification of terms of debt agreements other than in a troubled debt restructuring. EITF Issue No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments," provides guidance for exchanges of debt instruments between, or modifications of a debt instrument by, a debtor and a creditor in a nontroubled debt situation. EITF Issue No. 98-14, "Debtor's Accounting for Changes in Line-of-Credit or Revolving-Debt Arrangements," discusses how to account for changes in line-of-credit or revolving-debt arrangements (for example, changing interest rates, draw-down amounts, covenants, and maturity).

[*] Financial Accounting Standards Board (FASB) Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*, is effective as of the beginning of the first fiscal year that begins after November 15, 2007. Earlier adoption is permitted if certain conditions described in paragraph 30 of the statement are met.

[2] Some organizations may meet the definition of a not-for-profit organization, as discussed in paragraphs 1.01–.02 of this guide, but may nevertheless not be tax-exempt under the IRC. For example, an organization that may otherwise qualify for tax-exempt status under the IRC may lose its tax exemption because it has violated the private inurement rules applicable to tax-exempt organizations. Chapter 15, "Tax Considerations," of this guide, discusses various requirements for maintaining tax-exempt status under the IRC.

on various portions of their income, such as federal excise taxes on investment income or federal and state income taxes on unrelated business income.[3] FASB Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*, provides guidance on recognizing (*a*) the amount of taxes payable (or refundable) for the current year and (*b*) deferred-tax liabilities (and assets) for the estimated future tax consequences of temporary differences and carryforwards.

**10.04** Organizations adopt many tax positions relative to tax laws, including those adopted in determining whether tax is due, a refund is owed, or a tax return needs to be filed. A tax position could result in or affect the measurement of a current or deferred tax asset or liability in the statement of financial position. FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, an amendment of FASB. FASB Statement No. 109, which is discussed further in paragraph 15.02 of this guide, provides recognition and measurement guidance for a tax position taken or expected to be taken in a tax return.[†]

## Deferred Revenue

**10.05** Resources received in exchange transactions from customers, patients, and other service beneficiaries for specific projects, programs, or activities that have not yet taken place should be recognized as liabilities to the extent that the earnings process has not been completed. For example, resources received from the advance sale of season theater tickets should be recognized as deferred revenue, representing the obligation to hold the performances. That revenue is earned as the theater performances are held.

## Refunds Due to and Advances From Third Parties

**10.06** Some not-for-profit organizations receive (*a*) advances from third parties, such as government agencies and foundations, based on the estimated cost of providing services to constituents and (*b*) resources from third parties to be used to make loans to the organization's constituents. Advances from third parties for services not yet performed, as well as refunds due to third parties for amounts previously received under such agreements, should be included as liabilities on a statement of financial position.

## Promises to Give

**10.07** A promise to give carries rights and obligations—the recipient of a promise to give has a right to expect that the promised assets will be transferred in the future, and the maker has a social and moral obligation, and generally a legal obligation, to make the promised transfer. Paragraph 18 of FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*,

---

[3] Chapter 15 of this guide discusses tax issues concerning not-for-profit organizations.

[†] FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*, is effective for fiscal years beginning after December 15, 2006. However, FASB Staff Position (FSP) FIN 48-2, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*, defers the effective date of that interpretation to fiscal years beginning after December 15, 2007, for certain nonpublic enterprises as defined by paragraph 289 of FASB Statement No. 109, *Accounting for Income Taxes*, including nonpublic not-for-profit organizations. Earlier application is permitted. Not-for-profit organizations that have already adopted the provisions of FASB Interpretation No. 48 are not eligible for the deferral. The AICPA has prepared a practice guide to help in understanding the interpretation. The practice guide is available by following the link "Professional Standards and Ethics" at http://tax.aicpa.org/Resources.

requires donors to recognize a liability for unconditional promises made to give cash or other assets to recipients or to settle or cancel the recipients' liabilities. 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.[4] 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 for the entire amount payable should be recognized and measured at fair value. If the present value of the amounts to be paid is used to measure fair value,[5] the discount rate should be determined at the time the unconditional promise to give is initially recognized and, in conformity with paragraph 12 of Accounting Principles Board (APB) Opinion No. 21, *Interest on Receivables and Payables*, should not be revised subsequently unless the measurement objective for periods subsequent to the period of initial recognition is fair value, such as when the organization makes an election in conformity with FASB Statement No. 159.[6] Conditional promises to give should not be recognized until the conditions are substantially met.[7]

**10.08** In conformity with paragraph 15 of APB Opinion No. 21, the interest method should be used to amortize discounts on contributions payable if contributions payable are measured using present value techniques and the organization has not elected to measure the payable at fair value as described in paragraph 10.01. Other methods of amortization may be used if the results are not materially different. The discount should be amortized between the date the promise to give is initially recognized and the date the cash or other contributed assets are paid. The amortization of any discount related to unconditional promises to give should be reported as a component of contribution expense, in the same functional classification in which the promise to give was reported.

**10.09** In addition to disclosures required by FASB Statement No. 5, *Accounting for Contingencies*, and No. 47, *Disclosure of Long-Term Obligations*,

---

[4] If a not-for-profit organization makes contributions or awards grants to other organizations upon specific requests of others, the not-for-profit organization may be acting as an agent, trustee, or intermediary in a transfer between the donor and the beneficiary specified by the donor (agency transaction). Paragraph 10.11 describes liabilities for amounts held for others in agency transactions. Paragraphs 5.05–.21 provide further guidance about agency transactions. (See paragraphs 8–10 of FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*.)

[5] Paragraphs 3.24–.43 of this guide discuss FASB Statement No. 157, *Fair Value Measurements*, which defines fair value and establishes a framework for measuring fair value. Appendix B of FASB Statement No. 157 provides standards for using present value techniques when the measurement objective is fair value. FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year or its interim periods. However, FSP FAS 157-2, *Effective Date of FASB Statement No. 157*, delays the effective date of FASB Statement No. 157 until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for fair value measurements of all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). See footnote † to paragraph 3.25 for more information about the types of assets and liabilities to which the deferral applies.

[6] The discount rate may differ from the discount rate used to discount contributions receivable.

[7] Chapter 5, "Contributions Received and Agency Transactions," of this guide, provides additional guidance for recognizing conditional promises to give.

the notes to the financial statements should include a schedule of unconditional promises to give that shows the total amount separated into amounts payable in less than one year, in one to five years, and in more than five years, and for unconditional promises to give that are reported using present value techniques, the unamortized discount.

## Annuity Obligations

**10.10** Some contributions received by not-for-profit organizations, such as interests in charitable gift annuity contracts and charitable remainder and lead trusts, impose obligations on the organization to make future payments to others. Guidance for reporting such contributions, often referred to as "split-interest agreements," is included in chapter 6, "Split-Interest Agreements," of this guide. Annuity obligations arising from split-interest gifts should be recognized as liabilities.[8] Periodic revaluations of these liabilities result in changes in the value of split-interest agreements, which should be included as changes in the appropriate net asset classes in a statement of activities.

## Amounts Held for Others Under Agency Transactions

**10.11** Some not-for-profit organizations receive assets in agency transactions. If cash and other financial assets are held under agency transactions, the organization should report a liability to the specified beneficiary concurrently with its recognition of those assets received from the donor. If the assets received from the donor are donated materials, supplies, or other nonfinancial assets, the recipient organization may choose either to (*a*) report the receipt of the asset as a liability to the beneficiary concurrent with recognition of the assets received or (*b*) not to report the transaction at all. The choice is an accounting policy that should be applied consistently from period to period. An organization should consider the need for disclosure in the notes to the financial statements pursuant to APB Opinion No. 22, *Disclosure of Accounting Policies*, and FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, paragraph 11. The preceding is discussed in paragraph 11 of FASB Statement No. 136. Paragraphs 5.05–.21 of this guide discuss agency transactions in more detail.

## Exit or Disposal Activities

**10.12** Exit activities include, but are not limited to, the closure of activities in a particular location, the relocation of activities from one location to another, changes in management structure, sale or termination of a line of business, or a fundamental reorganization that affects the nature and focus of operations. FASB Statement No. 146, *Accounting for Costs Associated With Exit or Disposal Activities*, discusses recognition of liabilities for the costs of exit activities, including one-time termination benefits provided to current employees that are involuntarily terminated, costs to terminate a contract that is not a capital lease, and costs to consolidate facilities or relocate employees. Paragraph 9.11 of this guide discusses exit and disposal obligations associated

---

[8] Paragraphs 6.11–.18 discuss subsequent measurement of the obligations under split-interest obligations, including whether to revise the discount rate assumptions should be revised at each measurement date to reflect current market conditions.

with the retirement (sale, abandonment, recycling, disposal, or other other-than-temporary idling) of tangible long-lived assets and the associated asset retirement costs.

## Guarantees

**10.13** FASB Interpretation No. 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*, requires organizations that issue certain guarantees, including guarantees of the debt of others, to recognize a liability for those guarantees, even in circumstances in which it is not probable that payments will be required under the guarantee, as well as to disclose additional information about the guarantee in their financial statements. The amount to recognize as a liability at inception of the guarantee is not the amount guaranteed, but is the greater of (*a*) the guarantee's fair value, which is, as a practical expedient, the premium that would be required by the guarantor to issue the same guarantee in a standalone arm's-length transaction with an unrelated party, nor (*b*) the contingent liability amount, if any, required to be recognized by paragraph 8 of FASB Statement No. 5. If the guarantee is provided to the other entity without receiving commensurate consideration in exchange, the contribution made should be reported in conformity with FASB Statement No. 116. The liability recognized should typically be reduced in future periods as the guarantor is released from risk under the guarantee.

## Contingencies

**10.14** In conformity with FASB Statement No. 5, notes to the financial statements may have to include information about, or a liability may have to be accrued for, loss contingencies. Examples of circumstances that may result in such contingencies include the following:

- Noncompliance with donor-imposed restrictions on contributed assets
- Problems with the organization's tax-exempt status, or that a determination letter regarding that status has not been received

## Pension and Other Defined Benefit Postretirement Plan Obligations‡

**10.15** FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*, requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) in its statement of financial position and to recognize

‡ FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*, has multiple effective dates. The requirement to recognize the funded status of a defined benefit postretirement plan and the related disclosure requirements was effective for not-for-profit organizations as of the end of the fiscal year ending after June 15, 2007. The requirement to measure plan assets and benefit obligations as of the date of the employer's fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008. Earlier application is encouraged.

changes in that funded status in the year in which the changes occur as changes in unrestricted net assets. The underfunded status of a plan is a liability, and the overfunded status of a plan is an asset. The underfunded or overfunded status is measured as the difference between the fair value of plan assets and the benefit obligation. For a defined benefit pension plan, the benefit obligation is the projected benefit obligation. For any other postretirement benefit plan, the benefit obligation is the accumulated postretirement benefit obligation. An employer is required to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions.

## Auditing

**10.16** Many audit objectives, controls, and auditing procedures for debt and other liabilities of not-for-profit organizations are similar to those of other organizations. In addition, the auditor may need to consider the following specific audit objectives, selected controls, and auditing procedures that are unique to not-for-profit organizations.

**10.17** The following table illustrates the use of assertions in developing audit objectives and designing substantive tests. The examples are not intended to be all-inclusive nor is it expected that all the procedures would necessarily be applied in an audit. The auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure to obtain sufficient appropriate audit evidence. The use of assertions in assessing risks and designing appropriate audit procedures to obtain audit evidence is described in paragraphs .14–.26 of AU section 326, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1). Various audit procedures and the purposes for which they may be performed are described in paragraphs .27–.41 of AU section 326.

## Auditing Considerations

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| | | ***Transactions*** | |
| *Contributions Made* | | | |
| Occurrence | Amounts recognized as contributions made are properly authorized and are reported in the period in which they become unconditional. | Controls ensure that only unconditional contributions made and promises to give are recognized in the financial statements. | Examine documentation supporting recognition of contributions made including notification of donee and whether the contribution is conditional or unconditional. |
| Completeness | All unconditional contributions made are recognized. | Controls ensure that all unconditional contributions made are recognized in the financial statements. | Review minutes of governing board and governing board committee meetings for information about contributions. |
| Valuation and allocation | Contributions made are measured at fair value at initial recognition. | Controls ensure the appropriate valuation of contributions made, including promises to give, at the time of initial recognition. | Review and test the method used for valuing contributions made, including promises to give. |
| | | ***Account Balances*** | |
| *Tax-Exempt Financing* | | | |
| Completeness | Amounts related to tax-exempt debt are recognized in the financial statements. | Reconcile outstanding balances and other relevant data with information received from the trustee. | Confirm outstanding balances and other relevant data with trustee. |

*(continued)*

**Auditing Considerations—continued**

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| | ***Account Balances—continued*** | | |
| | | | Review minutes of governing board and governing board committee meetings for information about tax-exempt financing. |
| *Promises to Give* | | | |
| Occurrence | Amounts recognized as contributions payable represent valid unconditional promises to give. | Controls ensure that only unconditional promises to give are recognized in the financial statements. | Examine documentation supporting recognition of contributions payable, including information such as the absence of conditions and the periods over which the promises to give become due. |
| Completeness | All unconditional promises to give are recognized. | Controls ensure that all unconditional promises to give are recognized in the financial statements. | Review minutes of governing board and governing board committee meetings for information about promises to give. |
| Cut-off | All unconditional promises to give are recognized in the proper period. | Controls assure that contributions made near fiscal period end are recorded in the appropriate period. | Review cash disbursements subsequent to year-end to ascertain that contributions made were recorded in the proper period. |
| Valuation and allocation | Contributions made and related liabilities expected to be paid beyond one year are measured using the method elected by the organization. | Controls ensure the appropriate valuation of promises to give at the end of the fiscal period. | Review and test the method used for valuing promises to give payable more than one year from the date of the financial statements. |

**Auditing Considerations—continued**

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| | ***Presentation and Disclosure*** | | |
| *Tax-Exempt Financing* | | | |
| Completeness | Disclosures related to tax-exempt debt are adequate. | Management monitors compliance with bond covenants and is aware of possible events of default. | Review financing agreements to ascertain that information about tax-exempt financing is properly reported and disclosed. |

# Chapter 11

# *Net Assets*

## Introduction

**11.01** Paragraph 49 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements—a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2)*, defines *net assets* as "the residual interest in an entity's assets remaining after liabilities are deducted."[1] As a residual interest, net assets cannot be measured independently of an organization's assets and liabilities. Changes in net assets result from transactions and other events and circumstances in which total assets and total liabilities change by different amounts. In many not-for-profit organizations, such changes include nonreciprocal transfers of assets received from donors who do not expect to receive either repayment or proportionate economic benefit in return. Display of and disclosures about net assets and changes in them are intended to assist donors and other users in assessing an organization's efforts to provide goods and services to its constituencies, its efficiency and effectiveness in providing such services, and its continuing ability to do so.

**11.02** Changes in net assets result from revenues, expenses, gains, and losses; those changes are discussed in chapters 5–10 and 12–13 of this guide. This chapter describes principles for reporting total net assets in statements of financial position and changes in total net assets in statements of activities, as well as related disclosures.

## Net Asset Classes*

**11.03** The following three classes of net assets should, if applicable, be reported in statements of financial position: (*a*) permanently restricted, (*b*) temporarily restricted, and (*c*) unrestricted.[2] Net assets should be included in one of the three classes depending on the presence and type of donor-imposed restrictions limiting an organization's ability to use or dispose of specific contributed assets or the economic benefits embodied in those assets. Donor stipulations should not be considered restrictions unless they include limitations on the use of contributed assets that are more specific than the broad limits imposed by the organization's purpose and nature.

**11.04** Donor-imposed restrictions generally apply to net assets. Donors may also restrict specific assets as to their use (for example, land contributed

---

[1] Though not-for-profit organizations may use other terms, such as *equity*, this Accounting and Auditing Guide (guide) uses the term *net assets* to describe the residual interest.

* Financial Accounting Standards Board (FASB) has a project on its agenda to issue a FASB Staff Position (FSP) with guidance concerning the classification and disclosure of net assets related to donor-restricted endowment funds. Paragraph 8.34 and its related footnote provide additional information. Readers should be alert to the issuance of the final standards.

[2] Though FASB Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*, encourages the use of the terms *unrestricted*, *temporarily restricted*, and *permanently restricted* net assets, other titles for these classes may also be used, and further disaggregation of total net assets may also be reported. For example, *equity* may be used for net assets and unrestricted net assets may be labeled *other* and subdivided into *board-designated* net assets and *undesignated* net assets.

for a park) or over time (for example, contributed securities that must be held in perpetuity). Paragraphs 3.03 and 11.15 of this guide discuss reporting requirements for specific assets that have been received with donor-imposed restrictions.

## Permanently Restricted Net Assets

**11.05** Permanently restricted net assets must be maintained by the organization in perpetuity. Permanently restricted net assets increase when organizations receive contributions for which donor-imposed restrictions limiting the organization's use of an asset or its economic benefits neither expire with the passage of time nor can be removed by the organization's meeting certain requirements. For example, contributions of cash or securities restricted by the donor with the stipulation that they be invested in perpetuity and contributions of collection items (if they are capitalized[3]) required by the donor to be maintained permanently in the organization's collections should be recognized as increases in permanently restricted net assets.

**11.06** Permanently restricted net assets may also change as a result of increases and decreases in existing assets that are subject to permanent restrictions. For example, increases in the carrying amounts of assets that are invested in perpetuity because of donor-imposed restrictions should be recognized as increases in permanently restricted net assets to the extent that donor stipulations or applicable law requires those increases to be retained permanently.

## Temporarily Restricted Net Assets

**11.07** Temporarily restricted net assets are those net assets whose use by the organization has been limited by donors (*a*) to later periods of time or after specified dates or (*b*) to specified purposes.[4] For example, contributions restricted by the donor to use by the organization over the next five years or to support a specific future program should be recognized as increases in temporarily restricted net assets. Contributions of assets (such as equipment or buildings) that by their nature are used up over time and that the donor stipulates must be used by the organization should also be recognized as increases in temporarily restricted net assets.[5]

**11.08** Temporarily restricted net assets may also change as a result of increases and decreases in existing assets or the economic benefits embodied in those assets that are subject to donor-imposed temporary restrictions. For example, if the donor has stipulated that income earned on temporarily restricted net assets must be added to principal until the principal is spent for a restricted purpose, the income should be reported as increases in temporarily restricted net assets.

---

[3] Chapter 7, "Other Assets," of this guide, discusses accounting policies concerning the capitalization of collection items.

[4] Contributions received with restrictions that are met in the same reporting period may be reported as unrestricted if the organization discloses such a policy and reports consistently from period to period. Paragraph 5.42 provides further guidance concerning that policy.

[5] Some organizations may adopt an accounting policy of implying time restrictions on contributed long-lived assets in the absence of explicit donor-imposed restrictions. Paragraphs 5.33–.34 provide additional guidance on alternative policies.

## Unrestricted Net Assets

**11.09** Unrestricted net assets include those net assets whose use is not restricted by donors, even though their use may be limited in other respects, such as by contract or by board designation. Changes in net assets arising from exchange transactions (except income and gains on assets that are restricted by donors or by law) should be included in the unrestricted class.

**11.10** Organizations such as social and country clubs may issue membership interests, such as capital shares. If those interests are wholly or partially refundable when the member dies, moves away, resigns his or her membership, or at a fixed date, FASB Statement of Financial Accounting Standards No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*,[†] provides guidance. This guide discusses only interests that are mandatorily redeemable at a fixed date whose amounts either are fixed or are determined by reference to an external index. This guide will be updated to discuss other mandatorily redeemable interests issued by not-for-profit organizations when FASB Statement No. 150 becomes effective for those interests.

**11.11** An interest that is mandatorily redeemable at a fixed date for a fixed or indexed amount—that embodies an unconditional obligation requiring the issuing not-for-profit organization to redeem it by transferring its assets at a fixed date (or dates) should be classified as a liability and initially measured at fair value. An interest that instead embodies a conditional obligation to redeem it by transferring assets upon an event not certain to occur (such as *only* upon moving from the community) is initially classified as unrestricted net assets. If the uncertain event occurs, the condition is resolved, or the event becomes certain to occur, and payment of a fixed or indexed amount is to be made at a fixed date (such as three months from the event's occurrence), the interest is reclassified as a liability. Upon reclassification, the issuing not-for-profit organization would measure the obligation at fair value and reduce net assets by the amount of that initial measure, recognizing no gain or loss.

**11.12** Subsequently, those mandatorily redeemable interests are measured at the present value of the amount to be paid at settlement (discounted at the rate implicit at inception) if both the amount of cash and the settlement date are fixed. If the amount to be paid varies based on an external index, those instruments are subsequently measured at the amount of cash that would be paid under the terms specified in the contract if settlement occurred at the reporting date. The change in the liability amount from the prior period is reported as interest cost (reported as described in chapter 13).

---

[†] FSP FAS 150-3, *Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement 150*, deferred the effective date of FASB Statement No. 150. In accordance with FSP FAS 150-3, FASB Statement No. 150 is effective in fiscal periods beginning after December 15, 2004, for financial instruments issued by not-for-profit organizations if those instruments are mandatorily redeemable on fixed dates for amounts that are either fixed or determinable by reference to an external index (such as an interest rate index). The effective date for other mandatorily redeemable financial instruments of not-for-profit organizations is deferred indefinitely pending further Board action and early adoption is precluded. Readers should be alert to changes in the effective date.

## Reclassifications

**11.13** Reclassifications of net assets—that is, simultaneous increases in one net asset class and decreases in another—should be made if (*a*) the organization fulfills the purposes for which the net assets were restricted, (*b*) donor-imposed restrictions expire with the passage of time or with the death of a split interest agreement beneficiary (if the net assets are not otherwise restricted), (*c*) a donor withdraws, or court action removes, previously imposed restrictions, or (*d*) donors impose restrictions on otherwise unrestricted net assets.[6] For example, the amount of a donor's contribution that must be used by the organization for a specified program would be reclassified from temporarily restricted to unrestricted net assets in the period in which the organization conducts the program.[7] Paragraph 9.08 of this guide discusses reclassifications concerning the use of contributed depreciable assets.

## Disclosure

**11.14** A statement of financial position should include, at a minimum, the amounts of total permanently restricted, temporarily restricted, and unrestricted net assets and the amount of total net assets. A statement of activities should include the amount of total changes in net assets and of changes in each net asset class. These amounts should articulate with the net asset amounts in the statement of financial position. Reclassifications of amounts between net asset classes should be reported separately from other transactions in the statement of activities. Specific changes in each net asset class should be aggregated into reasonably homogeneous groups.

**11.15** Information about the following should be shown on the face of the financial statements or in the notes:

- Different kinds of permanent restrictions, such as those related to collection items and other specific assets to be held in perpetuity and to assets that have been contributed by donors with stipulations that they be invested in perpetuity
- Different kinds of temporary restrictions, such as those concerning the support of specific operating activities, use in specific future periods, or the acquisition of long-term assets

Separate disclosures of significant limitations other than those imposed by donors, such as those imposed by governing boards, are permitted to be made on the face of the financial statements or in the notes to the financial statements.

## Auditing

**11.16** Since net assets cannot be measured independently of an organization's assets and liabilities, the auditor's consideration of net asset balances generally focuses on the assertions about rights and obligations and presentation and disclosure. In addition, the auditor may need to consider the following

---

[6] Paragraph 5.40 discusses donors imposing restrictions on otherwise unrestricted net assets.

[7] A purpose restriction is often fulfilled when the organization incurs an expense or recognizes a liability to a vendor to acquire goods or services that satisfies the restriction. Paragraph 5.44 of this guide discusses appropriate accounting when expenses are incurred for a purpose for which both unrestricted and temporarily restricted net assets are available.

specific audit objectives, selected controls, and auditing procedures that are unique to not-for-profit organizations.

**11.17** The following table illustrates the use of assertions in developing audit objectives and designing substantive tests. The examples are not intended to be all-inclusive nor is it expected that all the procedures would necessarily be applied in an audit. The auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure to obtain sufficient appropriate audit evidence. The use of assertions in assessing risks and designing appropriate audit procedures to obtain audit evidence is described in paragraphs .14–.26 of AU section 326, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1). Various audit procedures and the purposes for which they may be performed are described in paragraphs .27–.41 of AU section 326.

**Auditing Considerations**

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| | ***Presentation and Disclosure*** | | |
| Rights and obligations; Classification | Net assets are used and accounted for in accordance with donor restrictions. | Management monitors compliance with donor restrictions. | Review minutes of governing board and governing board committee meetings for evidence of donor restrictions. |
| | Temporarily restricted net assets are reclassified as unrestricted net assets in the statement of activities when donor-imposed restrictions have been fulfilled. | Controls ensure that reclassification of temporarily restricted net assets occurs when donor-imposed restrictions have been fulfilled. | Determine compliance with donor restrictions; test expenditures to determine that restricted net assets are used for their restricted purposes. |
| | | | Determine that appropriate reclassifications are reported in the statement of activities when donor-imposed restrictions have been fulfilled. |

# Chapter 12

# *Revenues and Receivables From Exchange Transactions*

## Introduction

**12.01** This chapter discusses recognition, measurement, and display issues for revenues and related receivables arising from exchange transactions.[1] Because of the specialized nature of investment activities, they are discussed separately in chapter 8, "Investments," of this Audit and Accounting Guide (guide). Chapter 5, "Contributions Received and Agency Transactions," of this guide, includes guidance on distinguishing exchange transactions from contributions and agency transactions.

## Revenues

**12.02** Paragraph 78 of FASB Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements—a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2)*, defines *revenues* as "inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations." Exchange transactions that give rise to revenues for not-for-profit organizations typically involve their efforts to provide goods or services to members, clients, students, customers, and other beneficiaries for a fee.

**12.03** Revenues are distinguished from gains, which are increases in an organization's net assets from peripheral or incidental transactions. In some situations, judgment is required to determine whether an increase in net assets should be reported as a revenue or as a gain. That determination should be based on the relationship of the transaction to the organization's activities. Transactions and other events that would properly be considered part of one organization's ongoing major or central activities (and hence give rise to revenues) may be considered peripheral for other organizations (and hence give rise to gains). For example, sales of computer equipment by a college store should be reported as revenues if such sales are considered part of the college's ongoing major or central activities. Sales of old computer equipment used in a museum's administrative offices would, however, be reported as gains if such sales are peripheral and if the equipment were sold above book value. Chapter 13, "Expenses, Gains, and Losses," of this guide, discusses reporting gains from exchange transactions.

## Recognition, Measurement, and Display

**12.04** The recognition, measurement, and display of revenues and related receivables arising from exchange transactions are similar for both

---

[1] Paragraph 48 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 116, *Accounting for Contributions Received and Contributions Made*, defines *exchange transactions* as "reciprocal transfers in which each party receives and sacrifices approximately equal value."

not-for-profit and for-profit entities. Revenues from exchange transactions should be recognized based on accrual accounting principles and should be measured by the increase in cash, receivables, or other assets or by the decrease in liabilities resulting from the transaction.[2] Revenues from exchange transactions should be reported as increases in unrestricted net assets in a statement of activities. As discussed in chapter 3, "Basic Financial Statements," of this guide, further classifications (for example, between operating and nonoperating) may be incorporated within a statement of activities beyond the net asset classes stipulated by FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations.*

**12.05** Revenues from exchange transactions should generally be reported gross of any related expenses.[3] If the 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.[4,5]

**12.06** Unless measured at fair value in conformity with FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*, receivables should be reported at the measures described in the remainder of this paragraph. Receivables arising from exchange transactions should be reported at net realizable value if the amounts are due within one year. Long-term receivables should be reported in conformity with Accounting Principles Board (APB) Opinion No. 21, *Interest on Receivables and Payables.* Receivables arising from exchange transactions should be reported net of allowances for uncollectible amounts, if applicable.[6]

---

[2] Consistent with generally accepted accounting principles, interest on loans made to students and to other individuals or organizations should be recognized as revenue when earned.

[3] Expenses that are directly related to specific gross revenues may, however, be displayed sequentially with those revenues. For example, gross revenues from special events less the direct costs related to those events, followed by a subtotal, may be reported in a statement of activities. Chapter 13 of this guide discusses reporting of special events.

[4] Net revenue may be reported as a single line item in a statement of activities, or the gross revenue is permitted to be reported less the related discount, provided that the discount is displayed immediately beneath the revenue.

[5] Paragraph 13.07 provides guidance concerning whether reductions in amounts charged for goods or services should be reported as discounts or expenses.

[6] Paragraphs 3.44–.46 of this guide discuss the option for organizations to report certain assets and liabilities at fair value in conformity with FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*, or FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140.* FASB Statement No. 159 is effective as of the beginning of the first fiscal year that begins after November 15, 2007. Earlier adoption is permitted if certain conditions described in paragraph 30 of the statement are met.

# Chapter 13

# *Expenses, Gains, and Losses*

## Introduction

**13.01** Generally, expenses, gains, and losses of not-for-profit organizations are similar to those of for-profit organizations and are recognized, measured, and displayed similarly. This chapter discusses certain expense, gain, and loss recognition, measurement, and display issues that are unique to not-for-profit organizations and that are not covered elsewhere in this Audit and Accounting Guide (guide).

## Expenses

**13.02** Paragraph 80 of Financial Accounting Standards Board (FASB) Concept No. 6, *Elements of Financial Statements—a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2)*, defines *expenses* as "outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations." Expenses are distinguished from losses, which are decreases in an organization's net assets from peripheral or incidental transactions and from all other transactions and other events and circumstances affecting the organization except those that result from expenses.

**13.03** Expenses should be reported in a statement of activities as decreases in unrestricted net assets. As discussed in chapter 3, "Basic Financial Statements," of this guide, further classifications (such as between operating and nonoperating) may be incorporated within a statement of activities beyond the net asset classes required by FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*.

**13.04** Paragraph 26 of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, specifies that a statement of activities or notes to the financial statements should provide information about expenses reported by their functional classification, such as major classes of program services and supporting activities.[1] No similar requirement exists with respect to losses.[2] Voluntary health and welfare organizations[3] are required to report information about functional classifications, together with information about expenses by their natural classifications (such as salaries, rent, electricity, interest expense,

---

[1] Reporting information about the functional classification of expenses may require the allocation of costs that benefit two or more functions. All references in this guide to the allocation of costs of informational materials and activities that include a fund-raising appeal among functions are subject to the provisions of SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising* (AICPA, *Technical Practice Aids*, ACC sec. 10,730). That SOP is incorporated in paragraphs 13.21, 13.23, 13.24, 13.51–.60, and appendixes A–E [paragraphs 13.62–.66] of this chapter, as well as paragraphs 6–11 and 37–66 of appendix A of this guide as conforming changes.

[2] Paragraphs 13.02 and 13.16–.18 of this guide discuss the differences between expenses and losses.

[3] Voluntary health and welfare organizations are defined in appendix D of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, and in the glossary of this guide.

depreciation, awards and grants to others, and professional fees), in a matrix format in a separate financial statement.[4] FASB Statement No. 117 encourages but does not require other not-for-profit organizations to provide information about expenses by their natural expense classification.

## Expense Recognition Issues

**13.05** Expenses are recognized when an organization's economic benefits are used up in delivering or producing goods, rendering services, or other activities or when previously recognized assets are expected to provide reduced or no future benefits. Some expenses, such as cost of goods sold, are recognized simultaneously with revenues that result directly and jointly from the same transactions or other events as the expenses. Some expenses, such as salaries, are recognized when cash is spent or liabilities are incurred for goods and services that are used up either simultaneously with acquisition or soon after. Some expenses, such as depreciation, are allocated by systematic and rational procedures to the periods during which the related assets are expected to provide services. An expense or loss is also recognized if it becomes evident that the previously recognized future economic benefits of an asset have been reduced or eliminated, or that a liability has been incurred or increased, without associated economic benefits.

### Fund-Raising Costs

**13.06** Fund-raising costs, including the cost of special fund-raising events, are incurred to persuade potential donors to make contributions to an organization and should be expensed as incurred.[5] Fund-raising costs incurred in one period, such as those made to obtain bequests, compile a mailing list of prospective contributors, or solicit contributions in a direct-response activity, may result in contributions that will be received in future periods. These costs also should be expensed as incurred.

### Financial Aid and Other Reductions in Amounts Charged for Goods and Services

**13.07** Some not-for-profit organizations provide reductions in amounts charged for goods or services, such as financial aid provided by colleges and universities. Reductions in amounts charged for goods or services provided by a not-for-profit organization should be reported as expenses if such reductions are given in exchange for goods or services provided to the organization, such as part of a compensation package. Amounts reported as expenses for such reductions should be reported in the same functional classification in which the cost of the goods or services provided to the organization are reported. If reductions in amounts charged for goods or services provided by a

---

[4] Not-for-profit organizations may have various kinds of functions. The discussion in this guide focuses on program, management and general, and fund-raising for illustrative purposes, because the Accounting Standards Executive Committee and the Not-for-Profit Organizations Committee (committees) believe the use of those functional classifications will likely become predominant practice. However, the committees neither encourage nor discourage the use of those or other functional classifications. Accordingly, the classifications used in the matrix may include program, management and general, and fund-raising or other classifications, such as cost of sales or investing.

[5] Costs are incurred when the item or service has been received.

not-for-profit organization are given other than in exchange for services provided to the organization, such amounts should be reported as follows:

- as expenses to the extent that the organization incurs incremental expense in providing such goods or services
- as discounts[6] if the organization incurs no incremental expense in providing such goods or services

## Advertising Costs

**13.08** SOP 93-7, *Reporting on Advertising Costs* (AICPA, *Technical Practice Aids*, ACC sec. 10,590), provides recognition, measurement, and disclosure guidance for the advertising activities of all entities, including not-for-profit organizations. (SOP 93-7 specifically notes, however, that fund-raising by not-for-profit organizations is not considered advertising and is not within the scope of the SOP.) SOP 93-7 requires certain disclosures about advertising activities, including disclosure of total advertising costs for a period.

**13.09** SOP 93-7 defines *advertising* as "the promotion of an industry, an entity, a brand, a product name, or specific products or services so as to create or stimulate a positive entity image or to create or stimulate a desire to buy the entity's products or services." Advertising by a not-for-profit organization also includes activities to create or stimulate a desire to use the organization's products or services that are provided without charge.

**13.10** Advertising costs should be expensed either as incurred or the first time the advertising takes place, except for direct-response advertising that results in probable future benefits. Direct-response advertising should be capitalized if it is expected to result in future benefits, as in sales resulting from direct response advertising of merchandise in excess of future costs to be incurred in realizing those revenues. If no future revenues are anticipated, however, because the products or services advertised are being provided by the organization without charge, there is no basis for capitalizing the costs of direct-response advertising after the first time the advertising takes place.

## Start-Up Costs

**13.11** SOP 98-5, *Reporting on the Costs of Start-Up Activities* (AICPA, *Technical Practice Aids*, ACC sec. 10,750), provides guidance on the financial reporting of start-up costs and organization costs. It requires costs of start-up activities and organization costs to be expensed as incurred.

**13.12** The SOP broadly defines start-up activities as those one-time activities related to opening a new facility, introducing a new product or service, conducting business in a new territory, conducting business with a new class of customer or beneficiary, initiating a new process in an existing facility, or commencing some new operations. Start-up activities include activities related to organizing a new entity (commonly referred to as organization costs).

**13.13** This SOP provides that certain costs that may be incurred in conjunction with start-up activities are not subject to the provisions of the SOP

---

[6] Paragraph 12.05 provides guidance concerning display of discounts.

and should be accounted for in accordance with other existing authoritative literature. SOP 98-5 provides examples to help entities determine what costs are and are not within its scope. It also includes illustrations in the appendix; one illustration provides a scenario in which a not-for-profit organization that has provided meals to the homeless is opening a shelter to house the homeless. The illustration shows the costs that are and are not subject to the SOP.

### Internal Use Computer Software Costs

**13.14** SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* (AICPA, *Technical Practice Aids*, ACC sec. 10,720), provides guidance on accounting for the costs of computer software developed or obtained for internal use. SOP 98-1 identifies the characteristics of internal-use software and provides examples to assist in determining when computer software is for internal use.[7]

### Contributions Made

**13.15** FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, provides guidance on contributions made as well as contributions received. The recognition rules for contributions made are discussed in paragraph 10.07 of this guide. The amortization of any discount related to unconditional promises to give should be reported in the same functional classification in which the promise to give was reported.[8]

## Gains and Losses

**13.16** Revenues are inflows of assets that result from an organization's ongoing major or central operations and activities. Gains are increases in net assets resulting from an organization's peripheral or incidental transactions and other events and circumstances affecting the organization other than those that result from revenues. Expenses are outflows of assets or incurrences of liabilities that result from an organization's ongoing major or central operations and activities. Losses are decreases in net assets from an organization's peripheral or incidental transactions and other events and circumstances affecting the organization other than those that result from expenses.

**13.17** Gains and losses result both from an organization's peripheral or incidental activities and from events and circumstances that stem from the environment and that are largely beyond the control of a particular organization and its management. Some gains and losses result from holding assets or liabilities while their values change, such as from changes in the fair value of securities or changes in foreign exchange rates. Other gains and losses result from natural catastrophes, such as fires, floods, and earthquakes. Still others

---

[7] Related literature includes FASB Emerging Issues Task Force (EITF) Issue No. 97-13, "Accounting for Costs Incurred in Connection with a Consulting Contract or an Internal Project That Combines Business Process Reengineering and Information Technology Transformation."

[8] Some transfers may appear to be contributions made but are actually reciprocal in nature. FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, states that if a not-for-profit organization transfers assets to a recipient organization and specifies itself or its affiliate as the beneficiary, the transfer is not a contribution, even if the not-for-profit organization explicitly grants the recipient organization variance power. Paragraphs 5.18–.21 provide further guidance about a transfer made by a not-for-profit organization for its own benefit or for the benefit of its affiliate.

result from transactions (such as an organization's sale of buildings and equipment that are no longer needed for its ongoing operations, or from its winning or losing a lawsuit) that are only peripheral or incidental to the organization.

**13.18** Transactions resulting in revenues for one not-for-profit organization may result in gains for another, which, in turn, determines how the related costs should be classified and displayed. Revenues and expenses are reported gross (except for investment revenues and related expenses, which are permitted to be reported net of related expenses, as discussed in paragraphs 8.10 and 13.27), while gains and losses may be reported net. Gains and losses should be reported as increases or decreases in unrestricted net assets unless their use is restricted by a donor or by law, in which case they should be reported as increases or decreases in temporarily restricted or permanently restricted net assets, as appropriate. Losses need not be reported by their functional classification or in the matrix that presents information about expenses according to both their functional and natural classifications.

## Reporting Costs Related to Sales of Goods and Services

**13.19** The way that costs related to sales of goods and services are displayed depends on whether the sales constitute a major or central activity of the organization or a peripheral or incidental activity. For example, a museum that has a store that is a major or central activity should report and display separately the revenues from the store's sales and the related cost of sales. Cost of sales is permitted to be reported immediately after revenues from sale of merchandise, and may be followed by a descriptive subtotal, or cost of sales may be reported with other expenses. If the store sells merchandise that is related to the museum's program, the store would be a program service and the cost of the store's sales would be reported as a program expense. In other circumstances, cost of sales could be reported as a separate supporting service. For example, if operating a cafeteria is a major or central activity but is not related to the organization's programs, the cafeteria's cost of sales would be reported as supporting services.

**13.20** In contrast, a church that occasionally produces and sells a cookbook (considered to be a peripheral or incidental activity) has gains (or losses) from those sales, and the receipts and related costs are permitted to be offset and only the net gains (or losses) are reported. (These losses are not classified as an expense so they should not be reported by their functional classification.)

## Reporting the Cost of Special Events and Other Fund-Raising Activities

**13.21** Some organizations conduct fund-raising or joint activities,[9] including special social and educational events (such as symposia, dinners, dances, and theater parties) in which the attendee receives a direct benefit (for example, a meal or theater ticket). FASB Statement No. 117 requires the reporting of the gross amounts of revenues and expenses from special events and other fund-raising activities that are ongoing major or central activities, but permits (but does not require) reporting net amounts if the receipts and related costs result from special events that are peripheral or incidental activities.

---

[9] See footnote 1.

**13.22** Organizations may report the gross revenues of special events and other fund-raising activities with the cost of direct benefits to donors (for example, meals and facilities rental) displayed either (1) as a line item deducted from the special event revenues or (2) in the same section of the statement of activities as are other programs or supporting services and allocated, if necessary, among those various functions. Alternatively, the organization could consider revenue from special events and other fund-raising activities as part exchange (for the fair value the participant received) and part contribution (for the excess of the payment over that fair value) and report the two parts separately.

**13.23** For example, assume an organization has a special event that is an ongoing and major activity with a ticket price of $100. Assume that the activity does not meet the audience criterion in paragraphs 13.47–.48, and, therefore, all costs of the activity, other than the direct donor benefits, should be reported as fund-raising. The event includes a dinner that costs the organization $25 and that has a fair value of $30. (Chapter 5, "Contributions Received and Agency Transactions," of this guide, discusses the appropriate reporting if the meal or other items of value are donated to the organization for resale.) In addition, the organization incurs other direct costs of the event in connection with promoting and conducting the event, including incremental direct costs incurred in transactions with independent third parties and the payroll and payroll-related costs for the activities of employees who are directly associated with, and devote time to, the event. Those other direct costs, which include (*a*) $5 that otherwise might be considered management and general costs if they had been incurred in a different activity, and (*b*) fund-raising costs of $10, are unrelated to the direct benefits to donors and, accordingly, should not be included as costs of benefits to donors. In addition, the organization has the following transactions, which are unrelated to the special event: unrestricted contributions of $200, program expenses of $60, management and general expenses of $20, and fund-raising expenses of $20.

**13.24** Some ways in which the organization could display the results of the special event as part of its statement of activities are illustrated as follows:

**Illustration 1**

| | | |
|---|---|---|
| Changes in unrestricted net assets: | | |
| Contributions | | $200 |
| Special event revenue | 100 | |
| Less: Costs of direct benefits to donors | (25) | |
| Net revenues from special events | | 75 |
| Contributions and net revenues from special events | | 275 |
| Other expenses: | | |
| Program | | 60 |
| Management and general | | 20 |
| Fund-raising | | 35 |
| Total other expenses | | 115 |
| Increase in unrestricted net assets | | $160 |

**Illustration 2**

| | |
|---|---|
| Changes in unrestricted net assets: | |
| Revenues: | |
| Contributions | $200 |
| Special event revenue | 100 |
| Total revenues | 300 |
| Expenses: | |
| Program | 60 |
| Costs of direct benefits to donors | 25 |
| Management and general | 20 |
| Fund-raising | 35 |
| Total other expenses | 140 |
| Increase in unrestricted net assets | $160 |

**Illustration 3**

| | | |
|---|---|---|
| Changes in unrestricted net assets: | | |
| Contributions | | $270 |
| Dinner sales | 30 | |
| Less: Costs of direct benefits to donors | (25) | |
| Gross profit on special events | | 5 |
| Contributions and net revenues from special events | | 275 |
| Other expenses: | | |
| Program | | 60 |
| Management and general | | 20 |
| Fund-raising | | 35 |
| Total other expenses | | 115 |
| Increase in unrestricted net assets | | $160 |

**13.25** Paragraphs 25 and 138 of FASB Statement No. 117 permit, but do not require, organizations to report receipts from special events that are peripheral or incidental activities net of related costs, without reporting those costs on the face of a statement of activities. Costs netted against receipts from peripheral or incidental special events should be limited to direct costs.

**13.26** The frequency of the events and the significance of the gross revenues and expenses distinguish major or central events from peripheral or incidental events. Events are ongoing major and central activities if (*a*) they are normally part of an organization's strategy and it normally carries on such activities or (*b*) the event's gross revenues or expenses are significant in relation to the organization's annual budget. Events are peripheral or incidental if they are not an integral part of an organization's usual activities or if their gross revenues or expenses are not significant in relation to the organization's annual budget. Accordingly, similar events may be reported differently by different organizations based on the organization's overall activities.

### Investment Revenues, Expenses, Gains, and Losses

**13.27** Investment revenues may be reported net of related expenses, such as custodial costs and internal and external investment advisory costs, provided that the amount of such expenses is disclosed either on the face of a statement of activities or in notes to the financial statements. Expenses that are netted against investment revenues should, however, be reported by their functional classification on the separate statement that reports information about expenses by their natural classification as well as by their functional classification in a matrix format (if the organization presents that statement). Realized and unrealized losses on investments may be netted against realized and unrealized gains on a statement of activities. Chapter 8, "Investments," of this guide, includes a more detailed discussion of investment gains and losses.

## Functional Reporting of Expenses

**13.28** As has been previously noted, FASB Statement No. 117 requires the presentation, in either a statement of activities or the notes to the financial statements, of information about expenses (but not losses) reported by their functional classification, such as major classes of program services and supporting activities. Program services are defined in paragraph 27 of FASB Statement No. 117 as "the activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the organization exists. Those services are the major purpose for and the major output of the organization and often relate to several major programs." Program services may include cost of sales and costs of other revenue-generating activities that are program related. Supporting services are defined in paragraph 28 as "all activities of a not-for-profit organization other than program services. Generally, they include management and general, fund-raising, and membership-development activities." Supporting services may include, as one or more separate categories, cost of sales and costs of other revenue-generating activities that are not program related. FASB Statement No. 117 provides examples of the kinds of activities that fall into each of those categories, and further elaboration is provided in the following sections.

### Functional Classifications

#### *Program Services*

**13.29** The number of functional reporting classifications for program services varies according to the nature of the services rendered. For some organizations, a single functional reporting classification may be adequate to portray what may, in effect, be a single, integrated program service that the organization provides. In most cases, however, several separate and identifiable services are provided, and in such cases the expenses for program services should be reported by the kind of service function or group of functions. For example, a large university may have programs for student instruction, research, and public service, among others. A health and welfare organization may have programs for health and family services, research, disaster relief, and public education, among others. A federated fund-raising organization's programs may include

making contributions to organizations supported by the federated fund-raising organization.

**13.30** Paragraph 26 of FASB Statement No. 117 specifies that information about expenses should be reported by their functional classification, such as *major* classes of program services and supporting activities. For guidance on what constitutes *major* classes of programs and supporting activities, not-for-profit organizations may consider, among other sources, FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information.*[10]

**13.31** The financial statements should provide information about program expenses. If the components of total program expenses are not evident from the details provided on the face of the statement of activities (for example, if cost of sales is not identified as either program or supporting services), the notes to the financial statements should disclose total program expenses and should provide information about why total program expenses disclosed in the notes does not articulate with the statement of activities. The financial statements should also provide a description of the nature of the organization's activities, including a description of each of its major classes of programs, either on the statement of activities (for example, using column headings) or in the notes to the financial statements.

## Supporting Services

**13.32** Not-for-profit organizations may have various kinds of supporting activities, such as management and general, fund-raising, and membership development. Some industries have functional categories of supporting activities that are prevalent in that industry. For example, colleges and universities typically have institutional support and institutional development activities. A single functional reporting classification is ordinarily adequate to portray each kind of supporting service. Organizations may, however, present more detailed disaggregated information for each kind of supporting service. For example, fund-raising expenses and the corresponding support that is obtained may be reported separately for each kind of fund-raising activity undertaken, either on the face of a statement of activities or in the notes to the financial statements.

**13.33** *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

---

[10] FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*, applies only to public business enterprises; however, the Statement's guidelines may be helpful to not-for-profit organizations in determining the number of functional classifications that would be appropriate in their particular circumstances.

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.

**13.34** *Fund-raising activities*[11] involve inducing potential donors to contribute money, securities, services, materials, facilities, other assets, or time.[12] They include publicizing and conducting fund-raising campaigns; maintaining donor mailing lists; conducting special fund-raising events; preparing and distributing fund-raising manuals, instructions, and other materials; and conducting other activities involved with soliciting contributions from individuals, foundations, governments, and others. (Paragraph 13.58 discusses how fund-raising activities of federated fund-raising organizations should be reported.) The financial statements should disclose total fund-raising expenses.

**13.35** *Membership-development activities* include soliciting for prospective members and membership dues, membership relations, and similar activities. To the extent that member benefits are received, membership is an exchange transaction. If there are no significant benefits or duties connected with membership, however, the substance of membership-development activities may, in fact, be fund-raising, and the related costs should be reported as fund-raising costs.[13] Membership development activities may be conducted in conjunction with other activities. In circumstances in which membership development is in part soliciting revenues from exchange transactions and in part soliciting contributions, the activity is a joint activity, as discussed in paragraphs 13.42–.55 of this guide. If membership development is a joint activity and the purpose, audience, and content of the activity are appropriate for achieving membership development, joint costs should be allocated between fundraising and the exchange transaction. In circumstances in which membership development is conducted in conjunction with other activities but does not include soliciting contributions (for example, the organization's membership dues are entirely exchange transactions and the activity is in part soliciting new members and in part program activities for existing members), the activity is not a joint activity, and the costs should be allocated to membership development and one or more other functions. For example, membership may entitle the members to group life and other insurance at reduced costs because of the organization's negotiated rates and to a subscription to the organization's magazine or newsletter. Under these circumstances, an appropriate part of the costs of soliciting members should be allocated to the membership-development function and a part to program services.

---

[11] See footnote 1.

[12] At its March 27, 2002 meeting, the FASB stated that it believes that paragraphs 26–28 of FASB Statement No. 117 require that information about expenses be reported by functional classification and that fund-raising activities include soliciting contributions of services from individuals, regardless of whether those services meet the recognition criteria for contributions in FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*. The FASB also observed that the definition of fundraising activities in this guide conforms to paragraphs 26–28 of FASB Statement No. 117 and provides that costs of soliciting donors to contribute services (time) should be reported as fund-raising activities regardless of whether those services meet the recognition criteria for contributions in FASB Statement No. 116.

[13] Paragraph 5.15 and table 5-2 of this guide provide indicators to help distinguish contribution and exchange portions of membership dues.

## Classification of Expenses Related to More Than One Function

**13.36** Some expenses are directly related to, and can be assigned to, a single major program or service or a single supporting activity. Other expenses relate to more than one program or supporting activity, or to a combination of programs and supporting services. These expenses should be allocated among the appropriate functions. Examples include a direct mail solicitation that combines fund-raising with program activities (subject to the provisions of paragraphs 13.41–.55), salaries of persons who perform more than one kind of service, and the rental of a building used for various programs and supporting activities.

## Direct Identification Versus Allocation Methods[14]

**13.37** Direct identification of specific expense (also referred to as *assigning* expenses) is the preferable method of charging expenses to various functions. If an expense can be specifically identified with a program or supporting service, it should be assigned to that function. For example, travel costs incurred in connection with a program activity should be assigned to that program.

**13.38** If direct identification (that is, assignment) is impossible or impracticable, an allocation is appropriate. The techniques used to allocate are common to all entities, for-profit and not-for-profit alike. A reasonable allocation of expenses among an organization's functions may be made on a variety of bases. Objective methods of allocating expenses are preferable to subjective methods. The paragraphs that follow provide guidance (in addition to that presented throughout this chapter) on allocating or presenting certain costs that may be incurred by not-for-profit organizations.[15]

**13.39** The allocation may be based on related financial or nonfinancial data. For example, the expenses associated with occupying and maintaining a building, such as depreciation, utilities, maintenance, and insurance, may be allocated based on the square footage of space occupied by each program and supporting service. If floor plans are not available and the measurement of the occupied space is impractical, an estimate of the relative portion of the building occupied by each function may be made. Occupying and maintaining a building is not a separate supporting service. Interest costs,[16] including interest on a building's mortgage, should be allocated to specific programs or supporting services to the extent possible; interest costs that cannot be allocated should be reported as part of the management and general function.

**13.40** An organization should evaluate its expense allocation methods periodically. The evaluation may include, for example, a review of the time records or activity reports of key personnel, the use of space, and the consumption of supplies and postage. The expense allocation methods should be reviewed by management and revised when necessary to reflect significant changes in the nature or level of the organization's current activities.

---

[14] This section provides general information about assigning and allocating costs among functional classifications. For costs incurred in joint activities, the guidance in this section is subject to the provisions of paragraphs 13.41–13.55.

[15] The guidance found in U.S. Office of Management and Budget Circular A-122 may also be helpful in allocating costs.

[16] Paragraph 21 of FASB Statement No. 34, *Capitalization of Interest Cost*, requires disclosure of total interest costs incurred.

## *Expenses of Materials and Activities That Combine Fund-Raising Activities With Activities That Have Elements of Another Function (Joint Activities)*

**13.41** Some not-for-profit organizations (NPOs) solicit support through a variety of fund-raising activities. These activities include direct mail, telephone solicitation, door-to-door canvassing, telethons, special events, and others. Sometimes fund-raising activities are conducted with activities related to other functions, such as program activities or supporting services, such as management and general activities.[17] Sometimes fund-raising activities include components that would otherwise be associated with program or supporting services, but in fact support fund-raising.

## *Accounting for Joint Activities*

**13.42** If the criteria of purpose, audience, and content are met, the costs of a joint activity that are identifiable with a particular function should be charged to that function and joint costs should be allocated between fund-raising and the appropriate program or management and general function. If any of the criteria are not met, all costs of the joint activity should be reported as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund-raising.

## *Purpose*

**13.43** The purpose criterion is met if the purpose of the joint activity includes accomplishing program or management and general functions. (Paragraphs 13.44–.45 provide guidance that should be considered in determining whether the purpose criterion is met. Paragraph 13.44 provides guidance pertaining to program functions only. Paragraph 13.45 provides guidance pertaining to both program and management and general functions.)

**13.44** *Program functions.* To accomplish program functions, the activity should call for specific action by the audience that will help accomplish the organization's mission. For purposes of applying the guidance in paragraphs 13.41–.54, the following are examples of activities that do and do not call for specific action by the audience that will help accomplish the organization's mission:

- An organization's mission includes improving individuals' physical health. For that organization, motivating the audience to take specific action that will improve their physical health is a call for

[17] The functional classifications of fund-raising, program, and management and general are discussed throughout paragraphs 13.41–.55 for purposes of illustrating how the guidance in these paragraphs would be applied by entities that use those functional classifications. Some entities have a functional structure that does not include fund-raising, program, or management and general, or that includes other functional classifications, such as membership development. This guide is not intended to require reporting the functional classifications of fund-raising, program, and management and general. In circumstances in which entities that have a functional structure that includes other functional classifications conduct joint activities, all costs of those joint activities should be charged to fund-raising (or the category in which fund-raising is reported), unless the purpose, audience, and content of those joint activities are appropriate for achieving those other functions.

specific action by the audience that will help accomplish the organization's mission. An example of an activity that motivates the audience to take specific action that will improve their physical health is sending the audience a brochure that urges them to stop smoking and suggests specific methods, instructions, references, and resources that may be used to stop smoking.

- An organization's mission includes educating individuals in areas other than the causes, conditions, needs, or concerns that the organization's programs are designed to address (referred to hereafter as "causes"). For that organization, educating the audience in areas other than causes or motivating the audience to otherwise engage in specific activities that will educate them in areas other than causes is a call for specific action by the audience that will help accomplish the organization's mission. Examples of organizations whose mission includes educating individuals in areas other than causes are universities and possibly other organizations. An example of an activity motivating individuals to engage in education in areas other than causes is a university inviting individuals to attend a lecture or class in which the individuals will learn about the solar system.
- Educating the audience about causes or motivating the audience to otherwise engage in specific activities that will educate them about causes is not a call for specific action by the audience that will help accomplish the organization's mission. Such activities are considered in support of fund-raising. (However, some educational activities that might otherwise be considered as educating the audience about causes may implicitly call for specific action by the audience that will help accomplish the organization's mission. For example, activities that educate the audience about environmental problems caused by not recycling implicitly call for that audience to increase recycling. If the need for and benefits of the specific action are clearly evident from the educational message, the message is considered to include an implicit call for specific action by the audience that will help accomplish the organization's mission.)
- Asking the audience to make contributions is not a call for specific action by the audience that will help accomplish the organization's mission.

If the activity calls for specific action by the audience that will help accomplish the organization's mission, the guidance in paragraph 13.45 should also be considered in determining whether the purpose criterion is met.

**13.45** *Program and management and general functions.* The following factors should be considered, in the order in which they are listed,[18] to determine whether the purpose criterion is met:

*a. Whether* ***compensation or fees*** *for performing the activity are based on contributions raised.* The purpose criterion is *not* met if

[18] In considering the guidance in paragraph 13.45, the factor in paragraph 13.45*a* (the compensation or fees test) is the preeminent guidance. If the factor in paragraph 13.45*a* is not determinative, the factor in paragraph 13.45*b* (whether a similar program or management and general activity is conducted separately and on a similar or greater scale) should be considered. If the factor in paragraph 13.45*b* is not determinative, the factor in paragraph 13.45*c* (other evidence) should be considered.

a majority of compensation or fees for any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity.[19,20]

b. *Whether a similar program or management and general activity is conducted separately and on a similar or greater scale.* The purpose criterion is met if either of the following two conditions is met:

(1) *Condition 1*:

— The program component of the joint activity calls for specific action by the recipient that will help accomplish the organization's mission, and

— A similar program component is conducted without the fund-raising component using the same medium and on a scale that is similar to or greater than the scale on which it is conducted with the fund-raising.[21]

(2) *Condition 2*:

— A management and general activity that is similar to the management and general component of the joint activity being accounted for is conducted without the fund-raising component using the same medium and on a scale that is similar to or greater than the scale on which it is conducted with the fund-raising.

If the purpose criterion is met based on the factor in paragraph 13.45*b*, the factor in paragraph 13.45*c* should not be considered.

c. *Other evidence*. If the factors in paragraph 13.45*a* or paragraph 13.45*b* do not determine whether the purpose criterion is met, other evidence may determine whether the criterion is met. All available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, the purpose criterion is met.

**13.46** The following are examples of indicators that provide evidence for determining whether the purpose criterion is met:

---

[19] Some compensation contracts provide that compensation for performing the activity is based on a factor other than contributions raised, but not to exceed a specified portion of contributions raised. For example, a contract may provide that compensation for performing the activity is $10 per contact hour, but not to exceed 60 percent of contributions raised. In such circumstances, compensation is not considered based on amounts raised, unless the stated maximum percentage is met. In circumstances in which it is not yet known whether the stated maximum percentage is met, compensation is not considered based on amounts raised, unless it is probable that the stated maximum percentage will be met.

[20] The *compensation or fees test* is a negative test in that it either (*a*) results in failing the purpose criterion or (*b*) is not determinative of whether the purpose criterion is met. Therefore, if the activity fails the purpose criterion based on this factor (the compensation or fees test), the activity fails the purpose criterion and the factor in paragraph 13.45*b* should not be considered. If the purpose criterion is not failed based on this factor, this factor is not determinative of whether the purpose criterion is met and the factor in paragraph 13.45*b* should be considered.

[21] Determining the scale on which an activity is conducted may be a subjective determination. Factors to consider in determining the scale on which an activity is conducted may include dollars spent, the size of the audience reached, and the degree to which the characteristics of the audience are similar to the characteristics of the audience of the activity being evaluated.

*a*. Evidence that the purpose criterion may be met includes the following:

- *Measuring program results and accomplishments of the activity*. The facts may indicate that the purpose criterion is met if the organization measures program results and accomplishments of the activity (other than measuring the extent to which the public was educated about causes).
- *Medium*. The facts may indicate that the purpose criterion is met if the program component of the joint activity calls for specific action by the recipient that will help accomplish the organization's mission and if the organization conducts the program component without a significant fund-raising component in a different medium. Also, the facts may indicate that the purpose criterion is met if the organization conducts the management and general component of the joint activity without a significant fund-raising component in a different medium.

*b*. Evidence that the purpose criterion may not be met includes the following:

- *Evaluation or compensation*. The facts may indicate that the purpose criterion is not met if (*a*) the evaluation of any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity or (*b*) some, but less than a majority, of compensation or fees for any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity.

*c*. Evidence that the purpose criterion may be either met or not met includes the following:

- *Evaluation of measured results of the activity*. The organization may have a process to evaluate measured program results and accomplishments of the activity (other than measuring the extent to which the public was educated about causes). If the organization has such a process, in evaluating the effectiveness of the joint activity, the organization may place significantly greater weight on the activity's effectiveness in accomplishing program goals or may place significantly greater weight on the activity's effectiveness in raising contributions. The former may indicate that the purpose criterion is met. The latter may indicate that the purpose criterion is not met.
- *Qualifications*. The qualifications and duties of those performing the joint activity should be considered.
  - — If a third party, such as a consultant or contractor, performs part or all of the joint activity, such as producing brochures or making telephone calls, the third party's experience and the range of services provided to the organization should be considered in determining whether the third party is

performing fund-raising, program (other than educating the public about causes), or management and general activities on behalf of the organization.

 - If the organization's employees perform part or all of the joint activity, the full range of their job duties should be considered in determining whether those employees are performing fund-raising, program (other than educating the public about causes), or management and general activities on behalf of the organization. For example, (*a*) employees who are not members of the fund-raising department and (*b*) employees who are members of the fund-raising department but who perform non-fund-raising activities are more likely to perform activities that include program or management and general functions than are employees who otherwise devote significant time to fund-raising.

- *Tangible evidence of intent.* Tangible evidence indicating the intended purpose of the joint activity should be considered. Examples of such tangible evidence include the following:

 - The organization's written mission statement, as stated in its fund-raising activities, bylaws, or annual report
 - Minutes of board of directors', committees', or other meetings
 - Restrictions imposed by donors (who are not related parties) on gifts intended to fund the joint activity
 - Long-range plans or operating policies
 - Written instructions to other entities, such as script writers, consultants, or list brokers, concerning the purpose of the joint activity, audience to be targeted, or method of conducting the joint activity
 - Internal management memoranda

### Audience

**13.47** A rebuttable presumption exists that the audience criterion is not met if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute to the organization. That presumption can be overcome if the audience is also selected for one or more of the reasons in paragraph 13.48*a*, 13.48*b*, or 13.48*c*. In determining whether that presumption is overcome, organizations should consider the extent to which the audience is selected based on its ability or likelihood to contribute to the organization and

contrast that with the extent to which it is selected for one or more of the reasons in paragraph 13.48*a*, 13.48*b*, or 13.48*c*. For example, if the audience's ability or likelihood to contribute is a significant factor in its selection and it has a need for the action related to the program component of the joint activity, but having that need is an insignificant factor in its selection, the presumption would not be overcome.

**13.48** In circumstances in which the audience includes no prior donors and is not otherwise selected based on its ability or likelihood to contribute to the organization, the audience criterion is met if the audience is selected for one or more of the following reasons:

*a.* The audience's need to use or reasonable potential for use of the specific action called for by the program component of the joint activity

*b.* The audience's ability to take specific action to assist the organization in meeting the goals of the program component of the joint activity

*c.* The organization is required to direct the management and general component of the joint activity to the particular audience or the audience has reasonable potential for use of the management and general component

### Content

**13.49** The content criterion is met if the joint activity supports program or management and general functions, as follows:

*a.* *Program.* The joint activity calls for specific action by the recipient that will help accomplish the organization's mission. If the need for and benefits of the action are not clearly evident, information describing the action and explaining the need for and benefits of the action is provided.

*b.* *Management and general.* The joint activity fulfills one or more of the organization's management and general responsibilities through a component of the joint activity.[22]

**13.50** Information identifying and describing the organization, causes, or how the contributions provided will be used is considered in support of fund-raising.

## Allocation Methods

**13.51** The cost allocation methodology used should be rational and systematic, it should result in an allocation of joint costs that is reasonable, and it should be applied consistently given similar facts and circumstances. Appendix C [paragraph 13.64] of this chapter provides explanations and illustrations of some acceptable methods for allocating costs of joint activities.

---

[22] Some states or other regulatory bodies require that certain disclosures be included when soliciting contributions. For purposes of applying guidance in paragraphs 13.41–.54, communications that include such required disclosures are considered fund-raising activities and are not considered management and general activities.

### *Incidental Activities*

**13.52** Some fund-raising activities conducted in conjunction with program or management and general activities are incidental to such program or management and general activities. For example, an organization may conduct a fund-raising activity by including a generic message, "Contributions to Organization X may be sent to [*address*]" on a small area of a message that would otherwise be considered a program or management and general activity based on its purpose, audience, and content. That fund-raising activity likely would be considered incidental to the program or management and general activity being conducted. Similarly, organizations may conduct program or management and general activities in conjunction with fund-raising activities that are incidental to such fund-raising activities. For example, an organization may conduct a program activity by including a generic program message such as "Continue to pray for [*a particular cause*]" on a small area of a message that would otherwise be considered fund-raising based on its purpose, audience, and content. That program activity would likely be considered incidental to the fund-raising activity being conducted. Similarly, an organization may conduct a management and general activity by including a brief management and general message—"We recently changed our phone number. Our new number is 123-4567"—on a small area of a message that would otherwise be considered a program or fund-raising activity based on its purpose, audience, and content. That management and general activity would likely be considered incidental to the program or fund-raising activity being conducted. In circumstances in which a fund-raising, program, or management and general activity is conducted in conjunction with another activity and is incidental to that other activity, and the conditions for allocation are met, joint costs are permitted but not required to be allocated and may therefore be charged to the functional classification related to the activity that is not the incidental activity. However, in circumstances in which the program or management and general activities are incidental to the fund-raising activities, it is unlikely that the conditions required to permit allocation of joint costs would be met.

### *Disclosures*

**13.53** Organizations that allocate joint costs should disclose the following in the notes to their financial statements:

*a.* The types of activities for which joint costs have been incurred

*b.* A statement that such costs have been allocated

*c.* The total amount allocated during the period and the portion allocated to each functional expense category

**13.54** Organizations are encouraged, but not required, to disclose the amount of joint costs for each kind of joint activity, if practical.

**13.55** Appendix A [paragraph 13.62] of this chapter includes a flowchart useful in accounting for joint activities. Appendix B [paragraph 13.63] of this chapter illustrates the application of the purpose, audience, and content criteria to determine whether a program or management and general activity has been conducted along with the fund-raising activity. Appendix C [paragraph 13.64] of this chapter illustrates allocation methods. Appendix D [paragraph 13.65] of

this chapter illustrates disclosures required when joint activities are conducted. Appendix E [paragraph 13.66] of this chapter discusses further the guidance in paragraphs 13.41–.54.

### *Support to Affiliated Organizations*

**13.56** Some organizations make payments or provide other support to local or national affiliates. The specific purposes and benefits of those payments may be determinable (for example, permission to raise funds in a specified geographical area, or the provision of joint purchasing arrangements and technical and fund-raising assistance, functions that the organization would otherwise have to carry out itself), or the purposes and benefits may be indeterminable. Payments in the form of grants and dues may also be made to affiliates.

**13.57** Payments to affiliated organizations should be reported by their functional classification to the extent that it is practicable and reasonable to do so and the necessary information is available, even if it is impossible to allocate the entire amount of such payments to functions. Payments to affiliates that cannot be allocated to functions should be treated as a separate supporting service, reported on a statement of activities as a separate line item, and labeled "unallocated payments to affiliated organizations."

## Expenses of Federated Fund-Raising Organizations

**13.58** Federated fund-raising organizations solicit and receive designated and undesignated contributions and make grants and awards to other organizations. The fund-raising activities of these organizations, including activities related to fund-raising on behalf of others, should be reported as fund-raising expenses.

# Income Taxes

**13.59** If a not-for-profit organization incurs income tax expense, the notes to the financial statements should disclose the amount of the taxes and describe the nature of the activities that generated the taxes.

# Auditing

**13.60** Many audit objectives, controls, and auditing procedures for expenses, gains, and losses of not-for-profit organizations are similar to those of other organizations. In addition, the auditor may need to consider the following specific audit objectives, selected controls, and auditing procedures that are unique to not-for-profit organizations.

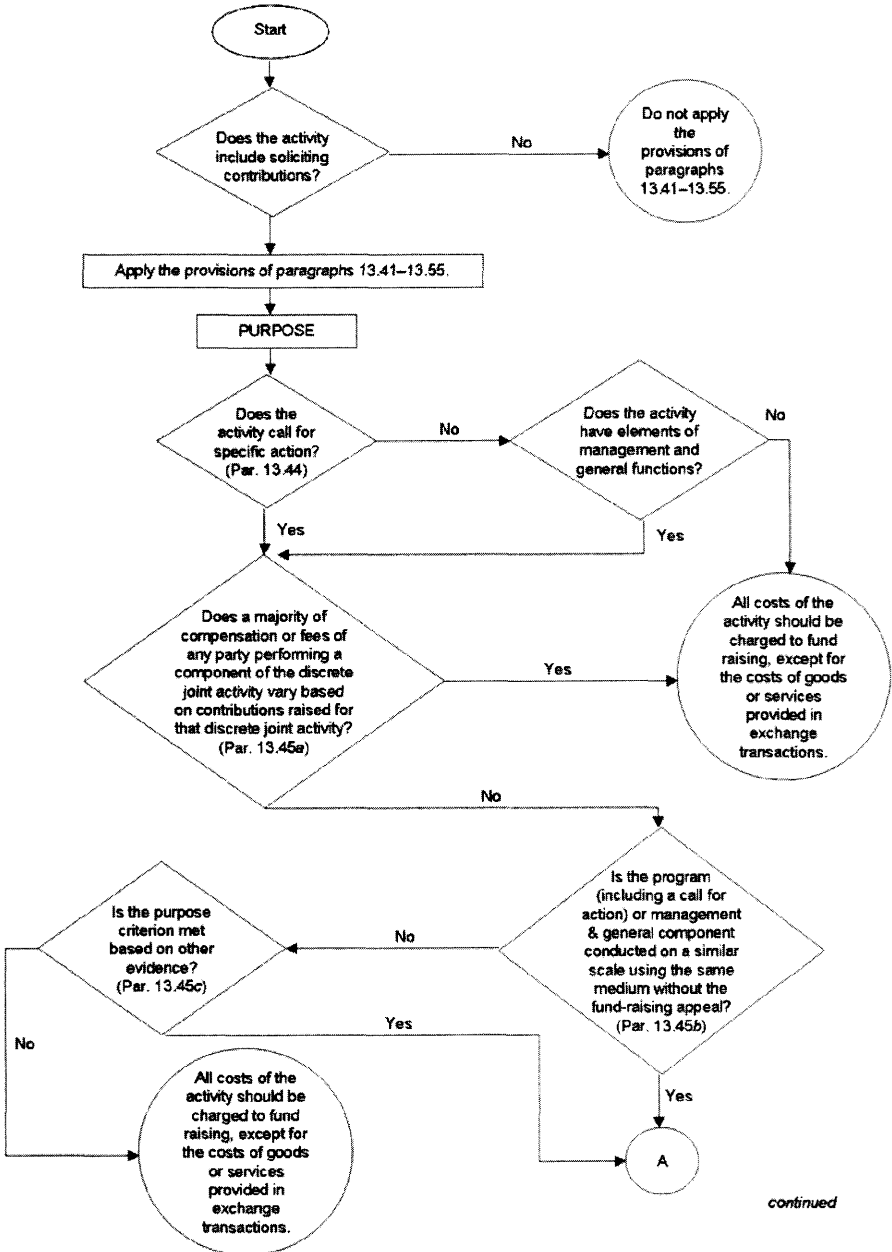
**13.61** The following table illustrates the use of assertions in developing audit objectives and designing substantive tests. The examples are not intended to be all-inclusive nor is it expected that all the procedures would necessarily be applied in an audit. The auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure to obtain sufficient appropriate audit evidence. The use of assertions in assessing risks and designing appropriate audit procedures to obtain audit evidence is described in paragraphs .14–.26 of AU section 326, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1). Various audit procedures and the purposes for which they may be performed are described in paragraphs .27–.41 of AU section 326.

**Auditing Considerations**

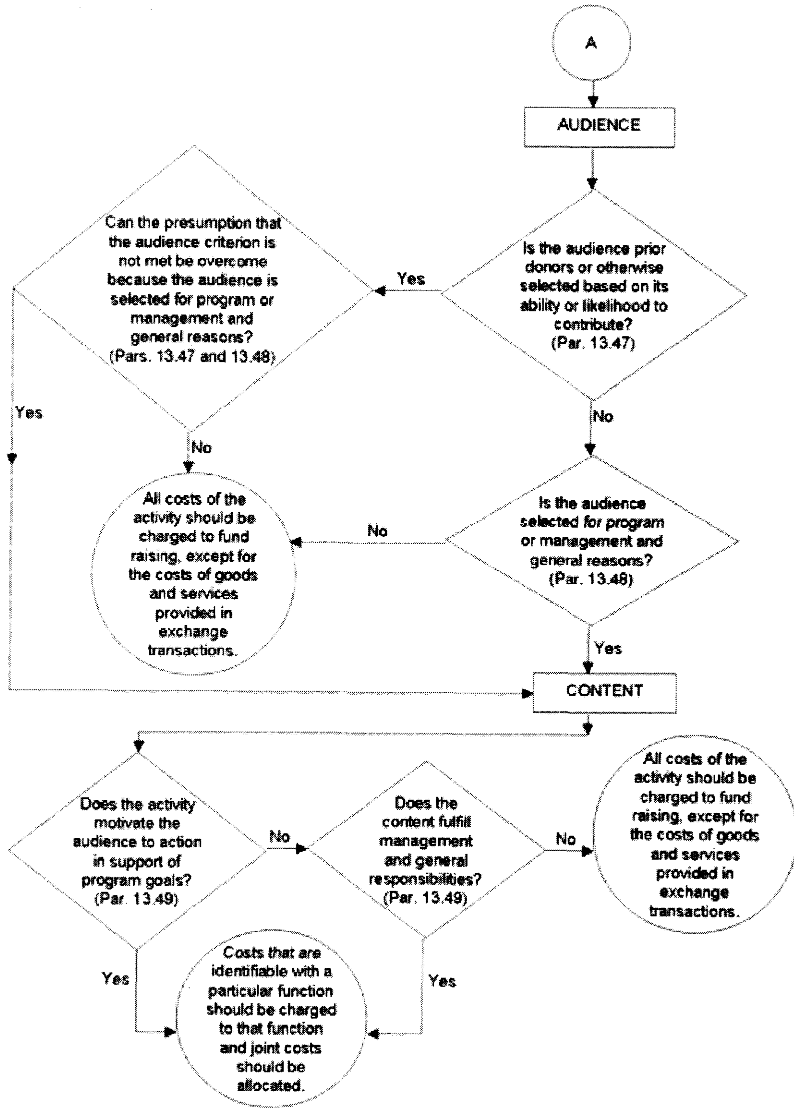
| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| *Presentation and Disclosure* | | | |
| Classification | Expenses are properly classified and displayed. | Controls ensure that expenses are properly classified and displayed. | Compare current period expenses in total and by functional classification with expectations based on prior-period expenses or budget, or both, and obtain explanations for variances from expectations.<br><br>Determine that expenses have been properly assigned and allocated to functional and, if applicable, natural classifications. |

13.62

# Appendix A—Accounting for Joint Activities[1]




[1] *Note*: This flowchart summarizes certain guidance in paragraphs 13.41–.54 and is not intended as a substitute for that guidance.


A
AUDIENCE
Is the audience prior donors or otherwise selected based on its ability or likelihood to contribute? (Par. 13.47)
Yes
Can the presumption that the audience criterion is not met be overcome because the audience is selected for program or management and general reasons? (Pars. 13.47 and 13.48)
Yes
No
All costs of the activity should be charged to fund raising, except for the costs of goods and services provided in exchange transactions.
No
Is the audience selected for program or management and general reasons? (Par. 13.48)
No
Yes
CONTENT
Does the activity motivate the audience to action in support of program goals? (Par. 13.49)
No
Does the content fulfill management and general responsibilities? (Par. 13.49)
No
All costs of the activity should be charged to fund raising, except for the costs of goods and services provided in exchange transactions.
Yes
Costs that are identifiable with a particular function should be charged to that function and joint costs should be allocated.
Yes

**13.63**

# Appendix B—Illustrations of Applying the Criteria of Purpose, Audience, and Content to Determine Whether a Program or Management and General Activity Has Been Conducted

## Illustration 1

*Facts*

**1.** Organization A's mission is to prevent drug abuse. Organization A's annual report states that one of its objectives in fulfilling that mission is to assist parents in preventing their children from abusing drugs.

**2.** Organization A mails informational materials to the parents of all junior high school students explaining the prevalence and dangers of drug abuse. The materials encourage parents to counsel children about the dangers of drug abuse and inform them about how to detect drug abuse. The mailing includes a request for contributions. Organization A conducts other activities informing the public about the dangers of drug abuse and encouraging parents to counsel their children about drug abuse that do not include requests for contributions and that are conducted in different media. Organization A's executive director is involved in the development of the informational materials as well as the request for contributions. The executive director's annual compensation includes a significant bonus if total annual contributions exceed a predetermined amount.

*Conclusion*

**3.** The purpose, audience, and content criteria are met, and the joint costs should be allocated.

**4.** The activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse and informing them about how to detect drug abuse) that will help accomplish the organization's mission. Therefore, the guidance in paragraph 13.45 should be considered. Neither of the factors in paragraph 13.45*a* or 13.45*b* is determinative of whether the purpose criterion is met. (Although Organization A's executive director's annual compensation varies based on annual contributions, the executive director's compensation does not vary based on contributions raised for this discrete joint activity.) Therefore, other evidence, such as the indicators in paragraph 13.46, should be considered. The purpose criterion is met based on the other evidence, because (*a*) the program component of this activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse) that will help accomplish the organization's mission, and it otherwise conducts the program activity in this illustration without a request for contributions, and (*b*) performing such programs helps accomplish Organization A's mission. (Note that had Organization A conducted the activity using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions, the purpose criterion would have been met under paragraph 13.45*b*.)

**5.** The audience criterion is met because the audience (parents of junior high school students) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

**6.** The content criterion is met because the activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse and informing them about how to detect drug abuse) that will help accomplish the organization's mission (assisting parents in preventing their children from abusing drugs), and it explains the need for and benefits of the action (the prevalence and dangers of drug abuse).

## Illustration 2

### *Facts*

**7.** Organization B's mission is to reduce the incidence of illness from ABC disease, which afflicts a broad segment of the population. One of Organization B's objectives in fulfilling that mission is to inform the public about the effects and early warning signs of the disease and specific action that should be taken to prevent the disease.

**8.** Organization B maintains a list of its prior donors and sends them donor renewal mailings. The mailings include messages about the effects and early warning signs of the disease and specific action that should be taken to prevent it. That information is also sent to a similar-sized audience but without the request for contributions. Also, Organization B believes that recent donors are more likely to contribute than nondonors or donors who have not contributed recently. Prior donors are deleted from the mailing list if they have not contributed to Organization B recently, and new donors are added to the list. There is no evidence of a correlation between recent contributions and participation in the program component of the activity. Also, the prior donors' need to use or reasonable potential for use of the messages about the effects and early warning signs of the disease and specific action that should be taken to prevent it is an insignificant factor in their selection.

### *Conclusion*

**9.** The purpose and content criteria are met. The audience criterion is not met.[1] All costs, including those that might otherwise be considered program or management and general costs if they had been incurred in a different activity, should be charged to fund-raising.

**10.** The activity calls for specific action by the recipient (action that should be taken to prevent ABC disease) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 13.46 should be considered. The purpose criterion is met because (*a*) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission (to reduce the incidence of illness from the disease), and (*b*) the program is

---

[1] Paragraph 13.42 of this guide provides that all costs of joint activities, except for costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should be charged to fund-raising if any of the criteria of purpose, audience, or content are not met. Accordingly, if one or more criteria are not met, the other criteria need not be considered. However, the illustrations in this appendix provide conclusions about whether each of the criteria would be met in circumstances in which one or more criteria are not met in order to provide further guidance.

also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (a similar mailing is done without the request for contributions, to a similar-sized audience).

**11.** The audience criterion is not met. The rebuttable presumption that the audience criterion is not met because the audience includes prior donors is not overcome in this illustration. Although the audience has a need to use or reasonable potential for use of the program component, that was an insignificant factor in its selection.

**12.** The content criterion is met because the activity calls for specific action by the recipient (actions to prevent ABC disease) that will help accomplish the entity's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

## Illustration 3

*Facts*

**13.** Organization C's mission is to reduce the incidence of illness from ABC disease, which afflicts a broad segment of the population. One of Organization C's objectives in fulfilling that mission is to increase governmental funding for research about ABC disease.

**14.** Organization C maintains a list of its prior donors and its employees call them on the telephone reminding them of the effects of ABC disease, asking for contributions, and encouraging them to contact their elected officials to urge increased governmental funding for research about ABC disease. The callers are educated about ABC, do not otherwise perform fund-raising functions, and are not compensated or evaluated based on contributions raised. Organization C's research indicates that recent donors are likely to contact their elected officials about such funding while nonrecent donors are not. Prior donors are deleted from the calling list if they have not contributed to Organization C recently, and new donors are added to the list.

*Conclusion*

**15.** The purpose, audience, and content criteria are met, and the joint costs should be allocated.

**16.** The activity calls for specific action by the recipient (contacting elected officials concerning funding for research about ABC disease) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 13.45 should be considered. Neither of the factors in paragraph 13.45*a* or 13.45*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 13.46, should be considered. The purpose criterion is met based on the other evidence, because (*a*) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the callers are educated about ABC and do not otherwise perform fund-raising functions), (*b*) the method of compensation for performing the activity does not indicate that it is a fund-raising activity (the employees are not compensated or evaluated based on contributions raised), and (*c*) performing such programs helps accomplish Organization C's mission.

**17.** The audience criterion is met because the audience (recent donors) is selected based on its ability to assist Organization C in meeting the goals of

the program component of the activity (recent donors are likely to contact their elected officials about such funding while nonrecent donors are not).

**18.** The content criterion is met because the activity calls for specific action by the recipient (contacting elected officials concerning funding for research about ABC disease) that will help accomplish the entity's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

## Illustration 4

### *Facts*

**19.** Organization D's mission is to improve the quality of life for senior citizens. One of Organization D's objectives included in that mission is to increase the physical activity of senior citizens. One of Organization D's programs to attain that objective is to send representatives to speak to groups about the importance of exercise and to conduct exercise classes.

**20.** Organization D mails a brochure on the importance of exercise that encourages exercise in later years to residents over the age of 65 in three zip code areas. The last two pages of the four-page brochure include a perforated contribution remittance form on which Organization D explains its program and makes an appeal for contributions. The content of the first two pages of the brochure is primarily educational; it explains how seniors can undertake a self-supervised exercise program and encourages them to undertake such a program. In addition, Organization D includes a second brochure on various exercise techniques that can be used by those undertaking an exercise program.

**21.** The brochures are distributed to educate people in this age group about the importance of exercising, to help them exercise properly, and to raise contributions for Organization D. These objectives are documented in a letter to the public relations firm that developed the brochures. The audience is selected based on age, without regard to ability to contribute. Organization D believes that most of the recipients would benefit from the information about exercise.

### *Conclusion*

**22.** The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that the costs of the second brochure should be charged to program because all the costs of the brochure are identifiable with the program function.)

**23.** The activity calls for specific action by the recipient (exercising) that will help accomplish the organization's mission. Therefore, the guidance in paragraph 13.45 should be considered. Neither of the factors in paragraph 13.45*a* or 13.45*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 13.46, should be considered. The purpose criterion is met based on the other evidence, because (*a*) performing such programs helps accomplish Organization D's mission, and (*b*) the objectives of the program are documented in a letter to the public relations firm that developed the brochure.

**24.** The audience criterion is met because the audience (residents over 65 in certain zip codes) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

**25.** The content criterion is met because the activity calls for specific action by the recipient (exercising) that will help accomplish the organization's mission

(increasing the physical activity of senior citizens), and the need for and benefits of the action are clearly evident (explains the importance of exercising).

### Illustration 5

*Facts*

**26.** The facts are the same as those in Illustration 4, except that Organization E employs a fund-raising consultant to develop the first brochure and pays that consultant 30 percent of contributions raised.

*Conclusion*

**27.** The content and audience criteria are met. The purpose criterion is not met, however, because a majority of compensation or fees for the fund-raising consultant varies based on contributions raised for this discrete joint activity (the fund-raising consultant is paid 30 percent of contributions raised). All costs should be charged to fund-raising, including the costs of the second brochure and any other costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity.

### Illustration 6

*Facts*

**28.** Organization F's mission is to protect the environment. One of Organization F's objectives included in that mission is to take action that will increase the portion of waste recycled by the public.

**29.** Organization F conducts a door-to-door canvass of a community that recycles a low portion of its waste. The purpose of the activity is to help increase recycling by educating the community about environmental problems created by not recycling, and to raise contributions. Based on the information communicated by the canvassers, the need for and benefits of the action are clearly evident. The ability or likelihood of the residents to contribute is not a basis for communities selected, and all neighborhoods in the geographic area are covered if their recycling falls below a predetermined rate. The canvassers are selected from individuals who are well-informed about the organization's environmental concerns and programs and who previously participated as volunteers in program activities such as answering environmental questions directed to the organization and developing program activities designed to influence legislators to take actions addressing those concerns. The canvassers have not previously participated in fund-raising activities.

*Conclusion*

**30.** The purpose, audience, and content criteria are met, and the joint costs should be allocated.

**31.** The activity calls for specific action by the recipient (implicitly—to help increase recycling) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 13.45 should be considered. Neither of the factors in paragraph 13.45*a* or 13.45*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 13.46, should be considered. The purpose criterion is met based on the other evidence, because (*a*) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the canvassers are selected from

individuals who are well-informed about the organization's environmental concerns and programs and who previously participated as volunteers in program activities such as answering environmental questions directed to the organization and developing program activities designed to influence legislators to take actions addressing those concerns), and (*b*) performing such programs helps accomplish Organization F's mission (to protect the environment).

**32.** The audience criterion is met because the audience (neighborhoods whose recycling falls below a predetermined rate) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

**33.** The content criterion is met because the activity calls for specific action by the recipient (implicitly—to help increase recycling) that will help accomplish the organization's mission (to protect the environment), and the need for and benefits of the action are clearly evident (increased recycling will help alleviate environmental problems).

## Illustration 7

### *Facts*

**34.** Organization G's mission is to provide summer camps for economically disadvantaged youths. Educating the families of ineligible youths about the camps is not one of the program objectives included in that mission.

**35.** Organization G conducts a door-to-door solicitation campaign for its camp programs. In the campaign, volunteers with canisters visit homes in middle-class neighborhoods to collect contributions. Organization G believes that people in those neighborhoods would not need the camp's programs but may contribute. The volunteers explain the camp's programs, including why the disadvantaged children benefit from the program, and distribute leaflets to the residents regardless of whether they contribute to the camp. The leaflets describe the camp, its activities, who can attend, and the benefits to attendees. Requests for contributions are not included in the leaflets.

### *Conclusion*

**36.** The purpose, audience, and content criteria are not met. All costs should be charged to fund-raising.

**37.** The activity does not include a call for specific action because it only educates the audience about causes (describing the camp, its activities, who can attend, and the benefits to attendees). Therefore, the purpose criterion is not met.

**38.** The audience criterion is not met, because the audience is selected based on its ability or likelihood to contribute, rather than based on (*a*) its need to use or reasonable potential for use of the action called for by the program component, or (*b*) its ability to take action to assist the organization in meeting the goals of the program component of the activity. (Organization G believes that people in those neighborhoods would not need the camp's programs but may contribute.)

**39.** The content criterion is not met because the activity does not call for specific action by the recipient. (The content educates the audience about causes that the program is designed to address without calling for specific action.)

## Illustration 8

*Facts*

**40.** Organization H's mission is to educate the public about lifesaving techniques in order to increase the number of lives saved. One of Organization H's objectives in fulfilling that mission, as stated in the minutes of the board's meetings, is to produce and show television broadcasts including information about lifesaving techniques.

**41.** Organization H conducts an annual national telethon to raise contributions and to reach the American public with lifesaving educational messages, such as summary instructions concerning dealing with certain life-threatening situations. Based on the information communicated by the messages, the need for and benefits of the action are clearly evident. The broadcast includes segments describing Organization H's services. Organization H broadcasts the telethon to the entire country, not merely to areas selected on the basis of giving potential or prior fund-raising results. Also, Organization H uses national television broadcasts devoted entirely to lifesaving educational messages to conduct program activities without fund-raising.

*Conclusion*

**42.** The purpose, audience, and content criteria are met, and the joint costs should be allocated.

**43.** The activity calls for specific action by the recipient (implicitly—to save lives) that will help accomplish the organization's mission. Therefore, the guidance in paragraph 13.45 should be considered. The purpose criterion is met because (*a*) the program component of the activity calls for specific action by the recipient that will help accomplish Organization H's mission (to save lives by educating the public), and (*b*) a similar program activity is conducted without the fund-raising using the same medium and on a scale that is similar to or greater than the scale on which it is conducted with the appeal (Organization H uses national television broadcasts devoted entirely to lifesaving educational messages to conduct program activities without fund-raising).

**44.** The audience criterion is met because the audience (a broad segment of the population) is selected based on its need to use or reasonable potential for use of the action called for by the program activity.

**45.** The content criterion is met because the activity calls for specific action by the recipient (implicitly—to save lives) that will help accomplish the organization's mission (to save lives by educating the public), and the need for and benefits of the action are clearly evident (saving lives is desirable).

## Illustration 9

*Facts*

**46.** Organization I's mission is to provide food, clothing, and medical care to children in developing countries.

**47.** Organization I conducts television broadcasts in the United States that describe its programs, show the needy children, and end with appeals for contributions. Organization I's operating policies and internal management memoranda state that these programs are designed to educate the public about the needs of children in developing countries and to raise contributions. The

employees producing the programs are trained in audiovisual production and are familiar with Organization I's programs. Also, the executive producer is paid $25,000 for this activity, with a $5,000 bonus if the activity raises over $1,000,000.

*Conclusion*

**48.** The purpose, audience, and content criteria are not met. All costs should be charged to fund-raising.

**49.** The activity does not include a call for specific action because it only educates the audience about causes (describing its programs and showing the needy children). Therefore, the purpose criterion is not met. (Also, note that if the factor in paragraph 13.45*a* were considered, it would not be determinative of whether the purpose criterion is met. Although the executive producer will be paid $5,000 if the activity raises over $1,000,000, that amount would not be a majority of the executive producer's total compensation for this activity, because $5,000 would not be a majority of the executive producer's total compensation of $30,000 for this activity. Also, note that if other evidence, such as the indicators in paragraph 13.46, were considered, the purpose criterion would not be met based on the other evidence. Although the qualifications and duties of the personnel performing the activity indicate that the employees producing the program are familiar with Organization I's programs, the facts that some, but less than a majority, of the executive producer's compensation varies based on contributions raised, and that the operating policies and internal management memoranda state that these programs are designed to educate the public about the needs of children in developing countries [with no call for specific action by recipients] and to raise contributions, indicate that the purpose is fund-raising.)

**50.** The audience criterion is not met because the audience is selected based on its ability or likelihood to contribute, rather than based on (*a*) its need to use or reasonable potential for use of the action called for by the program component, or (*b*) its ability to take action to assist the organization in meeting the goals of the program component of the activity. (The audience is a broad segment of the population of a country that is not in need of or has no reasonable potential for use of the program activity.)

**51.** The content criterion is not met because the activity does not call for specific action by the recipient that will help accomplish the organization's mission. (The content educates the audience about the causes without calling for specific action.)

## Illustration 10

*Facts*

**52.** Organization J is a university that distributes its annual report, which includes reports on mission accomplishments, to those who have made significant contributions over the previous year, its board of trustees, and its employees. The annual report is primarily prepared by management and general personnel, such as the accounting department and executive staff. The activity is coordinated by the public relations department. Internal management memoranda indicate that the purpose of the annual report is to report on how management discharged its stewardship responsibilities, including the university's overall performance, goals, financial position, cash flows, and results of

operations. Included in the package containing the annual report are requests for contributions and donor reply cards.

*Conclusion*

**53.** The purpose, audience, and content criteria are met, and the joint costs should be allocated.

**54.** The activity has elements of management and general functions. Therefore, no call for specific action is required. Neither of the factors in paragraph 13.45*a* or 13.45*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 13.46, should be considered. The purpose criterion is met based on the other evidence, because (*a*) the employees performing the activity are not members of the fund-raising department and perform other non-fund-raising activities and (*b*) internal management memoranda indicate that the purpose of the annual report is to fulfill one of the university's management and general responsibilities.

**55.** The audience criterion is met because the audience is selected based on its reasonable potential for use of the management and general component. Although the activity is directed primarily at those who have previously made significant contributions, the audience was selected based on its presumed interest in Organization J's annual report (prior donors who have made significant contributions are likely to have an interest in matters discussed in the annual report).

**56.** The content criterion is met because the activity (distributing annual reports) fulfills one of the entity's management and general responsibilities (reporting concerning management's fulfillment of its stewardship function).

## Illustration 11

*Facts*

**57.** Organization K is a not-for-profit organizations (NPO). In accordance with internal management memoranda documenting its policies requiring it to comply with Internal Revenue Service (IRS) regulations, it mails prior donors who have made *quid pro quo* payments in excess of $75 documentation required by the IRS. The documentation is included on a perforated piece of paper. The information above the perforation line pertains to the documentation required by the IRS. The information below the perforation line includes a request for contributions and may be used as a donor reply card.

*Conclusion*

**58.** The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that the costs of the information below the perforation line are identifiable with fund-raising and therefore should be charged to fund-raising.)

**59.** The activity has elements of management and general functions. Therefore, no call for specific action is required. Neither of the factors in paragraph 13.45*a* or 13.45*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 13.46, should be considered. The purpose criterion is met based on the other evidence, because internal management memoranda indicate that the purpose of the activity is to fulfill one of Organization K's management and general responsibilities.

**60.** The audience criterion is met because the organization is required to direct the management and general component of the activity to the particular audience. Although the activity is directed at those who have previously contributed, the audience was selected based on its need for the documentation.

**61.** The content criterion is met because the activity (sending documentation required by the IRS) fulfills one of the entity's management and general responsibilities (complying with IRS regulations).

## Illustration 12

*Facts*

**62.** Organization L is an animal rights organization. It mails a package of material to individuals included in lists rented from various environmental and other organizations that support causes that Organization L believes are congruent with its own. In addition to donor response cards and return envelopes, the package includes (*a*) materials urging recipients to contact their legislators and urge the legislators to support legislation to protect those rights, and (*b*) postcards addressed to legislators urging support for legislation restricting the use of animal testing for cosmetic products. The mail campaign is part of an overall strategy that includes magazine advertisements and the distribution of similar materials at various community events, some of which are undertaken without fund-raising appeals. The advertising and community events reach audiences similar in size and demographics to the audience reached by the mailing.

*Conclusion*

**63.** The purpose, audience, and content criteria are met, and the joint costs should be allocated.

**64.** The activity calls for specific action by the recipient (mailing postcards to legislators urging support for legislation restricting the use of animal testing for cosmetic products) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 13.45 should be considered. Neither of the factors in paragraph 13.45*a* or 13.45*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 13.46, should be considered. The purpose criterion is met based on the other evidence, because (*a*) the program component of this activity calls for specific action by the recipient that will help accomplish the organization's mission, and it otherwise conducts the program activity in this illustration without a request for contributions, and (*b*) performing such programs helps accomplish Organization L's mission.

**65.** The audience criterion is met because the audience (individuals included in lists rented from various environmental and other organizations that support causes that Organization L believes are congruent with its own) is selected based on its ability to take action to assist the organization in meeting the goals of the program component of the activity.

**66.** The content criterion is met because the activity calls for specific action by the recipient (mailing postcards to legislators urging support for legislation restricting the use of animal testing for cosmetic products) that will help accomplish the organization's mission (to protect animal rights), and the need for and benefits of the action are clearly evident (to protect animal rights).

## Illustration 13

*Facts*

**67.** Organization M is a performing arts organization whose mission is to make the arts available to residents in its area. Organization M charges a fee for attending performances and sends advertisements, including subscription forms, for the performances to residents in its area. These advertisements include a return envelope with a request for contributions. Organization M evaluates the effectiveness of the advertising based on the number of subscriptions sold as well as contributions received. In performing that evaluation, Organization M places more weight on the number of subscriptions sold than on the contributions received. Also, Organization M advertises the performances on local television and radio without a request for contributions but on a smaller scale than the mail advertising.

*Conclusion*

**68.** The purpose, audience, and content criteria are met, and the joint costs should be allocated.

**69.** The activity calls for specific action by the recipient (attending the performances) that will help accomplish the organization's mission. Therefore, the guidance in paragraph 13.45 should be considered. Neither of the factors in paragraph 13.45*a* or 13.45*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 13.46, should be considered. The purpose criterion is met based on the other evidence, because (*a*) the organization measures program results and accomplishments of the joint activity and in evaluating the effectiveness of the activity, the organization places significantly greater weight on the activity's effectiveness in accomplishing program goals than on the activity's effectiveness in raising contributions (Organization M evaluates the effectiveness of the advertising based on the number of subscriptions sold as well as contributions received and places more weight on the number of subscriptions sold than on the contributions received), (*b*) it otherwise conducts the program activity without a request for contributions, and (*c*) performing such programs helps accomplish Organization M's mission (to make the arts available to residents in its area).

**70.** The audience criterion is met because the audience (a broad segment of the population in Organization M's area) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

**71.** The content criterion is met because the activity calls for specific action by the recipient (attending the performances) that will help accomplish the organization's mission (making the arts available to area residents), and the need for and benefits of the action are clearly evident (attending the performance is a positive cultural experience). (Note that the purchase of subscriptions is an exchange transaction and, therefore, is not a contribution.)

## Illustration 14

*Facts*

**72.** Organization N is a university whose mission is to educate the public (students) in various academic pursuits. Organization N's political science department holds a special lecture series in which prominent world leaders speak

about current events. The speakers command relatively high fees and, in order to cover costs and make a modest profit, the university sets a relatively expensive fee to attend. However, the tickets are priced at the fair value of the lecture and no portion of the ticket purchase price is a contribution. Organization N advertises the lectures by sending invitations to prior attendees and to prior donors who have contributed significant amounts, and by placing advertisements in local newspapers read by the general public. At some of the lectures, including the lecture being considered in this illustration, deans and other faculty members of Organization N solicit significant contributions from attendees. Other lectures in the series are conducted on a scale similar to the scale of the lecture in this illustration without requesting contributions. Organization N's records indicate that historically 75 percent of the attendees have attended prior lectures. Of the 75 percent who have attended prior lectures, 15 percent have made prior contributions to Organization N. Of the 15 percent who have made prior contributions to Organization N, 5 percent have made contributions in response to solicitations made at the events. (Therefore, one-half of one percent of attendees make contributions in response to solicitations made at the events. However, those contributions are significant.) Overall, the audience's ability or likelihood to contribute is an insignificant factor in its selection. Organization N evaluates the effectiveness of the activity based on the number of tickets sold, as well as contributions received. In performing that evaluation, Organization N places more weight on the number of tickets sold than on the contributions received.

*Conclusion*

**73.** The purpose, audience, and content criteria are met, and the joint costs should be allocated.

**74.** The activity calls for specific action by the recipient (attending the lecture) that will help accomplish the organization's mission. Therefore, the guidance in paragraph 13.45 should be considered. The purpose criterion is met because (*a*) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and (*b*) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (other lectures in the series are conducted on a scale similar to the scale of the lecture in this illustration without requesting contributions).

**75.** The audience criterion is met. The rebuttable presumption that the audience criterion is not met because the audience includes prior donors is overcome in this illustration because the audience (those who have shown prior interest in the lecture series, prior donors, a broad segment of the population in Organization N's area, and those attending the lecture) is also selected for its reasonable potential for use of the program component (attending the lecture). Although the audience may make significant contributions, that was an insignificant factor in its selection.

**76.** The content criterion is met because the activity calls for specific action by the recipient (attending the lecture) that will help accomplish the organization's mission (educating the public [students] in various academic pursuits), and the need for and benefits of the action are clearly evident (attending the lecture is a positive educational experience). (Note that the purchase of the tickets is an exchange transaction and, therefore, is not a contribution. As discussed in paragraph 13.42 of this chapter, costs of goods or services provided in exchange

transactions that are part of joint activities, such as costs of direct donor benefits of a special event, should not be reported as fund-raising.[2])

## Illustration 15

### *Facts*

**77.** Organization O is a university whose mission is to educate the public (students) in various academic pursuits. Organization O's political science department holds a special lecture series in which prominent world leaders speak about current events. Admission is priced at $250, which is above the $50 fair value of the lecture and, therefore, $200 of the admission price is a contribution. Therefore, the audience's likelihood to contribute to the organization is a significant factor in its selection. Organization O advertises the lectures by sending invitations to prior attendees and to prior donors who have contributed significant amounts, and by placing advertisements in local newspapers read by the general public. Organization O presents similar lectures that are priced at the fair value of those lectures.

### *Conclusion*

**78.** The purpose and criterion are met. The audience criterion is not met. All costs, including those that might otherwise be considered program or management and general costs if they had been incurred in a different activity, except for the costs of the direct donor benefit (the lecture), should be charged to fund-raising.

**79.** The activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 13.45 should be considered. The purpose criterion is met because (*a*) the program component of the activity calls for specific action by the recipient that will help accomplish the organization's mission (educating the public [students] in various academic pursuits), and (*b*) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (other lectures in the series are conducted on a scale similar to the scale of the lecture in this illustration without including a contribution in the admission price.)

**80.** The audience criterion is not met. The rebuttable presumption that the audience criterion is not met because the audience is selected based on its likelihood to contribute to the organization is not overcome in this illustration. The fact that the $250 admission price includes a $200 contribution leads to the conclusion that the audience's ability or likelihood to contribute is an overwhelmingly significant factor in its selection, whereas there is no evidence that the extent to which the audience is selected for its need to use or reasonable potential for use of the action called for by the program component (attending the lecture) is overwhelmingly significant.

**81.** The content criterion is met because the activity calls for specific action by the recipient (attending the lecture) that will help accomplish the organization's mission (educating the public [students] in various academic pursuits), and the need for and benefits of the action are clearly evident (attending the lecture is a positive educational experience). (Note that the purchase of the tickets is an exchange transaction and, therefore, is not a contribution. As discussed in

---

[2] Paragraphs 13.21–.26 provide guidance concerning reporting special events.

paragraph 13.42 of this chapter, costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event, should not be reported as fund-raising.[3])

## Illustration 16

*Facts*

**82.** Organization P's mission is to reduce the incidence of illness from ABC disease, which primarily afflicts people over 65 years of age. One of Organization P's objectives in fulfilling that mission is to have all persons over 65 screened for ABC disease.

**83.** Organization P rents space at events attended primarily by people over 65 years of age and conducts free screening for ABC disease. Organization P's employees, who are educated about ABC disease and screening procedures and do not otherwise perform fund-raising functions, educate interested parties about the effects of ABC disease and the ease and benefits of screening for it. Organization P also solicits contributions at the events. The effectiveness of the activity is evaluated primarily based on how many screening tests are performed, and only minimally based on contributions raised. The employees are not compensated or evaluated based on contributions raised.

*Conclusion*

**84.** The purpose, audience, and content criteria are met, and the joint costs should be allocated.

**85.** The activity calls for specific action by the recipient (being screened for ABC disease) that will help accomplish the organization's mission. Therefore, the guidance in paragraph 13.45 should be considered. Neither of the factors in paragraph 13.45*a* or 13.45*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 13.46, should be considered. The purpose criterion is met based on the other evidence, because (*a*) a process exists to evaluate measured program results and accomplishments and in evaluating the effectiveness of the joint activity, the organization places significantly greater weight on the activity's effectiveness in accomplishing program goals than on the activity's effectiveness in raising contributions (Organization P evaluates the effectiveness of the activity based on the number of screening tests conducted as well as contributions received and places more weight on the number of tests conducted than on the contributions received); (*b*) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the employees are educated about ABC disease and the testing procedures and do not otherwise perform fund-raising functions); (*c*) the method of compensation for performing the activity does not indicate that it is a fund-raising activity (the employees are not compensated or evaluated based on contributions raised); and (*d*) performing such programs helps accomplish Organization P's mission (to prevent ABC disease).

**86.** The audience criterion is met because the audience (people over 65 years of age) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

---

[3] Paragraphs 13.21–.26 provide guidance concerning reporting special events.

**87.** The content criterion is met because the activity calls for specific action by the recipient (being screened for ABC disease) that will help accomplish the organization's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

### Illustration 17

*Facts*

**88.** Organization Q's mission is to provide cultural and educational television programming to residents in its area. Organization Q owns a public television station and holds a membership drive in which it solicits new members. The drive is conducted by station employees and consists of solicitations that are shown during long breaks between the station's regularly scheduled programs. Organization Q's internal management memoranda state that these drives are designed to raise contributions. Organization Q evaluates the effectiveness of the activity based on the amount of contributions received. Organization Q shows the programs on a similar scale, without the request for contributions. The audience is members of the general public who watch the programs shown during the drive. Station member benefits are given to those who contribute and consist of tokens of appreciation with a nominal value.

*Conclusion*

**89.** The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that there would be few, if any, joint costs. Costs associated with the fund-raising activities, such as costs of airtime, would be separately identifiable from costs of the program activities, such as licensing costs for a particular television program. Also, note that because no significant benefits or duties are associated with membership, member dues are contributions. Therefore, the substance of the membership-development activities is, in fact, fund-raising.)

**90.** The activity calls for specific action by the recipient (watching the television program) that will help accomplish the organization's mission. Therefore, the guidance in paragraph 13.45 should be considered. The purpose criterion is met because (*a*) the program component of the activity calls for specific action by the recipient that will help accomplish the organization's mission, and (*b*) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (Organization Q shows the television programs on a similar scale, without the request for contributions).

**91.** The audience criterion is met. The rebuttable presumption that the audience criterion is not met because the audience is selected based on its likelihood to contribute is overcome in this illustration because the audience (members of the general public who watch the television programs shown during the drive) is also selected for its reasonable potential for use of the program component (watching the television programs). Although the audience may make contributions, that was an insignificant factor in its selection.

**92.** The content criterion is met because the activity calls for specific action by the recipient (watching the television programs) that will help accomplish the organization's mission (providing cultural and educational television programming to residents in its area), and the need for and benefits of the action are clearly evident (watching the programs is a positive cultural and educational experience).

13.64

# Appendix C—Illustrations of Allocation Methods

**1.** Some commonly used cost allocation methods follow.

## Physical Units Method

**2.** Joint costs are allocated to materials and activities in proportion to the number of units of output that can be attributed to each of the materials and activities. Examples of units of output are lines, square inches, and physical content measures. This method assumes that the benefits received by the fund-raising, program, or management and general component of the materials or activity from the joint costs incurred are directly proportional to the lines, square inches, or other physical output measures attributed to each component of the activity. This method may result in an unreasonable allocation of joint costs if the units of output, for example, line counts, do not reflect the degree to which costs are incurred for the joint activity. Use of the physical units method may also result in an unreasonable allocation if the physical units cannot be clearly ascribed to fund-raising, program, or management and general. For example, direct mail and telephone solicitations sometimes include content that is not identifiable with fund-raising, program, or management and general; or the physical units of such content are inseparable.

*Illustration*

**3.** Assume a direct mail campaign is used to conduct programs of the organization and to solicit contributions to support the organization and its programs. Further, assume that the appeal meets the criteria for allocation of joint costs to more than one function.

**4.** The letter and reply card include a total of one hundred lines. Forty-five lines pertain to program because they include a call for action by the recipient that will help accomplish the organization's mission, while fifty-five lines pertain to the fund-raising appeal. Accordingly, 45 percent of the costs are allocated to program and 55 percent to fund-raising.

## Relative Direct Cost Method

**5.** Joint costs are allocated to each of the components on the basis of their respective direct costs. Direct costs are those costs that are incurred in connection with the multipurpose materials or activity and that are specifically identifiable with a function (program, fund-raising, or management and general). This method may result in an unreasonable allocation of joint costs if the joint costs of the materials and activity are not incurred in approximately the same proportion and for the same reasons as the direct costs of the materials and activity. For example, if a relatively costly booklet informing the reader about the organization's mission (including a call for action by the recipient that will help accomplish the organization's mission) is included with a relatively inexpensive fund-raising letter, the allocation of joint costs based on the cost of these pieces may be unreasonable, particularly if the booklet and letter weigh approximately the same and therefore contribute equally to the postage costs.

*Illustration*

**6.** The costs of a direct mail campaign that can be specifically identified with program services are the costs of separate program materials and a postcard

which calls for specific action by the recipient that will help accomplish the organization's mission. They total $20,000. The direct costs of the fund-raising component of the direct mail campaign consist of the costs to develop and produce the fund-raising letter. They total $80,000. Joint costs associated with the direct mail campaign total $40,000 and would be allocated as follows under the relative direct cost method:

| | |
|---|---|
| Program | $20,000/$100,000 * $40,000 = $8,000 |
| Fund-raising | $80,000/$100,000 * $40,000 = $32,000 |

## Stand-Alone Joint-Cost-Allocation Method

**7.** Joint costs are allocated to each component of the activity based on a ratio that uses estimates of costs of items included in joint costs that would have been incurred had the components been conducted independently. The numerator of the ratio is the cost (of items included in joint costs) of conducting a single component independently; the denominator is the cost (of items included in joint costs) of conducting all components independently. This method assumes that efforts for each component in the stand-alone situation are proportionate to the efforts actually undertaken in the joint cost situation. This method may result in an unreasonable allocation because it ignores the effect of each function, which is performed jointly with other functions, on other such functions. For example, the programmatic impact of a direct mail campaign or a telemarketing phone message may be significantly lessened when performed in conjunction with a fund-raising appeal.

*Illustration*

**8.** Assume that the joint costs associated with a direct mail campaign including both program and fund-raising components are the costs of stationery, postage, and envelopes at a total of $100,000. The costs of stationery, postage, and envelopes to produce and distribute each component separately would have been $90,000 for the program component and $70,000 for the fund-raising component. Under the stand-alone joint cost allocation method, the $100,000 in joint costs would be allocated as follows: $90,000/$160,000 x $100,000 = $56,250 to program services and $70,000/$160,000 × $100,000 = $43,750 to fund-raising.

13.65

# Appendix D—Illustrations of Disclosures

1. The disclosures discussed in paragraphs 13.53–.54 are illustrated in the following alternatives. Alternative 1 reports the required and encouraged information in narrative format. Alternative 2 reports that information in tabular format, as well as information concerning joint costs incurred for each kind of activity by functional classification, which is neither required nor encouraged, but which is not prohibited.

## Alternative 1

Note X. Allocation of Joint Costs

In 20XX, the organization conducted activities that included requests for contributions, as well as program and management and general components. Those activities included direct mail campaigns, special events, and a telethon. The costs of conducting those activities included a total of $310,000 of joint costs, which are not specifically attributable to particular components of the activities (joint costs). [*Note to reader: The following sentence is encouraged but not required.*] Joint costs for each kind of activity were $50,000, $150,000, and $110,000 respectively. These joint costs were allocated as follows:

| | |
|---|---|
| Fund-raising | $180,000 |
| Program A | 80,000 |
| Program B | 40,000 |
| Management and general | 10,000 |
| Total | $310,000 |

## Alternative 2

Note X. Allocation of Joint Costs

In 20XX, the organization conducted activities that included appeals for contributions and incurred joint costs of $310,000. These activities included direct mail campaigns, special events, and a telethon. Joint costs were allocated as follows:

| | *Direct Mail* | *Special Events* | *Telethon* | *Total* |
|---|---|---|---|---|
| Fund-raising | $40,000 | $50,000 | $90,000 | $180,000 |
| Program A | 10,000 | 65,000 | 5,000 | 80,000 |
| Program B | | 25,000 | 15,000 | 40,000 |
| Management and general | | 10,000 | | 10,000 |
| Total | $50,000 | $150,000 | $110,000 | $310,000 |

[***Note to reader:****Shading is used to highlight information that is neither required nor encouraged, but which is not prohibited. However, organizations may prefer to disclose it. Disclosing the total joint costs for each kind of activity ($50,000, $150,000, and $110,000) is encouraged but not required.*]

13.66

# Appendix E—Discussion of Conclusions

## Scope

**1.** This appendix applies only to costs of joint activities paragraphs 13.41–13.54. It does not address allocations of costs in other circumstances.

## Reporting Models and Related Requirements

**2.** Paragraph 26 of Financial Accounting Standards Board (FASB) Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, specifies that a statement of activities or notes to the financial statements should provide information about expenses reported by their functional classification, such as major classes of program services and supporting activities. Paragraph 13.34 of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* provides that the financial statements of not-for-profit organizations (NPOs) should disclose the total fund-raising expenses.

**3.** As discussed in footnote 17 to paragraph 13.41, this guide is not intended to require reporting the functional classifications of fund-raising, program, and management and general. Rather, those functional classifications are discussed throughout this guide for purposes of illustrating how the guidance in this guide would be applied by organizations that use those functional classifications. Organizations that do not use the functional classifications of fund-raising, program, and management and general should apply the guidance in this guide for purposes of accounting for joint activities, using their reporting model. For example, some organizations may conduct membership-development activities. As discussed in the Glossary, if there are no significant benefits or duties connected with membership, the substance of the membership-development activities may, in fact, be fund-raising. In such circumstances, the costs of those activities should be charged to fund-raising. To the extent that member benefits are received, membership is an exchange transaction. In circumstances in which membership development is in part soliciting revenues from exchange transactions and in part soliciting contributions and the purpose, audience, and content of the activity are appropriate for achieving membership development, joint costs should be allocated between fund-raising and the exchange transaction.

## Assigning Costs of Joint Activities

**4.** Paragraph 13.42 provides: "If the criteria of purpose, audience, and content are met, the costs of a joint activity that are identifiable with a particular function should be charged to that function and joint costs should be allocated between fund-raising and the appropriate program or management and general function. If any of the criteria are not met, all costs of the joint activity should be reported as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity...." For example, if the criteria are met, the costs of materials that accomplish program goals and that are unrelated to fund-raising, such as the costs of a program-related pamphlet included in a joint activity, should be charged to program, while joint costs, such as postage, should be allocated between fund-raising and program. However, if the pamphlet is used in fund-raising packets and the criteria are not met, the costs of the pamphlets

used in the fund-raising packets, as well as the joint costs, should be charged to fund-raising. (If some pamphlets are used in program activities that include no fund-raising, the cost of the pamphlets used in those separate program activities that include no fund-raising should be charged to program.)

## Educational Activities

**5.** Some organizations have missions that include educating the public (students) in areas other than causes. Paragraph 13.44 provides that, for those organizations, educating the audience in areas other than causes or motivating the audience to engage in specific activities, such as attending a lecture or class, that will educate them in areas other than causes is considered a call for specific action by the recipients that will help accomplish the organization's mission. Educating the audience about causes or motivating the audience to engage in specific activities that will educate them about causes without educating them in other subjects is not considered a call for specific action by the audience that will help accomplish the organization's mission. An example of a lecture or class that will educate students in an area other than causes is a lecture on the nesting habits of the bald eagle, given by the Save the Bald Eagle Society, an NPO whose mission is to save the bald eagle from extinction and educate the public about the bald eagle. An example of a lecture or class that will address particular causes is a lecture by the Bald Eagle Society on the potential extinction of bald eagles and the need to raise contributions to prevent their extinction. For purposes of applying the guidance in paragraphs 13.41–.54, motivating the audience to attend a lecture on the nesting habits of the bald eagle is a call for specific action that will help accomplish the entity's mission. If the lecture merely addresses the potential extinction of bald eagles and the need to raise contributions to prevent their extinction, without addressing the nesting habits of the bald eagle, motivating the audience to attend the lecture is not considered a call for specific action by the recipient that will help accomplish the organization's mission.

**6.** AcSEC notes that most transactions in which a student attends a lecture or class are exchange transactions and are not joint activities. Such transactions are joint activities only if the activity includes fund-raising.

## Audience

**7.** Paragraph 13.47 provides that a rebuttable presumption exists that the audience criterion is not met if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute to the organization. That presumption can be overcome if the audience is also selected for the program or management and general reasons specified in paragraph 13.48. Further, paragraph 13.47 provides that in determining whether that presumption is overcome, organizations should consider the extent to which the audience is selected based on its ability or likelihood to contribute to the organization and contrast that with the extent to which it is selected for the reasons that may overcome that presumption. Some organizations conduct joint activities that are special events, such as symposia, dinners, dances, and theater parties, in which the attendee receives a direct benefit (for example, a meal or theater ticket) and for which the admission price includes a contribution. For example, it may cost $500 to attend a dinner with a fair value of $50. In that case, the audience is required to make a $450 contribution in order to attend.

In circumstances in which the audience is required to make a contribution to participate in a joint activity, such as attending a special event, the audience's ability or likelihood to contribute is a significant factor in its selection. Therefore, in circumstances in which the audience is required to make a contribution to participate in a joint activity, the extent to which the audience is selected for the program or management and general reasons in paragraph 13.48 must be overwhelmingly significant in order to rebut the presumption that the audience criterion is not met.

**8.** The source of the names and the characteristics of the audience should be considered in determining the reason for selecting the audience. Some organizations use lists compiled by others to reach new audiences. The source of such lists may indicate the purpose or purposes for which they were selected. For example, lists acquired from organizations with similar or related programs are more likely to meet the audience criterion than are lists acquired from organizations with dissimilar or unrelated programs. Also, the characteristics of those on the lists may indicate the purpose or purposes for which they were selected. For example, a list based on a consumer profile of those who buy environmentally friendly products may be useful to an organization whose mission addresses environmental concerns and could therefore indicate that the audience was selected for its ability to take action to assist the organization in meeting program goals. However, a list based on net worth would indicate that the audience was selected based on its ability or likelihood to contribute, unless there was a correlation between net worth and the program or management and general components of the activity.

**9.** Some audiences may be selected because they have an interest in or affinity to the program. For example, homeowners may have an interest in the homeless because they are sympathetic to the plight of the homeless. Nevertheless, including homeowners in the audience of a program activity to provide services to the homeless would not meet the audience criterion, because they do not have a need or reasonable potential for use of services to the homeless.

**10.** Paragraph 13.48*c* provides that the audience criterion is met if the organization is required to direct the management and general component of the joint activity to the particular audience or the audience has reasonable potential for use of the management and general component. An example of a joint activity in which the audience is selected because the organization is required to direct the management and general component of the joint activity to the particular audience is an activity in which the organization sends a written acknowledgment or other information to comply with requirements of the Internal Revenue Service to prior donors and includes a request for contributions. An example of a joint activity in which the audience is selected because the audience has reasonable potential for use of the management and general component is an activity in which the organization sends its annual report to prior donors and includes a request for contributions.

### Content

**11.** Paragraph 13.49 provides that, to meet the content criterion, program activities should call for specific action by the recipient that will help accomplish the organization's mission. As discussed in the Glossary, the action should benefit the recipient or society. Examples of actions that benefit the recipient (such as by improving the recipient's physical, mental, emotional, or spiritual health

and well-being) or society (such as by addressing societal problems) include the following:

*a.* Actions that benefit the recipient:

- *Stop smoking.* Specific methods, instructions, references, and resources should be suggested.
- *Do not use alcohol or drugs.* Specific methods, instructions, references, and resources should be suggested.

*b.* Actions that benefit society:

- *Write or call.* The party to communicate with and the subject matter to be communicated should be specified.
- *Complete and return the enclosed questionnaire.* The results of the questionnaire should help the organization achieve its mission. For example, if the organization discards the questionnaire, it does not help the organization achieve its mission.
- *Boycott.* The particular product or company to be boycotted should be specified.

**12.** Paragraph 13.49*b* provides that to meet the content criterion, management and general functions are required to fulfill one or more of the organization's management and general responsibilities through a component of the joint activity. Some states or other regulatory bodies require that certain disclosures be included when soliciting contributions. Footnote 22 to paragraph 13.49 provides that for purposes of applying the guidance of paragraphs 13.41–13.54, communications that include such required disclosures are considered fund-raising activities and are not considered management and general activities. Some examples of such disclosures include the following:

- Information filed with the attorney general concerning this charitable solicitation may be obtained from the attorney general of [*the state*] by calling 123-4567. Registration with the attorney general does not imply endorsement.
- A copy of the registration and financial information may be obtained from the Division of Consumer Services by calling toll-free, within [*the state*], 1 (800) 123-4567. Registration does not imply endorsement, approval, or recommendation by [*the state*].
- Information about the cost of postage and copying, and other information required to be filed under [*the state*] law, can be obtained by calling 123-4567.
- The organization's latest annual report can be obtained by calling 123-4567.

## Allocation Methods

**13.** Paragraph 13.51 states, "The cost allocation methodology used should be rational and systematic, it should result in an allocation of joint costs that is reasonable, and it should be applied consistently given similar facts and circumstances." The allocation of joint costs should be based on the degree to which costs were incurred for the functions to which the costs are allocated (that is, program, management and general, or fund-raising). For purposes of determining whether the allocation methodology for a particular joint activity

should be consistent with methodologies used for other particular joint activities, facts and circumstances that may be considered include factors related to the content and relative costs of the components of the activity. The audience should not be considered in determining whether the facts and circumstances are similar for purposes of determining whether the allocation methodology for a particular joint activity should be consistent with methodologies used for other particular joint activities.

## Practicability of Measuring Joint Costs

**14.** The Glossary of this guide includes a definition of joint costs. Some costs, such as utilities, rent, and insurance, commonly referred to as indirect costs, may be joint costs. For example, the telephone bill for a department that, among other things, prepares materials that include both fund-raising and program components may commonly be referred to as an indirect cost. Such telephone bills may also be joint costs. However, for some organizations, it is impracticable to measure and allocate the portion of the costs that are joint costs. Considerations about which joint costs should be measured and allocated, such as considerations about materiality and the costs and benefits of developing and providing the information, are the same as considerations about cost allocations in other circumstances.

# Chapter 14

# Reports of Independent Auditors

## Reports on Financial Statements

**14.01** The guidance in AU section 508, *Reports on Audited Financial Statements*, as amended (AICPA, *Professional Standards*, vol. 1), applies to auditors' reports on the financial statements of not-for-profit organizations.[1] The facts and circumstances of each particular audit will govern the appropriate form of report. This chapter discusses the application of AU section 508 to report on the financial statements of not-for-profit organizations in specific circumstances. As noted in footnote 1 to chapter 2, not-for-profit organizations are not issuers subject to oversight by the Public Company Accounting Oversight Board (PCAOB) and auditors are not required to follow auditing standards issued by the PCAOB in an audit of a not-for-profit organization. Optional language may be added to the auditor's report on the financial statements to clarify that an audit conducted in accordance with generally accepted auditing standards (GAAS) does not require the same level of testing and reporting on internal control over financial reporting as an audit conducted in accordance with the standards of the PCAOB. See Auditing Interpretation No. 17, "Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards," of AU section 508 (AICPA, *Professional Standards*, vol. 1, AU sec. 9508 par. .85–.88) and footnote 10 of this chapter. Further, an auditor may be engaged to also follow PCAOB Auditing Standards in the audit of a not-for-profit organization. See Auditing Interpretation No. 18, "Reference to PCAOB Standards in an Audit Report on a Nonissuer," of AU section 508, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 9508 par. .89–.92).[2]

**14.02** The auditor's standard report described in AU section 508 refers to *results of operations*, which is usually understood to refer to an enterprise's net income for a period together with other changes in net worth. As described in chapter 3, "Basic Financial Statements," of this Audit and Accounting

---

[1] Paragraph .30 of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), eliminates the requirement that the auditor add an uncertainties paragraph to the auditor's report if certain criteria are met. Paragraph .08 of AU section 508 requires that auditors identify in the auditor's report the country of origin of the auditing standards and accounting principles used. Paragraph .01 of AU section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1), requires that the auditor's report should not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion. Among other things, sufficient appropriate audit evidence includes evidence that the audit documentation has been reviewed and that the entity's financial statements, including disclosures, have been prepared and that management has asserted that they have taken responsibility for them. Paragraph .06 of TIS section 9100, "Signing and Dating Reports" (AICPA, *Technical Practice Aids*), (nonauthoritative) states that management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations. The auditor will need to have the signed management representation letter in hand prior to releasing the auditor's report.

[2] Refer to paragraphs .85-.98 of Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards") for the audit reports that should be used if the auditor is engaged to audit both a not-for-profit organization's (that is, a nonissuer's) financial statements and management's assessment of the effectiveness of internal control over financial reporting in accordance with PCAOB Auditing Standards.

Guide (guide), a not-for-profit organization's statement of activities reports the changes in net assets[3] for the period but does not purport to present the results of operations, as would an income statement of a for-profit organization.[4] Accordingly, the opinion paragraph of the auditor's report should refer to changes in net assets, since that is more descriptive of the information in the statement of activities than results of operations.

## Reports on Comparative Financial Statements

**14.03** As noted in chapter 3 of this guide, not-for-profit organizations sometimes present comparative information for a prior year or years only in total rather than by net asset class. Paragraph .65 of AU section 508 provides requirements and guidance for reporting on comparative financial statements and states the following:

> The fourth standard of reporting requires that the auditor either express an opinion regarding the financial statements *taken as a whole* or an assertion to the effect that an opinion cannot be expressed in the auditor's report. Reference in the fourth reporting standard to the financial statements *taken as a whole* applies not only to the financial statements of the current period but also to those of one or more prior periods that are presented on a comparative basis with those of the current period. Therefore, a continuing auditor should update the report on the individual financial statements of the one or more prior periods presented on a comparative basis with those of the current period.

Footnote 24 to paragraph .65 of AU section 508 states the following:

> A continuing auditor need not report on the prior-period financial statements if only summarized comparative information of the prior period(s) is presented. For example, entities such as state and local governmental units may present prior-year financial information in their government-wide financial statements only for the total reporting entity rather than disaggregated by governmental activities, business-type activities, total primary government, and discretely presented component units. Also, not-for-profit organizations frequently present certain information for the prior period(s) in total rather than by net asset class. In some circumstances, the client may request the auditor to express an opinion on the prior period(s) as well as the current period. In those circumstances, the auditor should consider whether the information included for the prior period(s) contains sufficient detail to constitute a fair presentation in conformity with generally accepted accounting principles. In most cases, this will necessitate including additional columns or separate detail by reporting unit or net asset class, or the auditor would need to modify his or her report.

**14.04** Though Financial Accounting Standards Board (FASB) Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, does not require fund reporting, it does require, however, that certain basic information, such as reporting net assets and changes in net assets by net asset class, be provided.

---

[3] As discussed in paragraph 3.08, descriptive terms such as *change in equity* may be used.

[4] As discussed in chapter 3 of this guide, a not-for-profit organization may present an intermediate measure of operations within the statement of activities. As noted in chapter 3, however, if an intermediate measure of operations is reported, it must be in a financial statement that, at a minimum, reports the change in unrestricted net assets for the period. Such a statement would, therefore, ordinarily present more than merely the results of operations.

If the prior year(s) financial statements include the minimum information required by FASB Statement No. 117 and this guide for a complete set of financial statements (statement of financial position, statement of activities, statements of cash flows, and accompanying notes), the financial statements are not summarized information. Accordingly, a continuing auditor should report on them. Alternatively, if the prior year(s) financial statements are summarized and therefore do not include the minimum information required by FASB Statement No. 117 and this guide for a complete set of financial statements, a continuing auditor's report should not mention the summarized information in the description of the financial statements audited or in the opinion paragraph. However, a continuing auditor should make clear the degree of responsibility that he or she is assuming in relation to the prior year(s) summarized information.[5] The introductory paragraph of the auditor's report should state (*a*) that the summarized information has been derived from a complete set of financial statements, (*b*) the date of the auditor's report on the complete financial statements,[6] and (*c*) the type of opinion expressed.[7,8] An example of an introductory paragraph with such a statement is—

> We have audited the accompanying statement of financial position of XYZ Not-for-Profit Organization as of September 30, 19CY, and the related statements of activities and cash flows for the year then ended. These financial statements are the responsibility of XYZ Not-for-Profit Organization's management. Our responsibility is to express an opinion on these financial statements based on our audit. The prior year summarized comparative information has been derived from the Organization's 19PY financial statements and, in our report dated December 15, 19PY, we expressed an unqualified opinion on those financial statements.

**14.05** As noted in paragraph 3.20, if the comparative financial information is summarized and does not include the minimum information required by FASB Statement No. 117 and this guide—for example, if the statement of activities does not present revenues, expenses, gains, and losses by net asset class—certain disclosures about the nature of the information presented are

---

[5] AU section 508 discusses, in part, engagements in which the auditor is asked to report on an individual financial statement, such as a balance sheet, and not other individual financial statements, such as the statements of changes in net assets and cash flows (AU sec. 508 par. .33), reports on comparative financial statements (AU sec. 508 par. .67), and financial statements taken as a whole (AU sec. 508 par. .05 and .65). The guidance in AU section 508 ordinarily would not apply to circumstances in which the prior year(s) financial statements are summarized and, therefore, one or more of the individual financial statements do not include the minimum information necessary for a full generally accepted accounting principles (GAAP) presentation.

[6] Reference to the date of the original report removes any implication that records, transactions, or events after that date have been examined. The auditor does not have a responsibility to investigate or inquire further into events that may have occurred during the period between the date of the report on the complete financial statements and the date of the report on the summarized information.

[7] If the auditor's opinion on the complete financial statements was other than unqualified, the report should describe the nature of, and the reasons for, the qualification. The auditor should also consider the effect that any modification of the report on the complete financial statements might have on the report on the summarized information. For example, if the auditor's report on the complete financial statements referred to another auditor or included an explanatory paragraph because of a material uncertainty, a going concern matter, or an inconsistency in the application of accounting principles, the report on the summarized information should state that fact. However, no reference to the inconsistency is necessary if a change in accounting referred to in the auditor's report on the complete financial statements does not affect the comparability of the information being presented.

[8] If the prior year(s) summarized information has been derived from financial statements that were audited by another independent auditor, the report should state that fact, and the auditor should not express an opinion on that information.

required. If the disclosures required by paragraph 3.20 are omitted or are incomplete, the auditor ordinarily should add a paragraph to his or her report calling the omitted or incomplete disclosure to the readers' attention. Such a paragraph might include the same wording that appears in the illustrative note presented as an example in paragraph 3.21 of this guide. To reduce the likelihood that a reader might misinterpret such a paragraph to be a qualified opinion on the current period financial statements, the paragraph should follow the opinion paragraph and should not be referred to in either the scope or opinion paragraphs of the auditor's report.

## Unqualified Opinions

**14.06** The auditor's standard report contains an opinion that the financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles (GAAP). That conclusion may be expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with GAAS. An example of the auditor's standard report on financial statements covering a single year is as follows:

Independent Auditor's Report

> We have audited the accompanying statement of financial position of XYZ Not-for-Profit Organization as of September 30, 20XX, and the related statements of activities and cash flows for the year then ended.[9] These financial statements are the responsibility of XYZ Not-for-Profit Organization's management. Our responsibility is to express an opinion on these financial statements based on our audit.
>
> We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control over financial reporting. Accordingly, we express no such opinion.*][10] An audit

---

[9] Each of the statements presented, which may include a statement of functional expenses, should be identified in the introductory paragraph.

[10] This optional wording may be added to reports on the financial statement audits of not-for-profit organizations in accordance with Auditing Interpretation No. 17, "Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards," of AU section 508, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 9508 par. .85–.88), which provides reporting guidance for audits of nonissuers. (This wording may be added even in a report on the financial statements in an audit conducted in accordance with *Government Auditing Standards* or U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, in which the auditor reports on internal control over financial reporting but does not express an opinion on that internal control. See the AICPA Audit Guide Government Auditing Standards *and Circular A-133 Audits*.) Auditing Interpretation No. 17 addresses how auditors may expand this report to explain that their consideration of internal control was sufficient to provide the auditor sufficient understanding to plan the audit and determine the nature, timing and extent of tests to be performed, but was not sufficient to express an opinion on the effectiveness of the internal control. If this optional wording is added, the remainder of the paragraph should read as follows:

> "An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion."

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 audit provides 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 XYZ Not-for-Profit Organization as of September 30, 20XX, and the changes in its net assets and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*][11]

## Modified Reports and Departures From Unqualified Opinions

**14.07** AU section 508 indicates the circumstances in which an explanatory paragraph is required to be added following the standard opinion paragraph.[12] The statement also provides examples of auditors' reports in these circumstances. In addition, AU section 508 indicates circumstances in which departures from GAAP and limitations on the scope of the audit would require a qualified opinion, an adverse opinion, and a disclaimer of opinion, and provides examples of auditors' reports in those circumstances. Examples of possible departures from GAAP that an auditor of a not-for-profit organization's financial statements might encounter include the organization's failure to (*a*) recognize or appropriately measure promises to give, contributed services, or depreciation on plant and equipment in conformity with GAAP, and (*b*) provide information about expenses reported by their functional classification. The auditor's inability to obtain sufficient competent evidential matter to audit (*a*) contributed services that the organization has recorded or (*b*) receivables and revenues from fund-raising activities is an example of possible restrictions on the scope of the audit that an auditor of a not-for-profit organization's financial statements might encounter.

## Going Concern

**14.08** AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1), provides guidance to the auditor in evaluating whether there is substantial doubt

---

[11] Statement on Auditing Standards (SAS) No. 103, amends SAS No. 1, section 530, *Dating of the Independent Auditor's Report*, to require that the auditor's report be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion on the financial statements. See www.aicpa.org/download/auditstd/pract_alert/pa_2007_1.pdf for a practice alert regarding application of this SAS.

[12] Auditing Interpretation No. 12, "The Effect on the Auditor's Report of an Entity's Adoption of a New Accounting Standard That Does Not Require the Entity to Disclose the Effect of the Change in the Year of Adoption," of AU section 420, *Consistency of Application of Generally Accepted Accounting Principles* (AICPA, *Professional Standards*, vol. 1, AU sec. 9420 par. .69–.72), discusses whether to add an explanatory paragraph if an accounting standard does not require the organization to disclose the effect of the change in accounting principle in the year of adoption.

about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. AU section 341 also provides guidance on reporting in that situation, including an example of an explanatory paragraph (following the opinion paragraph) in the auditor's report describing an uncertainty about the entity's ability to continue as a going concern. Paragraph 2.48 of this guide contains examples of conditions or events that are particularly applicable to not-for-profit organizations and that might indicate that there could be substantial doubt about the organization's continued existence.

## Reporting on Supplementary Information

**14.09** Footnote 6 to paragraph 27 of FASB Statement No. 117 states the following:

> Information about an organization's major programs (or segments) can be enhanced by reporting the interrelationships of program expenses and program revenues.... Related nonmonetary information about program inputs, outputs, and results also is helpful.... Generally, reporting that kind of information is feasible only in supplementary information or management explanations or by other methods of financial reporting.

**14.10** Although nonmonetary information about an organization's activities and programs may be informative and helpful to users of the financial statements, this information is not necessary for fair presentation of financial position, changes in net assets, or cash flows on which the auditor is reporting. In addition, this information may not be auditable if it is obtained from records outside the accounting system that are not subject to controls, rather than being obtained (or derived by analysis or computation) from records subject to controls. AU section 550, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), provides guidance to the auditor with regard to other information that may be included in audited financial statements. Paragraph .07 of AU section 550 refers to paragraph .13 of AU section 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1), which states that when the auditor disclaims an opinion on all or part of the accompanying information in a document that he submits to his client or to others, such information should either be marked as unaudited or should include a reference to the auditor's disclaimer of opinion. The wording of the disclaimer will vary according to the circumstances. Two examples follow.

*Disclaimer on All of the Information*

> Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The (identify the accompanying information) is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and, accordingly, we express no opinion on it.

*Disclaimer on Part of the Information*

> Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information on pages XX—YY is presented for purposes of additional analysis and is not

a required part of the basic financial statements. Such information, except for that portion marked "unaudited," on which we express no opinion, has been subjected to the auditing procedures applied in the audit of the basic financial statements, and, in our opinion, the information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

## Bases of Accounting Other Than GAAP[13]

**14.11** Some not-for-profit organizations may find that financial statements prepared on the cash basis or the modified cash basis of accounting are adequate for their governing boards and other users. AU section 623, *Special Reports* (AICPA, *Professional Standards*, vol. 1), describes the auditor's reporting requirements when the financial statements are prepared on a comprehensive basis of accounting other than GAAP (other comprehensive basis of accounting [OCBOA]), including the cash receipts and disbursements basis of accounting and modifications of the cash basis having substantial support.[14]

**14.12** AU section 623 also permits an auditor to issue a special report on financial statements that have been prepared in conformity with the requirements or financial reporting provisions of a governmental regulatory agency but that do not conform with GAAP or constitute OCBOA. In that instance, the auditor's report should include a separate paragraph at the end of the report stating that the report is intended solely for the information and use of those within the entity and the regulatory agency with which the report is being filed, and is not intended to be and should not be used by anyone other than these specified parties. Such a restrictive paragraph is appropriate, even though by law or regulation the auditor's report may be made a matter of public record. The auditor may use this form of report, however, only if the financial statements and report are intended solely for filing with the regulatory agency to whose jurisdiction the organization is subject. Paragraph .04 of AU section 544, *Lack of Conformity With Generally Accepted Accounting Principles* (AICPA, *Professional Standards*, vol. 1), states that in circumstances in which the financial statements and reports will be used by parties or distributed by the entity to parties other than the regulatory agencies to whose jurisdiction the entity is subject, the auditor should use the standard form of report modified as appropriate because of the departures from GAAP and then in an additional paragraph express an opinion on whether the financial statements are presented in conformity with the regulatory basis of accounting.[15]

---

[13] Auditing Interpretation No. 14, "Evaluating the Adequacy of Disclosure and Presentation in Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)" of AU Section 623, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 9623 par. .90), provides guidance on evaluating the adequacy of disclosure and presentation in financial statement presented using OCBOA.

[14] The accrual basis of accounting is required by GAAP for a fair presentation of financial position, changes in net assets, and cash flows. Financial statements presented on the cash receipts and disbursements basis of accounting or using modifications of the cash basis having substantial support may be considered to present financial position, changes in net assets, and cash flows in conformity with GAAP only if they do not differ materially from financial statements prepared on an accrual basis.

[15] Auditing Interpretation No. 15, "Auditor Reports on Regulatory Accounting or Presentation When the Regulated Entity Distributes the Financial Statements to Parties Other Than the Regulatory Agency Either Voluntarily or Upon Specific Request" of AU Section 623 (AICPA, *Professional Standards*, vol. 1, AU sec. 9623 par. .96), issued in January 2005, provides an example of that report.

## Reporting on Prescribed Forms

**14.13** Some not-for-profit organizations prepare financial reports using forms prescribed by an affiliated organization. The auditor should review these forms and any accompanying preprinted auditor's report for compliance with GAAP and GAAS. If the financial statements prepared using the prescribed form do not conform with GAAP, either the auditor can attach a separate set of financial statements and report on them, or he or she can issue a report on the prescribed form but include a restriction on its distribution, as discussed previously. If the auditor considers the preprinted auditor's report inappropriate, he or she should prepare a separate report. When a separate report is used, the auditor should consider inserting language such as "See attached independent auditor's report" in the space provided for the auditor's signature on the preprinted form.

**14.14** Internal Revenue Service (IRS) Form 990, *Return of Organizations Exempt from Income Tax*, may be used in some states as an annual report by not-for-profit organizations for reporting to both state and federal governments. Many states require an auditor's opinion on the financial statements included in an IRS Form 990. An auditing interpretation of AU section 623 titled "Reports on the Financial Statements Included in Internal Revenue Form 990, 'Return of Organizations Exempt from Income Tax'" (AICPA, *Professional Standards*, vol. 1, AU sec. 9623 par. .47–.54), provides guidance on reporting on financial statements included in Form 990. (Paragraph .54 of that interpretation may no longer be relevant as a result of the issuance of FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, and No. 117.)

## Reports Required by *Government Auditing Standards*, the Single Audit Act Amendments of 1996, and OMB Circular A-133

**14.15** *Government Auditing Standards*, the Single Audit Act Amendments of 1996, and U.S. Office of Management and Budget (OMB) Circular A-133 broaden the auditor's responsibility to include reporting on not only an organization's financial statements but also its internal control and its compliance with laws and regulations. AICPA Audit Guide Government Auditing Standards *and Circular A-133 Audits*, describes and illustrates the required reports. The report on internal control over financial reporting and on compliance and other matters and the report on compliance with requirements applicable to each major program and on the internal control over compliance required by *Government Auditing Standards* are restricted-use reports under the provisions of AU section 532, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1). Thus, those reports are not intended to be used for other purposes, such as inclusion in an offering document for municipal securities filings. In addition, when a not-for-profit organization's financial statements are included in an offering document as an "obligated person," it is generally advisable to use an auditor's report on the financial statements that does not refer to the *Government Auditing Standards* audit or to those reports.

# Chapter 15

# Tax Considerations

## Introduction

**15.01** This chapter discusses certain tax considerations relevant to not-for-profit organizations. It does not contain a detailed discussion of the Internal Revenue Code (IRC) and of rulings that have been issued by the Internal Revenue Service (IRS) that apply to not-for-profit organizations, nor is it intended as a substitute for appropriate research in resolving tax issues.

**15.02** The tax considerations discussed in this chapter often result in an organization (or its for-profit or not-for-profit subsidiaries) making a determination about whether a transaction or event must be reported in a tax return. The term *tax position* refers to a position in a previously filed tax return or a position expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets and liabilities for interim or annual periods. The term *tax position* encompasses, but is not limited to the following:

- A decision to classify a transaction, entity, or other position in a tax return as tax exempt or subject to a lower rate of tax
- A decision not to file a tax return, such as a decision that a Form 990T need not be filed
- The characterization of income, such as a characterization of income as passive, or a decision to exclude reporting taxable income in a tax return
- An allocation or a shift of income between jurisdictions (federal, state, local, or foreign)

The validity of a tax position is a matter of tax law. It is not controversial to recognize the benefit of a tax position in financial statements when the degree of confidence is high that that tax position will be sustained upon examination by a taxing authority. However, in some cases, the law is subject to varied interpretation, and whether a tax position will ultimately be sustained may be uncertain. FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*, limits the recognition of uncertain tax positions to only those positions that are more likely than not to be sustained upon examination by a taxing authority based solely on the technical merits of the position.*

**15.03** Management generally should identify federal, state, and local laws and regulations that may have a direct and material effect on the determination of financial statement amounts. The auditor should make inquiries of

---

* FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109* is effective for fiscal years beginning after December 15, 2006. However, FASB Staff Position (FSP) FIN 48-2, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*, defers the effective date of that interpretation to fiscal years beginning after December 15, 2007, for certain nonpublic enterprises as defined by paragraph 289 of FASB Statement No. 109, *Accounting for Income Taxes*, including nonpublic not-for-profit organizations. Earlier application is permitted. Not-for-profit organizations that have already adopted the provisions of FASB Interpretation No. 48 are not eligible for the deferral. The AICPA has prepared a practice guide to help in understanding the interpretation. The practice guide is available by following the link "Professional Standards and Ethics" at http://tax.aicpa.org/Resources.

management concerning the client's compliance with laws and regulations. An organization's failure to maintain its tax-exempt status could have serious tax consequences and affect both its financial statements and related disclosures, and it could possibly require modification of the auditor's report. Failure to comply with tax laws and regulations could be an illegal act that may, as discussed in chapter 2, "General Auditing Considerations," of this Audit and Accounting Guide (guide), have either a direct and material effect on the determination of financial statement amounts (for example, the result of an incorrect accrual for taxes on unrelated business income) or a material indirect effect on the financial statements that would require appropriate disclosures (for example, the result of a potential loss of tax-exempt status).

## Basis of Exemption

**15.04** The IRS determines whether an organization qualifies for exemption from federal income tax. The following are some of the more common types of tax-exempt organizations:

- Corporations, united funds, other funds, and foundations organized and operated (*a*) exclusively for religious, charitable, scientific, testing-for-public-safety, literary, or educational purposes; (*b*) to foster national or international amateur sports competition; or (*c*) for the prevention of cruelty to children or animals
- Civic leagues, organizations operated exclusively for the promotion of social welfare, and certain local associations of employees
- Labor, agricultural, and horticultural organizations
- Business leagues, chambers of commerce, real estate boards, boards of trade, and professional football leagues that are not organized for profit
- Clubs organized for pleasure, recreation, and other not-for-profit purposes

**15.05** Exemptions from state and local sales, real estate, and other taxes vary from state to state. Organizations are generally subject to the laws of the state of incorporation as well as the laws of states in which they conduct significant activities. Each state's laws govern exemption from its taxes and should be consulted for the applicable definitions and requirements.

**15.06** Tax exemption is a privilege and not a right. At the federal level, the IRS has the authority to revoke exemptions for any one of several reasons. Furthermore, individual states have regulatory bodies that oversee not-for-profit organizations and that can revoke their state tax-exempt status without regard to their federal tax-exempt status and even prevent them from operating. There are many potential threats to an organization's federal tax-exempt status, of which the following are particularly important:

- Material changes in the organization's character, purpose, or method of operation
- Private inurement
- Private benefit
- Commerciality
- Lobbying

- Political campaign activities
- Unrelated business income
- Failure of the organization to meet the commensurate test
- Violation of public policy by the organization

**15.07** The IRS requires that organizations disclose on Form 990 any changes in the kinds of exempt activities the organization conducts, any changes in its governing documents, and whether there has been a liquidation, dissolution, or substantial contraction. If there has been a material change in the organization's character, purpose, or method of operation, it may be appropriate to seek IRS guidance in the form of a private letter ruling.

**15.08** Not-for-profit organizations are generally prohibited from making distributions to those who control or support them financially. IRS rules regulate transactions between a not-for-profit organization and insiders. IRC provisions concerning such transactions are stricter for private foundations than for other not-for-profit organizations. Insiders are individuals with a personal or private interest in the organization, such as governing board members, officers, certain employees, and substantial contributors. Transactions between insiders and not-for-profit organizations are permitted, but the organization has the burden of proving that the transactions do not result in private inurement. The organization must be able to satisfy the IRS that the transaction was reasonable, was adequately documented, had independent approval, and did not violate any law or regulation. Employee compensation can create an inurement problem if it is judged to be "unreasonably high."

**15.09** The concept of private benefit prohibits a not-for-profit organization from providing excessive benefits for the private interests of any specific individual or group—both insiders and outsiders. Incidental levels of private benefits are permitted, but the organization is required to demonstrate that such benefits are a necessary concomitant of a public related benefit. The organization generally should have sound policies for transactions with both insiders and outsiders, and these policies ordinarily should document that the transactions were appropriate and were approved by disinterested parties.

**15.10** A not-for-profit organization cannot qualify for tax exemption, or can have its tax-exempt status revoked, if it is, in reality, a commercial enterprise. Engaging in commercial activity, however, does not *per se* disqualify the organization from tax-exempt status unless the commercial activity becomes the organization's primary purpose. A gray area exists between commercial and noncommercial activities. To avoid problems with commerciality, many not-for-profit organizations have found it advantageous to create separate for-profit subsidiaries.

**15.11** The IRC allows public charities (but not private foundations) to lobby to influence federal, state, and local legislation (including initiatives and referenda), but it places limits on how much lobbying they can do. Membership organizations that are granted tax-exempt status under IRC Section 501(c)(4)(5) or (6) and lobby are required to make complex disclosures to their members or pay a proxy tax.

**15.12** Public charities are prohibited from engaging in partisan political campaign activities. Prohibited political activities include contributing to candidates or political organizations, including, for example, in-kind contributions of services, publicity, advertising, paid staff time, facilities, and office space. Also

prohibited are evaluating candidates and their positions on specific issues and encouraging voter registration for a specific political group. Permitted political activities include nonpartisan get-out-the-vote campaigns.

**15.13** Not-for-profit organizations can lose their tax-exempt status if the IRS determines that too large a percentage of their income is from business activities unrelated to their specific exempt purposes. There is, however, no specific percentage of unrelated business income that can be designated as too large a percentage and is, therefore, not permissible. The facts and circumstances of each unrelated business income situation should be considered. Unrelated business income and the unrelated business income tax are discussed in more detail in paragraphs 15.18–.20.

**15.14** A not-for-profit organization can lose its tax-exempt status if it fails the commensurate test, which provides that the scope of the organization's programs must be commensurate with its financial resources. The test requires that an organization have a charitable program that is both real and, taking the *organization's circumstances and financial* resources into account, substantial. This means that fund-raising expenses and administrative expenses should not be an excessive percentage of total expenses. Although no specific payout percentage has been established and individual facts and circumstances must be considered, low levels of program spending invite IRS scrutiny.

**15.15** An organization can also lose its tax exemption because it violates public policy, for example, through racial discrimination.

## Federal and State Filing Requirements

**15.16** Most tax-exempt organizations, except those with less than $25,000 in gross receipts or churches, must file annual information returns with the IRS. Most states also have their own registration and filing requirements, some of which include audited financial statements. As stated in paragraph .05 of AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1), the auditor should consider state laws and regulations that have a direct and material effect on the determination of financial statement amounts. An example of this would include the consideration of applicable tax laws that could effect a nonprofit's filing status or tax accruals.

## Public Charities and Private Foundations

**15.17** The IRS considers all charitable organizations (that is, those that are tax-exempt under IRC Section 501(c)(3)) to be private foundations unless they qualify as public charities (sometimes referred to as *nonprivate foundations*) under one of several IRC tests. Private foundations are subject to more restrictions under the tax law than are public charities. These restrictions include statutory prohibitions against self-dealing, excess business holdings, jeopardy investments, failing to distribute income, and taxable expenditures. In addition, private foundations are subject to an excise tax on their net investment income and are required to make annual distributions of five percent of the average market value of their noncharitable-use assets for charitable, educational, scientific, and similar purposes. (Noncharitable-use assets are assets that are not used or held for use directly in carrying on the organization's exempt purpose; they include assets held for investment and the production of investment income.) Private foundations are also required to publish annually

a notice that their annual reports are available for inspection. Public charities are exempt from federal unemployment taxes. Both public charities and private foundations may be exempt from property and sales taxes in some states.

## Unrelated Business Income

**15.18** Unrelated business income is gross income from an unrelated trade or business less expenses directly connected with the unrelated trade or business, certain net operating losses, and qualified charitable contributions. An unrelated trade or business of an exempt organization is any trade or business which is regularly carried on, and whose conduct is not substantially related to the exercise or performance of its exempt purpose. The IRS is primarily interested in how the unrelated business income was earned, not in how it is used, even if it is used to further the organization's tax-exempt purpose. Unrelated business income is subject to federal corporate taxes on income, including the alternative minimum tax (AMT). (The first $1,000 of net unrelated business income is excluded from taxation, and corporate net operating losses and various tax credits are allowed.)

**15.19** The unrelated-business-income tax requirements apply to all not-for-profit organizations except (*a*) corporations that have been organized under Acts of Congress and that are instrumentalities of the United States and (*b*) certain charitable trusts not subject to the tax on private foundations.

**15.20** Income from certain specified activities that might otherwise be considered unrelated business income is excluded from taxation. For example, unrelated business income does not include dividends, interest, royalties, and gains on the sale of property (unless that property was used in an unrelated trade or business). Unrelated business income also does not include income from activities in which substantially all of the work is done by volunteers, income from the sale of donated merchandise, and rents from real property. However, rents from debt-financed property, rents based on a percentage of net income rather than gross income, and rents on personal property are considered to be unrelated business income.

## Auditing

**15.21** As previously discussed, noncompliance with federal and state tax laws and regulations may have direct and material effects on an organization's financial statements. Noncompliance may also, possibly through the loss of the organization's tax-exempt status, have indirect effects on the statements. Since many organizations depend on their tax-exempt status for funding purposes and could lose their funding if that status was revoked, such indirect effects may also indicate that there is substantial doubt about the organization's ability to continue as a going concern.

**15.22** Many audit objectives, controls, and auditing procedures for the tax provisions and liabilities of not-for-profit organizations are similar to those of other organizations. In addition, the auditor may need to consider the specific audit objectives, selected controls, and auditing procedures listed in the table in paragraph 5.23 that are unique to not-for-profit organizations.

**15.23** The following table illustrates the use of assertions in developing audit objectives and designing substantive tests. The examples are not intended to be all-inclusive, nor is it expected that all the procedures would necessarily

be applied in an audit. The auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure to obtain sufficient appropriate audit evidence. The use of assertions in assessing risks and designing appropriate audit procedures to obtain audit evidence is described in paragraphs .14–.26 of AU section 326, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1). Various audit procedures and the purposes for which they may be performed are described in paragraphs .27–.41 of AU section 326.

**Auditing Considerations**

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| *Account Balances* | | | |
| Completeness | All liabilities and contingencies for taxes due and uncertain tax positions for the current and prior years are accrued or disclosed. | Tax returns are prepared and reviewed by knowledgeable personnel. | Inquire if tax returns have been filed on a timely basis. |
| | | | Review tax returns or filings and related correspondence for all "open" years. |
| | | | Review revenue agent's reports, if any, for evidence of additional liabilities or contingencies. |
| | | | Review minutes of governing board and governing board committee meetings and the accounting records for evidence of significant unrelated business income. |
| | | | Review the reasonableness of the computation of any unrelated business income tax liability. |

**Auditing Considerations—continued**

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| *Presentation and Disclosure* | | | |
| Rights and Obligations; Classification and Understand-ability | The not-for-profit organization has obtained qualifying tax exemptions from the appropriate government authorities. | Management monitors compliance with applicable tax regulations. | Ascertain whether the organization has been granted tax-exempt status. |
| | | | Review minutes of governing board meetings for changes in the organization's governing instruments that could affect its tax-exempt status. |
| | | | Consider the effect of new, expanded, or unusual activities on the organization's tax-exempt status. |
| Completeness | The organization's tax-exempt status, any tax contingencies, and unrecognized tax benefits for uncertain tax positions are disclosed in the notes to the financial statements. | | Determine whether the organization's tax-exempt status, any tax contingencies, and unrecognized tax benefits for uncertain tax positions are appropriately disclosed in the notes to the financial statements. |

# Chapter 16

# *Fund Accounting*

## Introduction

**16.01** Many not-for-profit organizations have used fund accounting both for internal recordkeeping and for external financial reporting purposes. Fund accounting segregates assets, liabilities, and fund balances into separate accounting entities associated with specific activities, donor-imposed restrictions, or objectives. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*, however, establishes a financial reporting model based on net assets, classified solely on the basis of donor-imposed restrictions, and requires not-for-profit organizations' external financial reporting to focus on aggregate information about the entity as a whole, rather than on individual funds.[1] Though fund accounting is not required by generally accepted accounting principles, some entities will continue to use fund accounting for internal recordkeeping purposes. Also, FASB Statement No. 117 and this Audit and Accounting Guide (guide) permit the continued disclosure, for external financial reporting purposes, of disaggregated data classified by fund groups, provided that the information required by FASB Statement No. 117 and this guide is presented. This chapter provides an overview of fund accounting and discusses the reporting of information derived from an internal fund accounting system in conformity with the reporting requirements of the net asset model.[2,3]

## Fund Accounting and External Financial Reporting

**16.02** Fund accounting is a system of recording resources whose use may be limited by donors, granting agencies, governing boards, or other individuals or entities or by law. To keep records of these limitations for internal purposes, some not-for-profit organizations maintain separate funds for specific purposes. Each fund consists of a self-balancing set of asset, liability, and fund balance accounts. Before the issuance of FASB Statement No. 117, most not-for-profit organizations prepared fund-accounting-based external financial statements by combining funds with similar characteristics into fund groups. Authoritative guidance for external financial reporting was provided by the two AICPA

---

[1] Both fund balances and net assets represent residual interests in assets less liabilities. Fund balances, however, are not the same as net asset balances.

[2] The discussion in this chapter assumes that the provisions of paragraph 17 of FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, concerning the recognition of expirations of donor-imposed restrictions are applied prospectively, in conformity with paragraph 30 of FASB Statement No. 116.

[3] The timing of recognition of changes in net assets under fund accounting and the net asset model may differ. For example, restrictions may expire under the net asset model in different periods than when expenses are reported in a fund. Accordingly, not-for-profit organizations that continue to use fund accounting for internal recordkeeping purposes should generally keep records of all transactions and events that have been recognized under one model but not the other and should adjust opening fund accounting balances to amounts representing opening net assets.

industry Audit Guides, one Audit and Accounting Guide, and two of the Statements of Position (SOPs) that are superseded by this guide.[4]

**16.03** For external financial reporting purposes, the total of all assets and liabilities included in all funds and changes in net assets should be measured and reported on a not-for-profit organization's financial statements in conformity with FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, and FASB Statement No. 117 and with chapters 3–13 of this guide. (As stated in footnote 8 of FASB Statement No. 117, "because receivables and payables between fund groups are not organizational assets or liabilities, a statement of financial position must clearly label and arrange those interfund items to eliminate their amounts when displaying total assets or liabilities.") Fund balances should be classified on a statement of financial position as unrestricted, temporarily restricted, or permanently restricted net assets based on the existence and type of donor-imposed restrictions.[5] For external financial reporting purposes, a fund balance may have to be divided among more than one net asset class. The remainder of this chapter describes seven commonly used kinds of funds and discusses how their fund balances should be reported based on the requirements of FASB Statement No. 117 and this guide.

## Unrestricted Current (or Unrestricted Operating or General) Funds

**16.04** Unrestricted current funds (also called *unrestricted operating* or *general* funds) are used to record organizations' activities that are supported by resources over which governing boards have discretionary control. Amounts designated by governing boards for specific purposes may be included in unrestricted current funds, or those amounts may be accounted for in other funds, such as plant funds, endowment funds, and loan funds. The principal sources of unrestricted current funds are unrestricted contributions from donors; exchange transactions with members, clients, students, customers, and others; and unrestricted investment income. Resources are used to help meet the costs of providing the organization's programs and supporting services.

**16.05** Fund balances of unrestricted current funds should be classified on a statement of financial position as unrestricted net assets unless donors have stipulated restrictions on the use of contributed assets that expire by passage of time. In those situations, net assets should be classified as temporarily restricted. Unrestricted fund balances that have been designated by governing bodies for specific purposes (such as quasi-endowment, funds functioning as endowment, funds for long-term investment, self-insurance reserve funds, or future development funds) should be classified as unrestricted net assets. Board designations are permitted to be disclosed, as discussed in paragraphs 3.07 and 11.15 of this guide.

---

[4] As noted in the Preface, this guide supersedes *Audits of Voluntary Health and Welfare Organizations*, *Audits of Colleges and Universities* (including SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*) and *Audits of Certain Nonprofit Organizations* (including SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*).

[5] Accounting for contributions received with donor-imposed restrictions is discussed in paragraphs 5.38–.42 of this guide.

## Restricted Current (or Restricted Operating or Specific-Purpose) Funds

**16.06** Restricted current funds (also called *restricted operating* or *specific-purpose* funds) are used to record organizations' activities that are supported by resources whose use is limited by external parties to specific operating purposes. The principal sources of restricted current funds are contributions from donors; contracts, grants, and appropriations; endowment income; and other sources where resource providers have stipulated the specific operating purposes for which the resources are to be used.

**16.07** Fund balances of restricted current funds represent net assets held for specified operating activities that have not yet been used. The portion of the fund balances, if any, that represents amounts contributed with donor-imposed restrictions should be classified as temporarily restricted net assets. Fund balances representing amounts received with limitations other than donor-imposed restrictions, such as contractual limitations, should be classified as unrestricted net assets. Any portion of the fund balances that represents unearned revenue resulting from exchange transactions should be classified as a liability.

## Plant (or Land, Building, and Equipment) Funds

**16.08** Some not-for-profit organizations record plant and equipment (and resources held to acquire them) in a plant (or land, building, and equipment) fund or funds. A *plant fund* may be a single group of accounts or may be subdivided into some or all of the following subfund account groups:

- Unexpended plant funds
- Funds for renewal and replacement
- Funds for retirement of indebtedness
- Investment (or net investment) in plant

**16.09** Unexpended plant fund balances and renewals and replacement fund balances represent net assets that have not yet been used to acquire, renew, and replace plant and equipment. Retirement-of-indebtedness fund balances represent net assets held to service debt related to the acquisition or construction of plant and equipment. The portion of those fund balances that represents amounts received with donor-imposed restrictions should be classified in a statement of financial position as temporarily restricted or permanently restricted net assets, depending on the nature of the restrictions. Other fund balances, including those arising under agreements with trustees under bond indentures and those designated by the organization's governing board for the purchase, construction, renewal, or replacement of property and equipment should be classified as unrestricted net assets.[6]

**16.10** Investment-in-plant fund balances represent assets invested in property and equipment less any liabilities related to those assets. These fund balances should be classified as permanently restricted net assets to the extent

---

[6] Board designations and other limitations on the use of unrestricted net assets stipulated by entities other than donors can be described on the face of the financial statements or in the notes. Paragraphs 3.07 and 11.15 of this guide discuss such disclosures.

that (1) donors have imposed restrictions on the assets' use that neither expire by passage of time nor can be fulfilled or removed by actions of the organization—for example, land that must be held in perpetuity—or (2) the proceeds from the ultimate sale or disposal of contributed assets must be reinvested in perpetuity. Amounts representing property and equipment donated or acquired with donor-imposed restrictions that expire by passage of time or that can be fulfilled or removed by actions of the organization should be classified as temporarily restricted net assets. Amounts representing gifts of property and equipment received without donor-imposed restrictions about how long the assets must be used should be classified as either unrestricted or temporarily restricted net assets, depending on the accounting policy adopted by the organization.[7] Amounts representing property and equipment acquired with unrestricted resources or with resources whose use is limited by parties other than donors should be classified as unrestricted net assets. Significant limitations on the use of property and equipment should be described in notes to the financial statements.[8]

## Loan Funds

**16.11** Some not-for-profit organizations use loan funds to account for loans made to students, employees, and other constituents and resources available for those purposes. The assets initially made available for the loans may be provided by donors or various governmental and other granting agencies or designated by governing boards. These organizations or individuals may also stipulate qualifications for individual borrowers. Some loan funds are self-perpetuating—that is, the principal and interest repayments on outstanding loans are used to make additional loans. Other loan funds are created on a temporary basis, and the original resource providers must be repaid. In some situations, repayments may be forgiven by resource providers if certain conditions are met.

**16.12** Fund balances of loan funds represent net assets available for lending. The portion of the fund balances representing net assets restricted by donors in perpetuity for use in making loans (for example, a revolving fund) should be classified as permanently restricted. The portion of the fund balances representing net assets temporarily restricted by donors (for example, if, each year, a portion of the fund may be used for the unrestricted purposes of the organization) should be classified as temporarily restricted. Amounts that have been designated by governing boards to be used as loan funds, such as amounts designated as matching funds for government loan programs (for example, government loans to students that require colleges and universities to match a portion of those loans) and other amounts used for loans that have not been restricted by donors, should be classified as unrestricted net assets. Any portion of loan fund balances that represents refundable advances, such as under a government loan program, should be reported as a liability.

---

[7] Paragraph 9.05 of this guide discusses alternative accounting policies concerning the contribution of long-lived assets received without donor-imposed restrictions.

[8] Examples of significant limitations on the use of property and equipment that should be described in the notes to the financial statements are provided in paragraph 9.15 of this guide.

## Endowment Funds

**16.13** Some not-for-profit organizations record cash, securities, or other assets held to provide income for the maintenance of the organization in an endowment fund or funds. Three kinds of endowment may be identified: permanent endowment, term endowment, and quasi endowment, or funds functioning as endowment. *Permanent endowment* refers to amounts that have been contributed with donor-specified restrictions that the principal be invested in perpetuity; income from those investments may also be restricted by donors. *Term endowment* is similar to permanent endowment, except that at some future time or upon the occurrence of a specified future event, the resources originally contributed become available for unrestricted or purpose-restricted use by the entity. *Quasi endowment* refers to resources designated by an entity's governing board to be retained and invested for specified purposes for a long but unspecified period.

**16.14** Fund balances of endowment funds represent net assets for which various limitations exist on the use of the resources invested and, in some cases, on the income generated by those resources. Amounts that represent net assets restricted by donors in perpetuity should be classified as permanently restricted. If donor-imposed restrictions exist that preclude the use of gains and losses (net appreciation) on permanent endowment, either as a result of explicit or implicit donor stipulation or by the organization's interpretation of the relevant law, those gains and losses should also be classified as permanently restricted. In the absence of such restrictions, those gains and losses should be classified as temporarily restricted or unrestricted, depending on the existence or absence of temporary restrictions imposed by the donor. Paragraph 8.34 of this guide and its related footnote provide additional information about the classification of the net assets of endowment funds.

**16.15** Fund balances that represent term endowments for which the principal must be maintained for a specific period or must be used at the end of the term for a specified purpose should be classified as temporarily restricted net assets. Amounts representing resources that will be permanently restricted at the end of a specified term should be classified as permanently restricted net assets.

**16.16** Fund balances that represent quasi endowments or other amounts designated by the organization's governing board should be classified as unrestricted net assets unless donor-imposed restrictions exist on their use. Board designations are permitted to be disclosed, as discussed in paragraphs 3.07 and 11.15 of this guide.

## Annuity and Life-Income (Split-Interest) Funds

**16.17** Annuity and life-income (or split-interest) funds may be used by not-for-profit organizations to account for resources provided by donors under various kinds of agreements in which the organization has a beneficial interest in the resources but is not the sole beneficiary. These agreements include charitable lead and remainder trusts, charitable gift annuities, and pooled (life) income funds. Split-interest agreements are discussed in chapter 6, "Split-Interest Agreements," of this guide.

**16.18** Fund balances of annuity and life-income funds represent a not-for-profit organization's beneficial interest in the resources contributed by donors under split-interest agreements. Any portion of the fund balances representing

amounts that will become part of permanent endowment when the agreements terminate should be classified as permanently restricted net assets. Any portion of the fund balances representing amounts that will be available for restricted purposes, or available for unrestricted use, by the entity when agreements terminate should be classified as temporarily restricted net assets. Any portion of the fund balances representing amounts that are available for unrestricted purposes should be classified as unrestricted net assets.

## Agency (Or Custodian) Funds

**16.19** Agency (or custodian) funds are used by not-for-profit organizations to account for resources held by the entity as an agent for resource providers before those resources are transferred to third-party recipients specified by the resource providers. The entity has little or no discretion over the use of those resources. Accounting for agency transactions and distinguishing agency transactions from contributions are discussed in chapter 5, "Contributions Received and Agency Transactions," of this guide. Because the assets and liabilities are always equal in agency funds, no net assets are reported.

## Summary

**16.20** The following exhibit summarizes the net asset classes into which various kinds of fund balances will typically be classified.

**Typical Classification of Fund Balances**

| | *Net Asset Class* | | |
|---|---|---|---|
| *Fund Type* | *Permanently Restricted* | *Temporarily Restricted* | *Unrestricted* |
| Unrestricted Current (or Unrestricted Operating or General) | Not applicable | Contributions with donor-imposed restrictions that expire with the passage of time (not usually present in unrestricted current funds) | Unrestricted fund balances, including those designated by governing bodies for specific purposes |
| Restricted Current (or Restricted Operating or Specific Purpose) | Not applicable | Contributions with donor-imposed restrictions that expire with the passage of time or that can be fulfilled or removed by actions of the organization | Unrestricted fund balances, including those designated by governing bodies for specific purposes[1] |
| Plant (or Land, Building, and Equipment) | Contributions with donor-imposed restrictions that do not expire with the passage of time or cannot be fulfilled or removed by actions of the organization[2] | Contributions with donor-imposed restrictions that expire with the passage of time or that can be fulfilled or removed by actions of the organization[3] | Unrestricted fund balances, including those designated by governing bodies for specific purposes[4] |

| | Net Asset Class | | |
|---|---|---|---|
| *Fund Type* | *Permanently Restricted* | *Temporarily Restricted* | *Unrestricted* |
| Loan | Contributions with donor-imposed restrictions that do not expire with the passage of time or can not be fulfilled or removed by actions of the organization | Contributions with donor-imposed restrictions that expire with the passage of time or that can be fulfilled or removed by actions of the organization | Unrestricted fund balances, including those designated by governing bodies for specific purposes |
| Endowment | Permanent endowment[5] | Temporary (or term) endowment[6] | Quasi endowment[7] |
| Annuity and Life-Income (Split Interests) | Donor-restricted in perpetuity | Amounts available for unrestricted or time-or-purpose restricted use when agreement terminates | Unrestricted fund balances, including those designated by governing bodies for specific purposes |
| Agency (or Custodian) | Not applicable | Not applicable | Not applicable |

[1] Any portion of the fund balances representing unearned revenue from exchange transactions should be classified as a liability.

[2] This would include contributed assets such as land and capitalized collection items that must be held in perpetuity and other contributed assets when donors have stipulated that the proceeds from their ultimate sale or disposal must be reinvested in perpetuity.

[3] Amounts representing assets contributed without donor-imposed restrictions about how long the land, building, or equipment must be used should be classified as unrestricted or temporarily restricted net assets, depending on the accounting policy adopted by the organization.

[4] Amounts representing assets contributed without donor-imposed restrictions about how long the land, building, or equipment must be used should be classified as unrestricted or temporarily restricted net assets, depending on the accounting policy adopted by the organization.

[5] Includes gains and losses on permanent endowment when donor restrictions or law permanently preclude their use.

[6] Includes gains on permanent endowment when donor restrictions or law specify their use.

[7] Includes gains on permanent endowment when donors or laws do not restrict or specify their use.

# Appendix A

## Background Information and Basis for Conclusions

**1.** This appendix provides background information and discusses the comments received on the April 14, 1995, exposure draft that preceded this Audit and Accounting Guide (guide)—Proposed Audit and Accounting Guide *Not-for-Profit Organizations*—and the basis for key conclusions in this guide.

## Background

**2.** In June 1993, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 116, *Accounting for Contributions Received and Contributions Made*, and FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*. At the time those statements were issued, guidance on accounting and reporting by not-for-profit organizations (NPO) was provided by the following AICPA pronouncements:

- Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* *
- Industry Audit Guide *Audits of Colleges and Universities*,* including AICPA Statement of Position (SOP) 74-8, *Financial Accounting and Reporting by Colleges and Universities*
- Audit and Accounting Guide *Audits of Certain Nonprofit Organizations*,* including SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations**

Some of the guidance in those AICPA pronouncements was inconsistent with FASB Statement Nos. 116 and 117.

**3.** In light of the comprehensive changes in generally accepted accounting principles (GAAP) for NPOs resulting from guidance in FASB Statement Nos. 116–117, as well as changes in practice that have occurred subsequent to the issuance of the pronouncements that this guide supersedes, the AICPA's Accounting Standards Executive Committee (AcSEC) and the Not-for-Profit Organizations Committee (the committees) concluded that the AICPA guidance should be completely rewritten, rather than merely revised for conforming changes based on the issuance of FASB Statement Nos. 116–117.

**4.** FASB Statement Nos. 116–117 provide broad, rather than industry-specific, guidance for the various kinds of NPOs. By providing broad guidance directed at critical issues, FASB Statement Nos. 116–117 allow organizations latitude to report relevant information in ways they believe are most useful to financial statements users. Paragraphs 3 and 49 of FASB Statement No. 117 specify that, within the parameters of that statement, the AICPA may provide more specific reporting guidance for certain NPOs.

**5.** In light of the broad standards included in FASB Statement Nos. 116–117 and the belief that like transactions should be accounted for in like ways,

---

* This publication has been superseded by the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.

regardless of the industry in which the organization operates, the committees believe that this guide should apply to all NPOs. Further, this guide should include guidance that is applied consistently by different kinds of NPOs, rather than guidance that differs based on the kind of NPO, such as voluntary health and welfare organizations or private colleges and universities.[1] Accordingly, this guide is directed at NPOs in general and not at specific kinds of such organizations.

**6.** The provisions of SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, have been difficult to implement and applied inconsistently in practice. That difficulty has been due in part to the following:

- The second sentence of paragraph 1 of SOP 87-2 stated that "some of the costs incurred by such organizations are clearly identifiable with fundraising, such as the cost of fund-raising consulting services." It is unclear whether activities that would otherwise be considered program activities should be characterized as program activities if they are performed or overseen by professional fund raisers. Also, it is unclear whether activities would be reported differently (for example, as program rather than fund raising) depending on whether the fund-raising consultant is compensated by a predetermined fee or by some other method, such as a percentage of contributions raised.
- SOP 87-2 was unclear about whether allocation of costs to fund-raising expense is required if the activity for which the costs were incurred would not have been undertaken without the fund-raising component.
- SOP 87-2 defined joint costs examples, and it is therefore unclear what kinds of costs were covered by SOP 87-2. For example, it is unclear whether salaries and indirect costs can be joint costs.
- Some believe the guidance in SOP 87-2 was inadequate to determine whether joint activities, such as those that request contributions and also list the warning signs of a disease, are designed to motivate their audiences to action other than to provide contributions to the entity. It is unclear what attributes the targeted audience should possess in order to conclude that a program function is being conducted.

**7.** In 1992, AcSEC undertook a project to supersede SOP 87-2, to provide clearer guidance than that provided by SOP 87-2, as well as to provide guidance that would improve on the guidance in SOP 87-2. In September 1993, AcSEC released an exposure draft of a proposed SOP, *Accounting for Costs of Materials and Activities of Not-for-Profit Organizations and State and Local*

---

[1] At the same time that Accounting Standards Executive Committee (AcSEC) undertook this project, AcSEC and the Health Care Committee undertook a project to revise the Audit and Accounting Guide *Audits of Providers of Health Care Services*. The guidance in that revised guide *Health Care Organizations* applies to health care providers that are not-for-profit organizations (NPO), as well as to for-profit and governmental health care providers. AcSEC believes that comparability among health care providers is more important than comparability between not-for-profit health care providers and other kinds of NPOs. Accordingly, this guide does not include guidance for not-for-profit health care providers. However, the guidance in *Health Care Organizations* for not-for-profit health care organizations is similar to the guidance in this guide for other NPOs, unless differences are justified for purposes of comparability among health care providers.

*Governmental Entities That Include a Fund-Raising Appeal*, for public comment. AcSEC received more than 300 comment letters on the exposure draft. AcSEC redeliberated the issues based on the comments received.

**8.** In 1996, after redeliberating the issues based on the comments received and making certain revisions to the draft SOP, AcSEC conducted a field test of the draft SOP. The objectives of the field test were to determine whether the provisions of the draft SOP were sufficiently clear and definitive to generate consistent and comparable application of the SOP. Based on the field test results, AcSEC concluded that the provisions of the draft SOP, with certain revisions, were sufficiently clear and definitive to generate consistent and comparable application of the SOP. In March, 1998, AcSEC issued SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising* (AICPA, *Technical Practice Aids*, ACC sec. 10,730). The provisions of that SOP are incorporated in chapter 13 of this guide.

**9.** Some respondents who commented on the exposure draft, as well as some interested parties who followed the project its due process subsequent to the exposure draft, commented that the SOP should be reexposed for public comment. Reasons cited include:

- Approximately three years had passed between the end of the comment period and AcSEC's decision to issue the SOP.
- AcSEC made significant revisions to the SOP subsequent to releasing the exposure draft for comment.

Considering whether a proposed standard should be reexposed for public comment is inherently a subjective process. Factors that AcSEC considered include—

- The significance of changes made to the exposure draft and whether those changes result in guidance that the public did not have an opportunity to consider.
- Whether the scope was revised in such a way that affected entities did not have an opportunity to comment.
- New information about or changes in the nature of the transactions being considered, practice, or other factors.

AcSEC believes that the length of time between exposure and final issuance is not pertinent to whether the SOP should be reexposed for public comment.

**10.** Based on consideration of the factors identified, AcSEC believes that the SOP should not be reexposed for public comment. AcSEC notes that although the SOP has been revised based on comments received on the exposure draft, those revisions do not change the overall model in the SOP. Those revisions were made primarily to clarify the SOP and improve its operationality. Further, AcSEC believes that the project received a high level of attention from interested parties. AcSEC provided working drafts to interested parties and those parties provided input out the process, up to and including the FASB's and the Governmental Accounting Standards Board's (GASB) clearance of SOP 98-2 for issuance.

**11.** Paragraphs 37–66 of this appendix discuss the key issues in the exposure draft and comments received on those issues, as well as the basis for AcSEC's conclusions on those and certain other issues.

## Discussion of Comment Letters and Basis for Conclusions

**12.** In April 1995, the committees released an exposure draft of a proposed Audit and Accounting Guide *Not-for-Profit Organizations* for public comment. The committees received 160 comment letters on the exposure draft. The committees redeliberated the issues based on the comments received. The following is a discussion of the key issues in the exposure draft and comments received on those issues, as well as the basis for the committees' conclusions on those and certain other issues.

## Scope

**13.** The exposure draft proposed that some organizations that have traditionally been considered to be NPOs do not meet the definition of a not-for-profit organization in FASB Statement No. 116. The exposure draft noted that, though FASB Statement No. 117 excludes those organizations from its scope, it contains broad guidelines that would enable them to prepare meaningful financial statements. Accordingly, the exposure draft proposed that, with certain limited exceptions, the guide apply to nongovernmental organizations of the kinds that have traditionally been considered to be NPOs, such as certain social clubs and trade associations, unless they are organized for for-profit purposes, regardless of whether a particular organization meets the definition of a not-for-profit organization in FASB Statement No. 116. Also, the exposure draft noted that certain FASB and other pronouncements apply to organizations other than those that meet the FASB Statement No. 116 definition of a not-for-profit organization (those pronouncements exempt NPOs). Accordingly, the exposure draft noted that organizations that do not meet the FASB Statement No. 116 definition of a not-for-profit organization, regardless of whether they are within the scope of this guide, are required to follow GAAP applicable to for-profit entities, such as FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. Some respondents commented that the guide should revise or clarify the definition of a not-for-profit organization. The committees believe that the intent of the FASB in drafting the definition in FASB Statement No. 116 was that the term *not-for-profit organizations* encompasses all entities defined as *not-for-profit organizations* by FASB Statement No. 116, including the kinds of organizations that were covered by the AICPA pronouncements that are superseded by this guide. Further, the committees believe that the guidance proposed in the exposure draft could create practice problems for entities for which it may be unclear whether they meet that definition. Accordingly, the guide has been revised to provide that the term *not-for-profit organizations* includes the kinds of organizations that were covered by the AICPA pronouncements that are superseded by this guide.

### *Nongovernmental Not-for-Profit Organizations*

**14.** As noted in paragraph 13 of this appendix, the exposure draft proposed that the guide apply to certain kinds of nongovernmental organizations. However, the exposure draft did not define *nongovernmental* and did not include guidance to help identify nongovernmental organizations. Some respondents commented that the guide should define *nongovernmental*. They pointed out that AU section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles (AICPA, *Professional Standards*, vol. 1), establishes separate hierarchies of sources of GAAP for nongovernmental and

governmental entities and that there is diversity in practice concerning how entities are determined to be *nongovernmental*.

**15.** Subsequent to the release of the exposure draft, during a public meeting in which they cleared the proposed Audit and Accounting Guide *Health Care Organizations* for final issuance, the FASB and GASB agreed on the definition of a *government*. Accordingly, this guide incorporates that definition and defines *nongovernment entities* as all entities not meeting the definition of a *government*.

## GAAP Hierarchy

**16.** Paragraph 1.12 of the guide states that NPOs should follow the display guidance in FASB Statement No. 117 and this guide, even though that guidance may conflict with display that would result from applying the guidance in certain pronouncements included in appendix D [paragraph 1.27] of chapter 1, "Introduction," of this guide. (The guidance in appendix D [paragraph 1.27] is included in category (*a*) of the GAAP hierarchy and is a higher category of GAAP than this guide, as discussed in appendix G [paragraph 1.30] of chapter 1.) Paragraph 1.12 does not imply that guidance in this guide is a higher category of GAAP than guidance in category (*a*). Paragraph 1.12 merely addresses the fact that NPOs use a financial reporting display model that differs from the model used by for-profit entities and that the not-for-profit model may not have been contemplated in developing the guidance in some category (*a*) pronouncements.

## Operations

**17.** The exposure draft proposed that "[i]f an intermediate measure of operations is reported, revenues and expenses that are an integral part of an organization's programs or mission and supporting activities should be included in that measure. Expenses related to revenues included in an intermediate measure of operations should also be included in that measure." Some respondents commented that that guidance is more restrictive than the guidance in FASB Statement No. 117 and should be deleted because it would result in unnecessary changes in practice. The committees agreed and therefore concluded that that guidance should be deleted.

## Reporting Expenses

**18.** FASB Statement No. 117 requires that the statement of activities report the gross amounts of revenues and expenses. However, FASB Statement No. 117 permits an exception for investment expenses, such as custodial fees and investment advisory fees, which may be netted against investment revenues, provided that the amount of the expenses is disclosed either on the face of the statement of activities or in the notes to financial statements. In addition, FASB Statement No. 117 provides that voluntary health and welfare organizations should report expenses by their functional and natural classifications in a matrix format, because that information is meaningful to users of voluntary health and welfare organizations' financial statements. Further, FASB Statement No. 117 encourages other NPOs to provide information about expenses by their natural classification. The committees considered whether expenses that are netted against investment revenues should be reported by their functional classification on the separate statement that reports information about expenses by their natural classification as well as by their functional

classification in a matrix format if the organization presents that statement. Similarly, the committees considered whether the natural classification of expenses that are reported by other than their natural classification, such as salaries included in cost of goods sold or facility rental costs of special events reported as direct benefits to donors, should be reported by their natural classification if information about expenses reported by their natural classification is presented. The committees believe that permitting those expenses to be reported as other than by their natural classification defeats the purpose of reporting information about expenses by their natural classification and makes such presentations incomplete. In particular, the committees considered circumstances in which investment expenses or cost of sales include significant payroll and payroll related expenses. The committees believe that that information is useful to those financial statement users and that it should be required to be reported in circumstances in which the separate statement that reports information about expenses by their natural classification as well as by their functional classification in a matrix format is presented.

## Economic Interest

**19.** SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations* (AICPA, *Technical Practice Aids*, ACC sec. 10,610), provides that a not-for-profit organization should consolidate another not-for-profit organization if the reporting organization has certain kinds of control and an economic interest. The SOP provides that an economic interest is "an interest in another entity that exists if (*a*) the other entity holds or utilizes significant resources that must be used for the unrestricted or restricted purposes of the not-for-profit organization, either directly or indirectly by producing income or providing services, or (*b*) the reporting organization is responsible for the liabilities of the other entity." The SOP provides examples of economic interests. Subsequent to issuing the SOP, questions arose concerning whether a not-for-profit organization has an economic interest in another entity if the organization has a right to or a responsibility for the operating results of another entity or, upon dissolution, the reporting entity is entitled to the net assets, or is responsible for any deficit, of another entity. The committees believe that such circumstances result in an economic interest under the definition in the SOP. Accordingly, in applying the guidance in SOP 94-3, NPOs should consider the example of an economic interest included in this guide.

## Noncompliance With Donor-Imposed Restrictions

**20.** In some circumstances, a not-for-profit organization may not be in compliance with donor-imposed restrictions, including requirements that it maintain an appropriate composition of assets (usually cash and marketable securities in amounts needed to comply with all donor restrictions). In their May 7, 1992, letter responding to a request by the FASB about the adequacy of existing accounting and auditing standards, the AICPA's Not-for-Profit Organizations Committee and Not-for-Profit Organizations Guide Task Force said:

> We believe [FASB Statement No. 5, *Accounting for Contingencies*, AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), and AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1)] require that noncompliance with donor-imposed restrictions be disclosed if there is a reasonable possibility that a material contingent liability has been incurred

at the date of the financial statements or there is at least a reasonable possibility that the noncompliance could lead to a material loss of revenue, or cause an entity not to be able to continue as a going concern. Such noncompliance could result in a material contingent liability, result in a material loss of future revenue, or cause the organization to be unable to continue as a going concern.

The committees agree with the conclusions expressed in the May 7, 1992 letter. Accordingly, the guide provides that noncompliance with donor-imposed restrictions should be disclosed if there is a reasonable possibility that a material contingent liability has been incurred at the date of the financial statements or there is at least a reasonable possibility that the noncompliance could lead to a material loss of revenue or could cause an entity to be unable to continue as a going concern.

## Agency Transactions

**21.** The exposure draft, primarily chapter 5, "Contributions Received and Agency Transactions," of this guide, included proposed guidance concerning reporting agency transactions. In addition, the letter transmitting the exposure draft specifically requested comments on issues related to variance power and donor-advised provisions. Some of the guidance included in the exposure draft, as well as tentative conclusions reached during the committees' deliberations concerning issues related to variance power and donor-advised provisions, was more detailed than the guidance concerning agency transactions included in FASB Statement No. 116. In December 1995, the FASB released an exposure draft of a proposed interpretation of FASB Statement No. 116. That interpretation, which is expected to be issued close to the issuance date of this guide, is expected to provide guidance concerning agency transactions. Accordingly, the committees believe that sections of the guide that provide guidance concerning agency transactions beyond the guidance included in FASB Statement No. 116 should be deleted, pending issuance of the FASB's interpretation. The committees expect to revise the guide to incorporate the conclusions included in the interpretation when it is issued.[2]

**22.** FASB Statement No. 116 provides that unconditional promises to give should be recognized as contribution revenue and receivables in the period in which the promise is received. The committees considered the application of that guidance to circumstances in which the reporting organization receives the contribution an agent. The committees concluded that in circumstances in which the reporting organization receives the contribution an agent, the reporting organization has in substance received a contribution when the agent has received the contribution, including unconditional promises to give, on behalf of the reporting organization. Therefore, in order to report meaningful information about the financial position, activities, and changes in net assets of the reporting organization, the committees concluded that if a contribution is transferred to the ultimate recipient an agent, the ultimate recipient should

---

[2] In September 1996, the FASB issued Interpretation No. 42, *Accounting for Transfers of Assets in Which a Not-for-Profit Organization Is Granted Variance Power—an interpretation of FASB Statement No. 116*. In June 1999, FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, superseded FASB Interpretation No. 42, incorporating its guidance into the statement without reconsideration. The provisions of that statement have been incorporated into this guide.

recognize the contribution when sufficient verifiable evidence that the agent has received the promise to give or other assets becomes available. The committees considered whether such guidance is operational, because the reporting organization may have no access to information about contributions that the agent has received on its behalf. The committees believe that in most instances in which agents receive contributions on behalf of the reporting organization, the relationship of the entities will be such that the reporting organization will have access to that information.

## Distinguishing Contributions From Other Kinds of Transactions

**23.** FASB Statement No. 116 includes guidance to help distinguish exchange transactions from contributions. However, that guidance is broad and requires judgment to implement. The exposure draft summarized the guidance in FASB Statement No. 116 concerning distinguishing exchange transactions from contributions and included indicators to help users determine whether certain transactions would be reported as contributions or exchanges. Some respondents commented that the guide should provide more detailed guidance to help distinguish exchange transactions from contributions. In particular, some respondents noted that, due to the nature of governmental entities' missions, it may be particularly difficult to determine whether resources received from governmental entities should be reported as exchange transactions or contributions. The committees deliberated this issue and agreed that they were unable to provide guidance beyond that provided by FASB Statement No. 116 and the exposure draft. Accordingly, the guide includes only the indicators included in the exposure draft.

## Measuring and Reporting Promises to Give

**24.** The exposure draft proposed that unconditional promises to give that are expected to be collected more than one year from the date of the financial statements should be reported at the gross amount of promises to give, less discounts to reflect the present value of estimated future cash flows. The exposure draft also proposed that bad debt expense be reported for the gross amount of promises to give that are expected to be uncollectible and the expense should be reflected in the net asset class in which the contribution revenue is reflected. Also, the exposure draft proposed that any subsequent differences between the estimated and actual uncollectible amounts be reported in the net asset class in which the contribution revenue was originally reflected or in the class in which the net assets are represented.

**25.** Some respondents commented that uncollectible promises to give should not be reported as bad debt expense because such promises are nonreciprocal transactions and the organization incurs no expense if they are not collected. They believe that contributions should be measured at the present value of the amount expected to be collected. Some believe that subsequent-year adjustments due to differences between the amount expected to be collected and the amount actually collected should be reported as adjustments to contributions in the net asset class in which the contribution was originally reported, while others believe that such adjustments should be reported as bad debt expense.

**26.** Others believe that uncollectible promises to give do meet the definition of expenses because such promises are assets and not collecting them is tantamount to an outflow of assets. They note that in some circumstances,

management may elect to make no attempt to collect such amounts, and they believe that the effects of such decisions should be reported in the financial statements.

**27.** Some respondents commented that reporting bad debt expense in the net asset class in which the contribution revenue is reported conflicts with the requirement in FASB Statement No. 117 that expenses be reported as decreases in unrestricted net assets. Some respondents suggested reporting the uncollectibility of promises as a loss, rather than as an expense. Some respondents suggested reporting the uncollectibility of promises as a contrarevenue or as a reduction in contributions with financial statement disclosure of amounts netted.

**28.** The committees agree that uncollectible promises to give should not be reported as expenses on the initial recognition of contributions receivable. The committees believe such uncollectible promises are a factor to consider in determining the fair value of unconditional promises to give, and therefore are not expenses.

## Split-Interest Agreements

**29.** Some donors enter into trust or other arrangements under which NPOs receive benefits that are shared with other beneficiaries. Such agreements are commonly referred to as *split-interest agreements*. The guidance in the guide concerning such agreements is based on the underlying guidance in FASB Statement No. 116, particularly the requirement that unconditional promises to give should be reported as contributions, measured at fair value. Accordingly, the committees concluded that unconditional rights to receive assets under such agreements, such as income streams and residual interests in trusts, should be recognized as contributions measured at fair value, which is generally the present value of expected cash flows.

**30.** The assets related to split-interest agreements are invested and administered by either the organization, a trustee, or a fiscal agent, and distributions are made to a beneficiary or beneficiaries during the term of the agreement. In transactions not involving split-interest agreements, a trustee may hold title to assets in a trust and may have custody of them, but the assets generally are held for the benefit of the beneficiaries, not the trustee. A trustee makes decisions about investing the assets of the trust for the benefit of the holders of the beneficial interests and cannot obtain for itself the benefits represented by those assets. In split-interest agreements, however, a not-for-profit organization acting as trustee has a beneficial interest in the assets of the trust.

**31.** The committees considered whether a not-for-profit organization should report assets held as trustee under such agreements, and related liabilities, in its statement of financial position. The committees considered practice for other transactions in which entities hold assets as trustees. For example, paragraph 20.16 of the AICPA Audit and Accounting Guide *Depository and Lending Institutions* provides that "while a trust department or trust company may have responsibility for the custody of trust assets, they are not assets of the institution and, therefore, should not be included in the institution's financial statements." The committees noted that that guidance may not be analogous to a not-for-profit organization acting as a trustee in a split-interest agreement, because such assets may be assets of the not-for-profit organization. The committees considered whether such assets meet the definition of an asset in FASB Statement of Financial Accounting Concepts No. 6, *Elements of Financial*

*Statements—a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2).* Paragraph 25 of FASB Concepts Statement No. 6 defines assets as "...probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." Paragraph 26 states that—

> An asset has three essential characteristics: (*a*) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (*b*) a particular entity can obtain the benefit and control other's access to it, and (*c*) the transaction or event giving rise to the entity's right to or control of the benefit has already occurred.

The committees concluded that assets held by a not-for-profit organization acting as a trustee in a split-interest agreement meet the definition of an asset because (*a*) the organization has a beneficial interest in assets, (*b*) the organization can obtain the benefit and control other's access to it, and (*c*) the transaction or event giving rise to the organization's right to or control of the benefit (the split interest agreement) has already occurred. Accordingly, the committees believe that assets held by a not-for-profit organization acting as a trustee under a split-interest agreement should be reported differently than other assets held by other entities acting as a trustee. Further, the committees believe that reporting only the unconditional right to receive future cash flows from the trust for the organization's interest, and not the assets and liabilities related to those cash flows, would omit relevant information about the organization's performance during the period, such as the economic resources used to produce those future cash flows, and about the organization's management of those resources.

## Contributed Inventory

**32.** The exposure draft proposed that contributions of inventory should be reported in the period received and should be measured at fair value. The exposure draft stated that the item received should not be recognized as a revenue and asset if it has no value, as might be the case for certain clothing and furniture that cannot be sold by the not-for-profit organization. Current practice under SOP 78-10 is to report contributions of inventory at fair value, provided the organization has a clearly measurable and objective basis for determining the fair value. Further, SOP 78-10 provided that, if the materials are such that values cannot be reasonably determined, such as clothing, furniture, and so forth, which vary greatly in value depending on condition and style, they should not be recorded as contributions. Most respondents that commented on this issue believe that contributed inventory should not be reported at fair value. Many respondents said that the costs of reporting that information would exceed the benefits. They believe that such information is impracticable to obtain, unreliable, and not needed by financial statement users.

**33.** The committees continue to believe that information about the value of contributed inventory is meaningful and that it should be reported. However, the committees recognize that it may be difficult to obtain. Accordingly, the guide provides that, if methods such as the use of estimates, averages, or computational approximations can reduce the cost of measuring the fair value of contributed inventory, use of those methods is appropriate, provided the methods are applied consistently and the results of applying those

methods are reasonably expected not to be materially different from the results of a detailed measurement of the fair value of contributed inventory.

## Investments

**34.** FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, does not address measurement issues concerning investments other than investments in equity securities with readily determinable fair value and all investments in debt securities. Investments not covered by FASB Statement No. 124 are referred to in this guide as *other investments*. The various AICPA Industry Audit Guides, Audit and Accounting Guides, and SOPs that are superseded by this guide included guidance concerning other investments, but that guidance is inconsistent. The committees considered whether the guide should include measurement guidance for other investments, so that all NPOs report other investments similarly. The committees noted that FASB Statement Nos. 115 and 124 provide no guidance for other investments, and that practice for reporting other investments of for-profit entities is diverse. Further, the committees noted that the board's primary reason for excluding other investments from the scope of those projects was practical; including other investments in the scope of those projects could have raised significant issues that might not have been resolved in time to complete those projects on a timely basis. The committees agreed that addressing issues concerning accounting for other investments could have raised significant issues that might not have been resolved in time to complete this guide on a timely basis. Accordingly, this guide retains the measurement guidance for accounting for other investments included in the AICPA publications that are superseded by this guide, until such time as the FASB or AcSEC issues more definitive guidance.

## Reduction in Amounts Charged for Goods or Services

**35.** The exposure draft proposed that, if a not-for-profit organization regularly provides discounts to certain recipients of its goods or services, such as some types of financial aid for students, revenue should be reported net of those discounts. Though the exposure draft was silent concerning whether all financial aid provided by a college and university is a discount, the letter transmitting the exposure draft noted that the committees believe that not all such aid is a discount and specifically asked respondents to comment on this issue. For example, benefits provided in exchange for services, such as free tuition for employees, are expenses rather than discounts. Most respondents that commented on this issue agreed that the guide should provide that benefits provided in exchange for services, such as free tuition for employees, are expenses rather than discounts. The committees agreed that benefits provided in exchange for goods or services provided by a not-for-profit organization are a cost of such goods or services. Accordingly, the guide provides that reductions in amounts charged for goods or services provided by a not-for-profit organization should be reported as expenses if such reductions are given in exchange for services provided to the organization, such as part of a compensation package.

## Total Fund-Raising and Program Expenses

**36.** FASB Statement No. 117 provides that NPOs should report information about expenses reported by their functional classification such as major classes of program services and supporting services. Also, FASB Statement No. 117 provides that the financial statements of NPOs should include certain

minimum information. However, FASB Statement No. 117 includes no requirements concerning reporting total expenses or particular expense categories. The committees considered whether the guide should require NPOs to report information other than the minimum information required by FASB Statement No. 117. In particular, the committees considered whether information about total fund-raising and total program expenses should be reported. The committees concluded that information about total fund-raising and program expenses is meaningful and useful to users of not-for-profit organization's financial statements. Further, the committees agree that information about total fund-raising expenses is particularly meaningful to those financial statement users. Accordingly, the guide provides that the financial statements should disclose total fund-raising expenses and that information about total program expenses should be provided by either disclosing total program expense or by presenting information about the components of total program expenses on the details provided on the face of the statement of activities.

## Costs of Joint Activities

### *Overall Framework*

**37.** SOP 98-2 uses the model in SOP 87-2 as a starting point and clarifies guidance that was unclear, provides more detailed guidance, revises some guidance, and expands the scope of costs covered to include all costs of joint activities. The model established by SOP 87-2 was to account for joint costs as fund raising unless an entity could demonstrate that a program or management and general function had been conducted. SOP 87-2 used verifiable indications of the reasons for conducting the activity, such as content, audience, the action requested, if any, and other corroborating evidence as a basis for determining whether a program or management and general function had been conducted.

**38.** On an overall basis, the majority of respondents who commented on the September 1993 exposure draft of a proposed SOP, *Accounting for Costs of Materials and Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include a Fund-Raising Appeal*, opposed it, for various reasons, including the following:

- The guidance in SOP 87-2 is operational, results in sound financial reporting, and should be retained.
- The guidance in SOP 87-2 should be retained but clarified.
- The guidance proposed in the exposure draft should be revised. (Some commented that it overstates fund raising; others commented that it understates fund raising.)

**39.** AcSEC concluded that it supports the model in the exposure draft, subject to certain revisions. AcSEC believes that SOP 98-2 provides clear, detailed accounting guidance that, when applied, will increase comparability of financial statements. Those statements will also include more meaningful disclosures without incurring increased costs.

**40.** Some respondents commented that the model in the exposure draft would adversely affect entities both financially and operationally. Various reasons were given, including the following:

- It would inhibit the ability of entities, particularly small entities and entities that raise contributions direct solicitations, to generate the necessary revenue to perform their program services.
- *Most entities would not meet the criteria in SOP 98-2 for reporting costs of joint activities as program or management and general, because they must combine their mission statements, public information and education, and fund-raising appeals due to a lack of resources. Some noted that this may result in unsatisfactory ratings from public watchdog groups.*

AcSEC did not find these arguments compelling. SOP 98-2 provides accounting guidance; it provides no guidance concerning how entities should undertake their activities. Also, SOP 98-2 does not prohibit allocation merely because activities carrying out different functions are combined. In fact, SOP 98-2 provides guidance for reporting costs as program or management and general in circumstances in which those activities are combined with fund-raising. Moreover, actions taken by financial statement users are not the direct result of the requirements of SOP 98-2. Rather, those actions may result from more relevant and useful information on which to base decisions.

**41.** Some respondents commented that the exposure draft is biased toward reporting expenses as fund raising. AcSEC believes that determining whether the costs of joint activities should be classified as program, management and general, or fund raising sometimes is difficult, and such distinctions sometimes are subject to a high degree of judgment. AcSEC believes that external financial statement users focus on and have perceptions about amounts reported as program, management and general, and fund raising. That focus and those perceptions provide incentives for entities to report expenses as program or management and general rather than fund raising. Therefore, in circumstances in which joint activities are conducted, a presumption exists that expenses should be reported as fund raising rather than as program or management and general. The criteria in SOP 98-2 provide guidance for entities to overcome that presumption.

### *Accounting for Joint Activities*

**42.** SOP 98-2 requires that if any of the criteria of purpose, audience, and content are not met, all costs of the activity should be reported as fund raising, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund raising. (SOP 98-2 expands on the model established by SOP 87-2 by including all costs of joint activities other than costs of goods or services provided in exchange transactions, rather than merely joint costs.) AcSEC believes that the criteria of purpose, audience, and content are each relevant in determining whether a joint activity should be reported as fund raising, program, or management and general because each provides significant evidence about the benefits expected to be obtained by undertaking the activity.

**43.** Some respondents commented that reporting costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity as fund raising is misleading and that the scope of the SOP should include only joint costs of joint activities. Some

commented that reporting costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity as fund raising conflicts with FASB Statement No. 117, which defines fund raising, program, and management and general and requires NPOs to report information about expenses using those functional classifications.

**44.** AcSEC believes that the purpose for which costs other than joint costs are incurred may be fund raising, program, or management and general, depending on the context in which they are used in the activity undertaken. For example, a program-related pamphlet may be sent to an audience in need of the program. In that context, the pamphlet is used for program purposes. However, in order to demonstrate to potential donors that the entity's programs are worthwhile, that same pamphlet may be sent to an audience that is likely to contribute, but that has no need or reasonable potential for use of the program. In that context, the pamphlet is used for fund raising. AcSEC believes this broader scope will result in more comparability and more meaningful financial reporting by covering all costs of activities that include fund raising and by assigning those costs to the function for which they are incurred, consistent with the guidance in FASB Statement No. 117.

**45.** AcSEC believes that costs of goods or services provided in exchange transactions should not be charged to fund raising because those costs are incurred in exchange for revenues other than contributions.

### *Criteria of Purpose, Audience, and Content*

**46.** *Call For Action.* The definition of *program* in FASB Statement No. 117 includes public education. As noted in paragraph 41 of this appendix, AcSEC believes that in circumstances in which joint activities are conducted, a presumption exists that expenses should be reported as fund raising rather than as program or management and general. AcSEC believes that in order to overcome that presumption, it is not enough that (*a*) the purpose of the activity include educating the public about causes, (*b*) the audience has a need or reasonable potential for use of any educational component of the activity pertaining to causes, or (*c*) the audience has the ability to assist the entity in meeting the goals of the program component of the activity by becoming educated about causes. Therefore, AcSEC concluded that for purposes of SOP 98-2, in order to conclude that the criteria of purpose, audience, and content are met program activities are required to call for specific action by the recipient (other than becoming educated about causes) that will help accomplish the organization's mission. As discussed in paragraph 13.44, in certain circumstances educational activities may call for specific action by the recipient that will help accomplish the entity's mission.

**47.** *Purpose.* AcSEC believes meeting the purpose criterion demonstrates that the purpose of the activity includes accomplishing program or management and general functions. Inherent in the notion of a joint activity is that the activity has elements of more than one function. Accordingly, the purpose criterion provides guidance for determining whether the purpose of the activity includes accomplishing program or management and general functions in addition to fund raising.

**48.** *Compensation and Evaluation Tests.* The exposure draft proposed that all costs of the joint activity should be charged to fund raising if (*a*) substantially all compensation or fees for performing the activity are based on amounts raised or (*b*) the evaluation of the party performing the activity is based on amounts

raised. Some respondents commented that basing the method of compensation or evaluating the performance of the party performing the activity based on contributions raised should not lead to the conclusion that all costs of the activity should be charged to fund raising. Others commented that the method of compensation is unrelated to whether the purpose criterion is met. The reasons given included the following:

- It is counterintuitive to imply that those performing multipurpose activities that include fund raising would not be compensated or evaluated based on amounts raised.
- Such guidance would create a bias toward entities that use employees to raise contributions and against entities that hire professional fund raisers and public relations firms and is therefore not neutral.

Some respondents gave examples of circumstances in which substantially all compensation is based on contributions raised and asserted that the activity was nevertheless a program activity. In each of those examples, AcSEC considered all the facts presented and concluded that the activity was fund raising.

**49.** AcSEC continues to support the spirit of the proposed guidance, because AcSEC believes that basing a majority of compensation on funds raised is persuasive evidence that the activity is a fund-raising activity. Nevertheless, AcSEC believes that the proposed guidance was unclear and would be difficult to implement, primarily because of the broad definition of "based on contributions raised" included in the glossary of the exposure draft. In connection with that issue, AcSEC was concerned that any joint activities performed by a fund-raising department or by individuals whose duties include fund raising, such as executive officers of small NPOs who are employed based on their ability to raise contributions, would be required to be reported as fund raising because the compensation of the parties performing those activities is based on amounts raised. Also, AcSEC had concerns that it would be difficult to determine whether fixed contract amounts were negotiated based on expected contributions. Therefore, AcSEC concluded that the compensation test should be revised to provide that the purpose criterion is not met if a majority of compensation or fees for any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity. AcSEC believes that guidance is sound and is operational.

**50.** AcSEC believes that the guidance in paragraph 13.45*a* is not biased against entities that hire professional fund raisers, because it applies to the entity's employees as well as professional fund raisers. For example, if a majority of an employee's compensation or fees for performing a component of a discrete joint activity varies based on contributions raised for that discrete joint activity, the purpose criterion is not met.

**51.** *Similar Function-Similar Medium Test.* Some respondents misinterpreted the exposure draft as providing that, in order to meet the purpose criterion, the program or management and general activity must be conducted without the fund-raising component, using the same medium and on a scale that is similar to or greater than the program or management and general component of the activity being accounted for. That was not a requirement proposed by the exposure draft. The exposure draft proposed that meeting that condition would result in meeting the purpose criterion. Failing the criterion

merely leads to consideration of other evidence, such as the indicators in paragraph 13.46. AcSEC has revised SOP 98-2 to state this more clearly.

**52.** *Other Evidence.* The compensation test and the similar function-similar medium test may not always be determinative because the attributes that they consider may not be present. Therefore, SOP 98-2 includes indicators that should be considered in circumstances in which the compensation test and the similar function-similar medium test are not determinative. The nature of those indicators is such that they may be present in varying degrees. Therefore, all available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, the purpose criterion is met.

**53.** *Audience.* The exposure draft proposed that if the audience for the materials or activities is selected principally on its ability or likelihood to contribute, the audience criterion is not met and all the costs of the activity should be charged to fund raising. Further, the exposure draft proposed that if the audience is selected principally based on its need for the program or because it can assist the entity in meeting its program goals other than by financial support provided to the entity, the audience criterion is met. Some respondents commented that the audience criterion is too narrow, because it is based on the principal reason for selecting the audience. They asserted that for some activities no principal reason exists for selecting an audience; entities select the audience for those activities for multiple reasons, such as both the audience's ability to contribute and its ability to help meet program goals. Some commented that for some activities, entities select audiences that have provided past financial support because, by providing financial support, those audiences have expressed an interest in the program.

**54.** AcSEC believes that meeting the audience criterion should demonstrate that the audience is selected because it is a suitable audience for accomplishing the activity's program or management and general functions. Therefore, the reasons for selecting the audience should be consistent with the program or management and general content of the activity. However, AcSEC believes it is inherent in the notion of joint activities that the activity has elements of more than one function, including fund raising, and acknowledges that it may be difficult to determine the principal reason for selecting the audience. Accordingly, AcSEC concluded that if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute, a rebuttable presumption should exist that the audience was selected to raise funds. AcSEC believes that the reasons for selecting the audience that can overcome that presumption, which are included in paragraph 13.48, demonstrate that the audience is selected because it is a suitable audience for accomplishing the activity's program or management and general functions based on the program or management and general content of the activity.

**55.** *Content.* AcSEC believes that meeting the content criterion demonstrates that the content of the activity supports program or management and general functions. AcSEC believes that accounting guidance should not impose value judgments about whether the entity's mission, programs, and responsibilities are worthwhile. Therefore, whether the content criterion is met depends on the relationship of the content to the entity's mission, programs, and management and general responsibilities.

**56.** Paragraph 13.49 provides that, to meet the content criterion, program activities should call for specific action by the recipient that will help accomplish the entity's mission. The exposure draft proposed that slogans, general calls to prayer, and general calls to protest do not meet the content criterion; some respondents disagreed. AcSEC concluded that SOP 98-2 should be silent concerning whether slogans, general calls to prayer, and general calls to protest are calls to action that meet the content criterion. AcSEC believes that determining whether those items are calls to action that meet the content criterion requires judgments based on the particular facts and circumstances.

**57.** Some respondents commented that educating the public about causes without calling for specific action should satisfy the content criterion. They noted that this is particularly relevant for NPOs subject to Internal Revenue Code (IRC) section 501(c)4, because those NPOs are involved in legislative reform. Also, some noted that it may be the entity's mission or goal to educate the public about causes. They believe that, in those cases, the NPO's program is to educate the public about causes without necessarily calling for specific action by the recipient.

**58.** As discussed in paragraph 46 of this appendix, AcSEC concluded that education that does not motivate the audience to action is in fact done in support of fund raising. However, SOP 98-2 acknowledges that some educational messages motivate the audience to specific action, and those messages meet the content criterion. AcSEC believes that the provision will result in the activities of some NPOs subject to IRC section 501(c)4 (and some other entities, whose mission or goal is to educate the public) meeting the content criterion.

**59.** Paragraph 13.48*c* provides that one way that the audience criterion is met is if the entity is required to direct the management and general component of the activity to the particular audience. Further, as discussed in paragraph 10 of appendix E [paragraph 13.65] to chapter 13 (*Discussion of Conclusions*), an audience that includes prior donors and is selected because the entity is required to send them certain information to comply with requirements of the Internal Revenue Service (IRS) is an example of an audience that is selected because the entity is required to direct the management and general component of the activity to that audience. Paragraph 13.49*b*provides that one way that the content criterion is met is if the activity fulfills one or more of the entity's management and general responsibilities a component of the joint activity. However, footnote 22 to paragraph 13.49*b* provides that disclosures made when soliciting contributions to comply with requirements of states or other regulatory bodies are considered fund-raising activities, and are not considered management and general activities. AcSEC considered whether it is inconsistent to conclude both that (*a*) activities conducted to comply with requirements of regulatory bodies concerning contributions that have been received are management and general activities, and that (*b*) activities conducted to comply with requirements of regulatory bodies concerning soliciting contributions are fund-raising activities. AcSEC believes that those provisions are not inconsistent. AcSEC believes there is a distinction between (*a*) requirements that must be met as a result of receiving contributions and (*b*) requirements that must be met in order to solicit contributions. AcSEC believes that activities that are undertaken as a result of receiving contributions are management and general activities while activities that are undertaken in order to solicit contributions are fund-raising activities.

### Incidental Activities

**60.** Many entities conduct fund-raising activities in conjunction with program or management and general activities that are incidental to such program or management and general activities. Similarly, entities may conduct program or management and general activities in conjunction with fund-raising activities that are incidental to such fund-raising activities. Such efforts may be a practical and efficient means for entities to conduct activities, although the principal purpose of the activity may be to fulfill either fund-raising, program, or management and general functions. The exposure draft proposed that incidental activities need not be considered in applying SOP 98-2. Some respondents disagreed with that guidance, while others commented that it was confusing. AcSEC continues to support that guidance. AcSEC believes that guidance is necessary to avoid requiring complex allocations in circumstances in which the criteria of purpose, audience, and content are met but the activity is overwhelmingly either fund raising, program, or management and general.

### Allocation Methods

**61.** Respondents had various comments concerning allocation methods, including the following:

- The SOP should focus on allocation methods rather than on circumstances in which entities should allocate.
- The SOP should prescribe allocation methods.
- The approach taken in the SOP—discussing, rather than requiring or prohibiting allocation methods—is sound.
- Certain allocation methods should be prohibited.
- The SOP should set maximum allocation percentages.

AcSEC believes that no particular allocation method or methods are necessarily more desirable than other methods in all circumstances. Therefore, SOP 98-2 neither prescribes nor prohibits any particular allocation methods. AcSEC believes entities should apply the allocation methods that result in the most reasonable cost allocations for their activities. Appendix C to chapter 13 [paragraph 13.63] illustrates several allocation methods, any one of which may result in a reasonable or unreasonable allocation of costs in particular circumstances. The methods illustrated are not the only acceptable methods. However, AcSEC believes that the methods illustrated in SOP 98-2 are among those most likely to result in meaningful cost allocations.

**62.** Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*, states in paragraph 7 that "the term *accounting principle* includes 'not only accounting principles and practices but also the methods of applying them.'" APB Opinion 20 also states in paragraphs 15–16 that

> ...In the preparation of financial statements there is a presumption that an accounting principle once adopted should not be changed in accounting for events and transactions of a similar type....The presumption that an entity should not change an accounting principle may be overcome only if the enterprise justifies the use of an alternative acceptable accounting principle [*allocation method*] on the basis that it is preferable.

A change in cost allocation methodology may be a change in accounting principle for entities covered by SOP 98-2. Accordingly, paragraph 13.51 of SOP 98-2 provides that the cost allocation methodology used should be applied consistently, given similar facts and circumstances.

### *Disclosures*

**63.** Respondents made various comments concerning the required and encouraged disclosures, including recommendations for additional disclosures and recommendations that certain disclosures be deleted. AcSEC was not persuaded that the costs of the other disclosures recommended by respondents are justified by their benefits. AcSEC believes that, with the exception of one disclosure, the disclosures prescribed by the exposure draft provide relevant information about the kinds of activities for which joint costs have been incurred and the manner in which those costs are reported in the financial statements. In considering disclosures proposed by the exposure draft about the allocation method, AcSEC observed that there are no requirements to disclose methods of allocating other expenses and questioned the utility of disclosing the allocation method in this circumstance. AcSEC concluded that the requirement to disclose the allocation method should be deleted.

**64.** Paragraph 13.54 encourages, but does not require, certain disclosures. AcSEC believes those disclosures provide useful information but that they should be encouraged rather than required because the costs of making them may not be justified by the benefits in all cases.

### *Effective Date of SOP 98-2*

**65.** Some respondents commented that the effective date should be deferred. AcSEC believes that the accounting systems required to implement SOP 98-2 are already in place and that implementation should be relatively straightforward. However, AcSEC acknowledges that some entities may change their operations based on the reporting that would result from SOP 98-2. Therefore, AcSEC concluded that SOP 98-2 should be effective for financial statements for years beginning on or after December 15, 1998.

### *Cost-Benefit*

**66.** Some respondents commented that the guidance would increase record keeping costs. AcSEC believes that implementing SOP 98-2 will not significantly increase record keeping costs, which are primarily the costs of documenting reasons for undertaking joint activities. Further, AcSEC believes that the costs of making the disclosures required by SOP 98-2 should be minimal, because entities should already have the information that is required to be disclosed. AcSEC believes that implementing SOP 98-2 will result in more relevant, meaningful, and comparable financial reporting and that the cost of implementing SOP 98-2 will be justified by its benefits.

## Illustrative Financial Statements

**67.** The exposure draft did not include illustrative financial statements. FASB Statement No. 117 includes illustrative financial statements; however, those statements illustrate the application of the requirements of FASB Statement No. 117 in a broad manner, rather than illustrating the application of those requirements to specific kinds of organizations, such as colleges and universities, museums, or voluntary health and welfare organizations. The

guide includes illustrations of certain portions of financial statements, as well as certain illustrative disclosures, though it does not include illustrations of industry-specific financial statements. Some respondents commented that the guide should include industry-specific illustrative financial statements.

**68.** The committees concluded that the guide should not be revised at this time to include illustrative financial statements that are more detailed than the illustrative financial statements included in FASB Statement No. 117. Though future editions of the guide may include illustrative financial statements that are more detailed than the illustrative financial statements included in FASB Statement No. 117, the committees believe that the initial version of the guide should not include such illustrative financial statements because practice is developing in this area. The committees believe practice should continue to develop and do not wish to inhibit that development by including illustrations that may, for practical purposes, become practice. The committees also believe the guide should be issued as soon as practicable and that including illustrative financial statements would likely delay its issuance. The committees believe that illustrative financial statements will likely be included in other, nonauthoritative sources, such as continuing professional education courses and manuals issued by industry groups.

## Transition

**69.** The transition rules in this guide provide that if there is more than one change in accounting principle as a result of applying the guidance in paragraphs 1.06–.17 of this guide, entities have the option of either applying the transition rules in the principles being adopted or reporting the cumulative effect of adopting those principles. The committees considered requiring all changes in accounting principles that result from applying the guidance in paragraphs 1.06–.17 of this guide to be reported using the transition rules of the pronouncements being adopted. Also, the committees considered requiring reporting the cumulative effect of all such changes, even in circumstances in which only one principle is adopted. The committees permitted reporting the cumulative effect in circumstances in which there is more than one change in accounting principle because applying the transition rules in each principle adopted may result in confusing information, the benefits of which would not exceed its costs. However, the committees concluded that in circumstances in which there is only one change in accounting principle, it would be inconsistent with the principle being adopted to conclude that the cost of applying the transition rules of the principle being adopted exceeds the benefits of applying those transition rules.

# Appendix B

## *Statement of Position 92-9, Audits of Not-for-Profit Organizations Receiving Federal Awards*

**With Conforming Changes as of December 18, 1995, Resulting From the Issuance of *Government Auditing Standards: 1994 Revision* and Statement on Auditing Standards No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance***

**Prepared by the
Not-for-Profit Organizations Committee**

**American Institute of
Certified Public Accountants**

**[Superseded by the issuance of SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards.* Refer to the AICPA Audit Guide Government Auditing Standards *and Circular A-133 Audits.*]**

# Appendix C

## *Statement of Position 98-2, Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*

**March 11, 1998**

**Amendment to**
**AICPA Audit and Accounting Guides *Health Care Organizations, Not-for-Profit Organizations,* and *Audits of State and Local Governmental Units***

### NOTE

[SOP 98-2 is incorporated within chapter 13 and appendix A of the guide as shown below:

Introduction: paragraph 1 incorporated in paragraph 13.41. The remainder is deleted.

Scope: deleted.

Conclusions: paragraphs 7–19 were moved to paragraphs 13.42–.55.

Effective Date: deleted.

Appendix A: Incorporated in appendix A to chapter 13 [paragraph 13.62].

Appendix B: Incorporated in paragraphs 6–11 of appendix A of the guide.

Appendix C: Incorporated in paragraphs 37–66 of appendix A of the guide.

Appendix D: Selected paragraphs incorporated in appendix E to chapter 13 [paragraph 13.66].

Appendix E: Incorporated in appendix B to chapter 13 [paragraph 13.63].

Appendix F: Incorporated in appendix C to chapter 13 [paragraph 13.64].

Appendix G: Incorporated in appendix D to chapter 13 [paragraph 13.65].

Appendix I: Changes made as indicated in chapter 13.

The table of contents, summary, foreword, scope paragraph, and appendix H have been deleted.]

SOP 98-2 can be found in its entirety in the AICPA publication *Technical Practice Aids*.

# Appendix D

## *Statement of Position 98-3, Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*

**[Deleted as a result of the conversion of SOP 98-3 to an AICPA Audit Guide *Government Auditing Standards and Circular A-133 Audits*.]**

# Appendix E

## *Information Sources*

Further information on matters addressed in this guide is available through various publications and services listed in the table that follows. Many non-government and some government publications and services involve a charge or membership requirement.

Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow the user to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

All telephone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed for data lines.

## Information Sources

| Organization | General Information | Fax Services | Web Site |
|---|---|---|---|
| **American Institute of Certified Public Accountants** | *Order Department*<br>220 Leigh Farm Road<br>Durham, NC 27707<br>(888) 777-7077<br>Information about AICPA CPE programs is available by calling (888) 777-7077 | *24 Hour Technical Hotline*<br>(877) 242-7212 | *AICPA Home Page*<br>The AICPA home page is currently located at www.aicpa.org. |
| **Financial Accounting Standards Board** | *Order Department*<br>P.O. Box 5116<br>Norwalk, CT 06856-5116<br>(800) 748-0659 | | The FASB home page is currently located at www.fasb.org. |
| **U.S. Department of Education** | Office of Inspector General<br>U.S. Department of Education, 400 Maryland Ave. SW<br>Washington, D.C. 20202<br>(800) 872-5327 | | The U.S. Department of Education home page is currently located at www.ed.gov. |
| **U.S. Office of Management and Budget** | Office of Administration<br>Publications Office<br>725 17th Street, NW<br>Washington, D.C. 20503<br>(202) 395-3080 | *24 Hour Fax Hotline*<br>(202) 395-3504 for certain Circulars and Standards | The OMB home page is currently located at www.whitehouse.gov/omb/.<br>Information pertaining to grants management is available at www.whitehouse.gov/omb/GRANTS. |

| Organization | General Information | Fax Services | Web Site |
|---|---|---|---|
| **National Association of College and University Business Officers** | 1110 Vermont Ave. N.W.<br>Suite 800<br>Washington, D.C. 20005<br>(202) 861-2500<br>(202) 861-2583 (f) | | The NACUBO home page is currently located at www.nacubo.org. |
| **National Health Council** | 1730 M Street, NW<br>Suite 500<br>Washington, D.C. 20036<br>(202) 785-3910<br>(202) 785-5923 (f) | | The National Health Council home page is located at www.nationalhealthcouncil.org. |
| **Other** | | | *The Rutgers Bulletin Board* on the World Wide Web includes various accounting related databases. The address for the home page is http://accounting.rutgers.edu/. |
| **U.S. Government Accountability Office** | U.S. GAO<br>441 G St. NW<br>Washington, D.C. 20548<br>(202) 512-3000<br>(202) 512-6000 Publications | | The GAO has a home page on the World Wide Web. The address is www.gao.gov. |

# Appendix F

## *References to AICPA Technical Practice Aids*

The following nonauthoritative questions and answers, commonly referred to as *Technical Practice Aids* (TPAs), have been prepared by AICPA staff and are included in AICPA *Technical Practice Aids*. The TPAs have not been approved, disapproved, or otherwise acted upon by the Accounting Standards Executive Committee or any other senior technical committee of the AICPA. They are not sources of established accounting principles as described in AU section 411, *The Meaning of* Present Fairly in Conformity with Generally Accepted Accounting Principles (AICPA, *Professional Standards*, vol. 1), nor are they sources of authoritative generally accepted auditing standards. Staff believes the TPAs listed in the following table may be useful and relevant for users of this guide. Other TPAs, as well as Consensus Positions of the FASB's Emerging Issues Task Force, may also be useful and relevant to users of this guide depending on the facts and circumstances.

| TPA Reference No. | Title |
|---|---|
| 1400.32 | Parent-Only Financial Statements and Relationship to GAAP |
| 5400.05 | Accounting and Disclosures Guidance for Losses From Natural Disasters—Nongovernmental Entities |
| 5600.07 | Determining a Lease Term for Accounting Purposes |
| 5600.08 | Lease Term for Accounting Purposes Differs From Term Stated in Lease (Part 1) |
| 5600.09 | Lease Term for Accounting Purposes Differs From Term Stated in Lease (Part 2) |
| 5600.10 | Rent Expense and Rent Revenue in an Operating Lease—General |
| 5600.11 | Rent Expense and Rent Revenue in an Operating Lease—Scheduled Increase in Rental Space |
| 5600.12 | Rent Expense and Rent Revenue in an Operating Lease—Rent Holiday |
| 5600.13 | Rent Expense and Rent Revenue in an Operating Lease—Scheduled Rent Increases |
| 5600.14 | Amortization/Depreciation of Leasehold Improvements in an Operating Lease (Part 1) |
| 5600.15 | Leasehold Improvements and Lease Term in an Operating Lease (Part 2) |
| 5600.16 | Landlord Incentive Allowance in an Operating Lease |
| 5600.17 | Cash Flows Statement Presentation of Landlord Incentive Allowance in an Operating Lease |
| 6140.01 | Inventory Valuation for a Not-For-Profit Scientific Organization |
| 6140.02 | Income Recognition of Membership Dues by Not-For-Profit Organizations |
| 6140.03 | Lapsing of Time Restrictions on Receivables That are Uncollected at Their Due Date |

| TPA Reference No. | Title |
|---|---|
| 6140.04 | Lapsing of Restrictions on Receivables if Purpose Restrictions Pertaining to Long-Lived Assets are Met Before the Receivables are Due |
| 6140.05 | NPO Accounting for Loans of Cash That are Interest Free or That Have Below-Market Interest Rates |
| 6140.06 | Functional Category of Cost of Sales of Contributed Inventory |
| 6140.07 | Functional Category of Costs of Special Events |
| 6140.08 | Functional Category of the Costs of Direct Donor Benefits |
| 6140.09 | Reporting Bad Debt Losses |
| 6140.10 | Consolidation of Political Action Committee |
| 6140.11 | Costs of Soliciting Contributed Services and Time That Do Not Meet the Recognition Criteria in FASB Statement No. 116 |
| 6140.12 | Nondiscretionary Assistance Programs |
| 6140.13 | Note to TIS Section 6140.14 to 6140.18—Implementation of FASB Statement No. 136—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (in the Beneficiary's Financial Statements) |
| 6140.14 | Application of FASB Statement No. 136—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary can influence the operating and financial decisions of the foundation to such an extent that the beneficiary can determine the timing and amount of distributions from the foundation.) |
| 6140.15 | Application of FASB Statement No. 136—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary cannot influence the operating and financial decisions of the foundation to such an extent that the beneficiary can determine the timing and amount of distributions from the foundation.) |
| 6140.16 | Application of FASB Statement No. 136—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (More Than One Beneficiary—Some Contributions Are Designated) |
| 6140.17 | Application of FASB Statement No. 136—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary makes an expenditure that meets a purpose restriction on net assets held for its benefit by the recipient organization—The beneficiary can influence the operating and financial decisions of the recipient to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient.) |

| TPA Reference No. | Title |
|---|---|
| 6140.18 | Application of FASB Statement No. 136—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary makes an expenditure that is consistent with a purpose restriction on net assets held for its benefit by the recipient organization—The beneficiary cannot influence the operating and financial decisions of the recipient to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient.) |
| 6140.19 | Application of FASB Statement No. 136—Classification of Distributions From a Financially Interrelated Fund-Raising Foundation (Recipient Organization) to a Health Care Beneficiary |
| 6140.20 | NPOs Reporting No Fund-Raising Expenses |
| 6140.21 | Should an NPO Report Amounts Charged to the NPO by a Professional Fund-Raiser Gross, as Fund-Raising Expenses, or Net, as a Reduction of Contributions? |
| 6140.22 | In Circumstances in Which the Reporting NPO Undertakes a Transaction in Which Another NPO (Fund-Raising NPO) Raises Contributions on Behalf of the Reporting NPO, and the Reporting NPO Compensates the Fund-Raising NPO for Raising Those Contributions (Compensation Including, But Not Limited to, an Administrative Fee), Should the Reporting NPO Report the Fund-Raising NPO's Compensation Gross, as Fund-Raising Expenses, or Net, as a Reduction of Contributions? |
| 6960.12 | Allocation of Overhead |

# Appendix G

## Comparison of Key Provisions of the Risk Assessment Standards to Previous Standards

This appendix discusses the key provisions of each of the risk assessment related Statements on Auditing Standards (SASs) and provides a summary of how each of the SASs differs, if at all, from the previous AICPA generally accepted audit standards.

## SAS No. 104, *Amendment to Statement on Auditing Standards No. 1,* Codification of Auditing Standards and Procedures ("Due Professional Care in the Performance of Work")

| *Key Provisions* | *How the SAS Differs From Previous Standards* |
|---|---|
| • SAS No. 104 defines *reasonable assurance* as a high level of assurance. | • SAS No. 104 clarifies the meaning of *reasonable assurance*. |

## SAS No. 105, *Amendment to Statement on Auditing Standards No. 95,* Generally Accepted Auditing Standards

| Key Provisions | *How the SAS Differs From Previous Standards* |
|---|---|
| • SAS No. 105 expands the scope of the understanding that the auditor must obtain in the second standard of field work from internal control to the entity and its environment, including its internal control.<br>• The quality and depth of the understanding to be obtained is emphasized by amending its purpose from planning the audit to assessing the risks of material misstatement of the financial statements whether due to error or fraud and to design the nature, timing, and extent of further audit procedures. | • Previous guidance considered the understanding of the entity to be a part of audit planning and emphasized that the understanding of internal control also was primarily part of audit planning.<br>• By stating that the purpose of your understanding of the entity and its internal control is part of assessing the risks of material misstatement, SAS No. 105 essentially considers this understanding to provide audit evidence that ultimately supports your opinion on the financial statements.<br>• SAS No. 105 emphasizes the link between understanding the entity, assessing risks, and the design of further audit procedures. It is anticipated that generic audit programs will not be an appropriate response for all engagements because risks vary between entities.<br>• The term *further audit procedures,* which consists of test of controls and substantive tests, replaces the term *tests to be performed* in recognition that risk assessment procedures are also performed.<br>• The term *audit evidence* replaces the term *evidential matter.* |

## SAS No. 106, *Audit Evidence*

| Key Provisions | *How the SAS Differs From Previous Standards* |
|---|---|
| • SAS No. 106 defines *audit evidence* as all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. | • Previous guidance did not define audit evidence.<br>• SAS No. 106 also describes basic concepts of audit evidence.<br>• The term *sufficient, appropriate audit evidence*, defined in SAS No. 106, replaces the term *sufficient, competent evidence*. |
| • SAS No. 106 recategorizes assertions by classes of transactions, account balances, and presentation and disclosure; expands the guidance related to presentation and disclosure; and describes how the auditor uses relevant assertions to assess risk and design audit procedures. | • SAS No. 106 recategorizes assertions to add clarity.<br>• *Assertion relating to presentation and disclosure* has been expanded and includes a new assertion that information in disclosures should be expressed clearly (understandability). |
| • SAS No. 106 defines *relevant* assertions as those assertions that have a meaningful bearing on whether the account is fairly stated. | • The term *relevant assertions* is new, and it is used repeatedly throughout SAS No. 106. |
| • SAS No. 106 provides additional guidance on the reliability of various kinds of audit evidence. | • The previous standard included a discussion of the competence of evidential matter and how different types of audit evidence may provide more or less valid evidence. SAS No. 106 expands on this guidance. |
| • SAS No. 106 identifies *risk assessment procedures* as audit procedures performed on all audits to obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and relevant assertion levels. | • SAS No. 106 introduces the concept of risk assessment procedures, which are necessary to provide a basis for assessing the risks of material misstatement. The results of risk assessment procedures, along with the results of further audit procedures, provide audit evidence that ultimately supports the auditors opinion on the financial statements. |

| Key Provisions | *How the SAS Differs From Previous Standards* |
|---|---|
| • SAS No. 106 provides that evidence obtained by performing risk assessment procedures, as well as that obtained by performing tests of controls and substantive procedures, is part of the evidence the auditor obtains to draw reasonable conclusions on which to base the audit opinion, although such evidence is not sufficient in and of itself to support the audit opinion. | |
| • SAS No. 106 describes the types of audit procedures that the auditor may use alone or in combination as risk assessment procedures, tests of controls, or substantive procedures, depending on the context in which they are applied by the auditor. | • Risk assessment procedures include the following:<br>— Inquiries of management and others within the entity<br>— Analytical procedures<br>— Observation and inspection |
| • SAS No. 106 includes guidance on the uses and limitations of inquiry as an audit procedure. | • Inquiry alone is not sufficient to evaluate the design of internal control and to determine whether it has been implemented. |

## SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*

| **Key Provisions** | ***How the SAS Differs From Previous Standards*** |
|---|---|
| • The auditor must consider audit risk and must determine a materiality level for the financial statements taken as a whole for the purpose of<br>1. determining the extent and nature of risk assessment procedures;<br>2. identifying and assessing the risks of material misstatement;<br>3. determining the nature, timing, and extent of further audit procedures; and<br>4. evaluating whether the financial statements taken as a whole are presented fairly, in conformity with generally accepted accounting principles. | • Previous guidance said that auditors should consider audit risk and materiality for certain specified purposes. SAS No. 107 states that the auditor must consider.<br>• New guidance explicitly states that audit risk and materiality are used to *identify* and assess the *risks* of material misstatement. |
| • Combined assessment of inherent and control *risks* is termed the *risk of material misstatement.* | • SAS No. 107 consistently uses the term *risk of material misstatement,* which often is described as a combined assessment of inherent and control risk. However, auditors may make separate assessment of inherent risk and control risks. |
| • The auditor should assess the risk of material misstatement as a basis for further audit procedures. Although that risk assessment is a judgment rather than a precise measurement of risk, the auditor should have an appropriate basis for that assessment.<br>• Assessed risks and the basis for those assessments should be documented. | • SAS No. 107 states that the auditor should have and document an appropriate basis for the audit approach.<br>• These two provisions of the risk assessment standards effectively eliminate the ability of the auditor to assess control risk at the maximum without having a basis for that assessment. In other words, it is no longer acceptable to default to maximum control risk. |

| Key Provisions | *How the SAS Differs From Previous Standards* |
|---|---|
| • The auditor must accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are trivial, and communicate them to the appropriate level of management. | • SAS No. 107 provides additional guidance on communicating misstatements to management.<br>• The concept of not accumulating misstatements below a certain threshold is included in the previous standards, but SAS No. 107 provides additional specific guidance on how to determine this threshold. |
| • The auditor should request management to respond appropriately when misstatements (known or likely) are identified during the audit. | • SAS No. 107 provides specific guidance regarding the appropriate auditor's responses to the types of misstatements (known or likely) identified by the auditor. |

## SAS No. 108, *Planning and Supervision*

| Key Provisions | *How the SAS Differs From Previous Standards* |
|---|---|
| • SAS No. 108 provides guidance on the following:<br>— Appointment of the independent auditor<br>— Establishing an understanding with the client<br>— Preliminary engagement activities<br>— The overall audit strategy<br>— The audit plan<br>— Determining the extent of involvement of professionals possessing specialized skills<br>— Using a professional who possesses information technology (IT) skills to understand the effect of IT on the audit<br>— Additional considerations in initial audit engagements<br>— Supervision of assistants | • Much of the guidance provided in SAS No. 108 has been consolidated from several existing standards.<br>• However, SAS No. 108 provides new guidance on preliminary engagement activities, including the development of an overall audit strategy and an audit plan:<br>— The overall audit strategy is what previously was commonly referred to as the audit approach. It is a broad approach to how the audit will be conducted, considering factors such as the scope of the engagement, deadlines for performing the audit and issuing the report, and recent financial reporting developments.<br>— The audit plan is more detailed than the audit strategy and is commonly referred to as the audit program. The audit plan describes in detail the nature, timing, and extent of risk assessment and further audit procedures you perform in an audit.<br>• SAS No. 108 states that you should establish a written understanding with your client regarding the services to be performed for each engagement. |

## SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*

| Key Provisions | *How the SAS Differs From Previous Standards* |
|---|---|
| • SAS No. 109 describes audit procedures that the auditor should perform to obtain the understanding of the entity and its environment, including its internal control. | • The auditor should perform risk assessment procedures to gather information and gain an understanding of the entity and its environment. These procedures include inquiries, observation, inspection, and analytical procedures. Previous standards did not describe the procedures that should be performed to gain an understanding of the client.<br>• Information about the entity may be provided by a variety of sources, including knowledge about the entity gathered in previous audits (provided certain conditions are met) and the results of client acceptance and continuance procedures.<br>• SAS No. 109 also directs the auditor to perform a variety of risk assessment procedures, and it describes the limitations of inquiry. |
| • The audit team should discuss the susceptibility of the entity's financial statements to material misstatement. | • Previous standards did not require a brainstorming session to discuss the risks of material misstatements. SAS No. 109 requires such a brainstorming session, which is similar to (and may be performed together with) the brainstorming session to discuss fraud. |
| • The purpose of obtaining an understanding of the entity and its environment, including its internal control, is to identify and assess the risks of material misstatement and design and perform further audit procedures responsive to the assessed risk. | • SAS No. 109 directly links the understanding of the entity and its internal control with the assessment of risk and design of further audit procedures. Thus, the understanding of the entity and its environment, including its internal control, provides the audit evidence necessary to support the auditor's assessment of risk. |

*(continued)*

| Key Provisions | *How the SAS Differs From Previous Standards* |
|---|---|
| • SAS No. 109 states the auditor should assess the risks of material misstatement at both the financial statement and relevant assertion levels. | • The previous standard included the concept of assessing risk at the financial statement level, but SAS No. 109 provides expanded and more explicit guidance.<br>• SAS No. 109 also directs the auditor to determine how risks at the financial statement level may result in risks at the assertion level. |
| • SAS No. 109 provides directions on how to evaluate the design of the entity's controls and how to determine whether the controls are adequate and have been implemented. | • Under the previous standard, the primary purpose of gaining an understanding of internal control was to plan the audit. Under SAS No. 109, your understanding of internal control is used to assess risks. Thus, the understanding of internal control provides audit evidence that ultimately supports the auditor's opinion on the financial statements.<br>• The previous standard directs the auditor to obtain an understanding of internal control as part of obtaining an understanding of the entity and its environment. SAS No. 109 requires auditors to evaluate the design of controls and determine whether they have been implemented. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing or detecting and correcting material misstatements. It is anticipated that this phase of the audit will require more work than simply gaining understanding of internal control. |
| • SAS No. 109 directs the auditor to consider whether any of the assessed risks are significant risks that require special audit consideration or risks for which substantive procedures alone do not provide sufficient appropriate audit evidence. | • The previous standard did not include the concept of significant risks.<br>• Significant risks exist on most engagements.<br>• The auditor should gain an understanding of internal control and also perform substantive procedures for all identified significant risks. Substantive analytical procedures alone are not sufficient to test significant risks. |

| **Key Provisions** | ***How the SAS Differs From Previous Standards*** |
|---|---|
| • SAS No. 109 provides extensive guidance on the matters that should be documented. | • The guidance provided by SAS No. 109 relating to documentation is significantly greater than that provided by previous standards. |

## SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*

| Key Provisions | *How the SAS Differs From Previous Standards* |
|---|---|
| • SAS No. 110 provides guidance on determining overall responses to address the risks of material misstatement at the financial statement level and the nature of those responses. | • The concept of addressing the risks of material misstatement at the financial statement level and developing an appropriate overall response is similar to the requirement in previous standards relating to the consideration of audit risk at the financial statement level. However, that guidance was placed in the context of audit planning. SAS No. 110 repositions your consideration of risk at the financial statement level so you make this assessment as a result of and in conjunction with your performance of risk assessment procedures. In some cases, this assessment may not be able to be made during audit planning.<br>• SAS No. 110 requires you to consider how your assessment of risks at the financial statement level affects individual financial statement assertions, so you may design and perform tailored further audit procedures (substantive tests or tests of controls).<br>• The list of possible overall responses to the risks of material misstatement at the financial statement level also has been expanded. |
| • Further audit procedures, which may include tests of controls, or substantive procedures should be responsive to the assessed risks of material misstatement at the relevant assertion level. | • Although the previous standards included the concept that audit procedures should be responsive to assessed risks, this idea was embedded in the discussion of the audit risk model. The SASs repeatedly emphasize the need to provide a clear link between your understanding of the entity, your risk assessments, and the design of further audit procedures.<br>• SAS No. 110 requires you to document the link between assessed risks and further audit procedures, which was not a requirement under the previous standards. |

| Key Provisions | *How the SAS Differs From Previous Standards* |
|---|---|
| • SAS No. 110 provides guidance on matters the auditor should consider in determining the nature, timing, and extent of such audit procedures. | • The new guidance on determining the nature, timing, and extent of tests of controls and substantive tests has been expanded greatly and addresses issues that previously were not included in the authoritative literature.<br>• SAS No. 110 states that the nature of further audit procedures is of most importance in responding to your assessed risks of material misstatement. That is, increasing the extent of your audit procedures will not compensate for procedures that do not address the specifically identified risks of misstatement.<br>• SAS No. 110 states that you should perform certain substantive procedures on all engagements. These procedures include the following:<br>— Performing substantive tests for all relevant assertions related to each material class of transactions, account balance, and disclosure regardless of the assessment of the risks of material misstatements<br>— Agreeing the financial statements, including their accompanying notes, to the underlying accounting records<br>— Examining material journal entries and other adjustments made during the course of preparing the financial statements |

## SAS No. 111, *Amendment to Statement on Auditing Standards No. 39,* Audit Sampling

| *Key Provisions* | *How the SAS Differs From Previous Standards* |
|---|---|
| • SAS No. 111 provides guidance relating to the auditor's judgment about establishing tolerable misstatement for a specific audit procedure and on the application of sampling to tests of controls. | • SAS No. 111 provides enhanced guidance on tolerable misstatement. In general, tolerable misstatement in an account should be less than materiality to allow for aggregation in final assessment.<br>• Ordinarily sample sizes for nonstatistical samples are comparable to sample sizes for an efficient and effectively designed statistical sample with the same sampling parameters. |

# Appendix H

## Schedule of Changes Made to the Text From the Previous Edition

**As of March 1, 2008**

This schedule of changes identifies areas in the text and footnotes of this guide that have been changed from the previous edition. Entries in the table of this appendix reflect current numbering, lettering (including that in appendix names), and character designations that resulted from the renumbering or reordering that occurred in the updating of this guide.

**Terms Used to Define Professional Requirements**

The 2008 editions of the AICPA Audit and Accounting Guides, including this guide, have been updated to conform with AU section 120, *Defining Professional Requirements in Statements on Auditing Standards*, AT section 20, *Defining Professional Requirements in Statements on Standards for Attestation Engagements*, and AR section 20, *Defining Professional Requirements in Statements on Standards for Accounting and Review Services* (AICPA, *Professional Standards*), in which professional requirements are categorized as either *unconditional requirements* or *presumptively mandatory requirements*, each of which is associated with specific wording such as "must or is required" or "should." These standards distinguish *professional requirements* set forth in the standards from *explanatory material* contained in the standards, the latter of which requires only the auditor's, practitioner's, or accountant's "attention and understanding." Whether the auditor, practitioner, or accountant performs the suggested procedures or actions in the engagement (as stated in the explanatory material) depends on the exercise of professional judgment in the circumstances consistent with the objective of the standard.

Because interpretive publications (including AICPA Audit and Accounting Guides, for example) are recommendations, the publications cannot establish requirements. Paragraph .06 of AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1), states, "The auditor should be aware of and consider interpretive publications applicable to his or her audit. If the auditor does not apply the auditing guidance included in an interpretive publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance."

An interpretive publication, such as this guide, should state the requirement of the standard, and then give recommendations on the application of the requirement in the specific circumstances. The terms *must, is required*, or *should* may be used in an interpretive publication only when it is clear that the requirement originated in a standard. Otherwise, the user may be uncertain whether a requirement or a recommendation is intended. The following conventions were used to conform the AICPA Audit and Accounting Guides to these standards, which define professional requirements:

- Terms to replace the use of *must, should*, and *is required* consist only of those explanatory material terms included in AU section 120, AT section 20, and AR section 20: *could, may*, and *might*, and these variations of those terms: *could consider, may consider*, and *might consider*.

- When referring guide users to interpretive publications (which consist of interpretations of the Statements on Auditing Standards (SASs), appendixes to the SASs, auditing guidance in AICPA Audit and Accounting Guides, and AICPA auditing Statements of Position) or to nonauthoritative knowledge sources, if an auditor can perform an adequate risk assessment without the recommended knowledge, *explanatory material* terms are used; if not, *should* or *should consider* is used.
- Specific auditing procedures generally are explanatory in nature (the standards generally do not include specific audit procedures). As such, explanatory material terms (*could, may, might, could consider, may consider*, or *might consider*) are used, unless the specific audit procedure is the established way or only way of achieving a generally accepted auditing standard objective for this industry, in which case *should* is used.
- If the recommendation is that the auditor consult or familiarize himself or herself with other sources of information, such as SEC regulations, income tax laws, and industry developments including regulatory, economic, and legislative developments, then the following considerations were used in developing which terms to use in the guides:
  - If the purpose of the recommendation is for the auditor, practitioner, or accountant to develop the required understanding of the entity and its environment for risk assessment purposes, and an auditor can perform an adequate risk assessment without the recommended knowledge, *explanatory material* terms are used within the recommendation; if not, *should* or *must* is used depending upon the associated standard requirement.
  - If the purpose of the recommendation is for the auditor, practitioner, or accountant to perform the engagement in accordance with AICPA *Professional Standards*, and the knowledge is available *only* from the source cited (such as SEC regulations, income tax law, and the like), then *should* is used. If the knowledge is available from other sources as well, *explanatory material* terms are used.
- The guides contain guidance for management, which includes best practices for the industry. Because the recommendations are best practices, the terms *ordinarily should* or *generally should* are used.

| Reference | Change |
|---|---|
| Notice to Readers and Preface | Updated. |
| Footnote COD to heading before paragraph 1.05 | Added. |
| Footnote BCR in paragraph 1.11 | Added. |

| Reference | Change |
|---|---|
| Footnote NIS in paragraph 1.11 | Revised. |
| Footnote * to heading before paragraph 1.15 | Revised. |
| Footnote BCR in paragraph 1.17 | Added. |
| Footnote NIS in paragraph 1.17 | Revised. |
| Footnote TAX in paragraph 1.17 | Revised. |
| Paragraph 1.24 | Revised to reflect the issuance of FASB Statement Nos. 141(R) and 160; footnote BCR added; footnote NIS revised. |
| Footnote OMN to paragraph 1.24 | Added. |
| Footnote FMV to paragraph 1.24 | Revised. |
| Footnote DBP to paragraph 1.24 | Revised. |
| Paragraph 1.25 | Revised to reflect the issuance of FASB Statement Nos. 141(R) and 160 and FSP FAS 157-2; revised for the passage of time; footnotes BCR and NIS revised. |
| Paragraph 1.26 | Revised to reflect the issuance of FASB Statement Nos. 141(R) and 160 and FSP FAS 157-2; revised for the passage of time; footnote BCR added; footnotes NIS, DBP, and FMV revised. |
| Paragraph 1.27 | Revised to reflect the issuance of FASB Statement Nos. 141(R) and 160 and FSP FAS 157-2; revised for the passage of time; footnote BCR added; footnotes NIS and FMV revised. |
| Footnote FGI in paragraph 1.27 | Added. |
| Paragraph 1.28 | Revised to reflect the issuance of FASB Statement Nos. 141(R) and 160, FSP FAS 157-2, and FSP FIN 48-2; revised for the passage of time; footnote BCR added; footnotes DBP, FMV, TAX, NIS, * and † revised. |
| Footnote FGI in paragraph 1.27 | Added. |
| Footnote LST in paragraph 1.27 | Added. |

*(continued)*

| Reference | Change |
|---|---|
| Footnote IAL in paragraph 1.27 | Added. |
| Paragraph 1.29 | Revised to reflect the issuance of FASB Statement Nos. 141(R) and 160, FSP FAS 157-2, and FSP FIN 48-2; revised for the passage of time; footnote BCR added. |
| Footnote COD in paragraph 1.30 | Added. |
| Paragraph 2.06 | Revised to reflect the appropriate use of terms used to define the professional requirements of auditors, practitioners, and accountants in AU section 120, AT section 20, and AR section 20 of AICPA *Professional Standards.*<br>Subsequently, these changes are referred to as "defining professional requirements" in the Schedule of Changes; revised to reflect the further integration of SAS Nos. 104–111, collectively known as the "risk assessment standards." |
| Paragraph 2.08 | Revised for clarification. |
| Paragraph 2.09 | Revised to reflect revisions to Ethics Interpretation No. 101-3. |
| Paragraph 2.12 | Revised to reflect the further integration of SAS Nos. 104–111, collectively known as the "risk assessment standards." |
| Paragraphs 2.21, 2.26, 2.28, 2.33, 2.43, 2.47–.48, 2.52–.53, and 2.56 | Revised to define professional requirements. |
| Paragraph 2.57 | Revised to reflect the further integration of SAS Nos. 104–111, collectively known as the "risk assessment standards." |
| Paragraph 2.58 | Revised to define professional requirements. |
| Former footnotes ǁ, #, and ** in paragraph 2.74 | Deleted. |
| Paragraph 2.75 | Revised to define professional requirements. |
| Former paragraph 2.76 | Deleted to define professional requirements. |
| Paragraphs 2.76 and 2.78 | Revised to define professional requirements. |
| Paragraph 2.79 | Revised to define professional requirements; replaced referencing of original SAS with AU section reference from the AICPA *Professional Standards* literature. |

| Reference | Change |
|---|---|
| Heading before paragraph 3.22 | Revised to reflect issuance of EITF Issue 07-1. |
| Footnote * in paragraph 3.22 | Added. |
| Paragraph 3.23 and footnote 13 | Added to reflect issuance of EITF Issue 07-1. |
| Footnote † in paragraph 3.25 | Revised to reflect the issuance of FSP FAS 157-2. |
| Former footnote ‡ in paragraph 3.44 | Deleted. |
| Footnote 5 in paragraph 5.12 | Revised to reflect issuance of FSP FAS 157-2. |
| Footnote * in paragraph 5.61 and footnote † in paragraph 5.67 | Revised. |
| Paragraphs 5.83–.84 | Revised to define professional requirements; revised to reflect the further integration of SAS Nos. 104–111, collectively known as the "risk assessment standards." |
| Paragraph 5.87 | Revised to define professional requirements. |
| Paragraph 5.88 | Revised to reflect the further integration of SAS Nos. 104–111, collectively known as the "risk assessment standards"; footnote # deleted. |
| Footnote 1 in paragraph 6.01 | Revised for clarification. |
| Footnote 6 in paragraph 6.07 | Revised to reflect issuance of FSP FAS 157-2. |
| Former footnote † in paragraph 6.14 | Deleted. |
| Footnote 14 in paragraph 6.16 | Revised for the passage of time. |
| Paragraph 6.46 | Revised to reflect the further integration of SAS Nos. 104–111, collectively known as the "risk assessment standards"; footnote ‡ deleted. |
| Footnote † in paragraph 6.46 | Revised. |
| Former footnote * in paragraph 6.48 | Deleted. |
| Footnote * in paragraph 6.48 | Revised. |

*(continued)*

| Reference | Change |
|---|---|
| Footnote * in paragraph 7.03 | Revised. |
| Paragraphs 7.16 and 7.18–.19 | Revised to define professional requirements. |
| Paragraph 7.20 | Revised to reflect the further integration of SAS Nos. 104–111, collectively known as the "risk assessment standards"; footnote ‡ deleted. |
| Footnote * in paragraph 8.06 | Added. |
| Footnote † in paragraphs 8.08 and 8.11 | Revised. |
| Paragraph 8.33 | Revised to reflect issuance of the practice aid *Alternative Investments—Audit Considerations*. |
| Paragraph 8.34 and footnote 12 | Revised to reflect the issuance of the *Uniform Prudent Management of Institutional Funds Act*, and the related FASB project, to define professional requirements. |
| Paragraph 8.35 | Revised to reflect the further integration of SAS Nos. 104–111, collectively known as the "risk assessment standards"; footnote ‖ deleted. |
| Paragraph 8.36 | Revised to reflect the issuance of EITF Issue 07-1; former footnote * deleted; footnotes * and † added. |
| Paragraph 8.37 and footnotes 6 and 8 | Revised to reflect the issuance of FSP SOP 07-1-1 and proposed FSP SOP 94-3-a. |
| Footnote 2 in paragraph 9.05 | Updated to reflect issuance of FSP FAS 157-2. |
| Paragraph 9.18 | Revised to reflect the further integration of SAS Nos. 104–111, collectively known as the "risk assessment standards"; footnote † deleted. |
| Footnote † in paragraph 10.04 | Revised. |
| Footnote 5 in paragraph 10.07 | Revised to reflect issuance of FSP FAS 157-2. |
| Footnote ‡ in heading before paragraph 10.15 | Revised. |
| Paragraph 10.17 | Revised to reflect the further integration of SAS Nos. 104–111, collectively known as the "risk assessment standards"; footnote ‖ deleted. |

| Reference | Change |
|---|---|
| Footnote * in heading before paragraph 11.03 | Added. |
| Paragraph 11.17 | Revised to reflect the further integration of SAS Nos. 104–111, collectively known as the "risk assessment standards"; footnote † deleted. |
| Footnote 6 in paragraph 12.06 | Revised for the passage of time. |
| Paragraph 13.61 | Revised to reflect the further integration of SAS Nos. 104–111, collectively known as the "risk assessment standards"; footnote * deleted. |
| Paragraph 14.01 | Replaced referencing of original SAS with AU section reference from the AICPA *Professional Standards* literature; footnote 1 revised for the issuance of TIS section 9100.06; footnote 2 revised for the issuance of PCAOB Auditing Standard No. 5. |
| Paragraphs 14.02–.03 | Revised to define professional requirements. |
| Paragraph 14.06 | Revised for clarification. |
| Paragraphs 14.07, 14.10, and 14.15 | Revised to define professional requirements. |
| Footnote * in paragraph 15.02 | Revised. |
| Paragraphs 15.03, 15.09, and 15.16 | Revised to define professional requirements. |
| Paragraph 15.23 | Revised to reflect the further integration of SAS Nos. 104–111, collectively known as the "risk assessment standards"; footnote † deleted. |
| Footnote 3 in paragraph 16.01 | Revised to define professional requirements. |
| Paragraph 16.14 | Revised for clarification. |
| Appendix E | Updated. |
| Appendix F | Updated. |

# Glossary

**activities.** Activities are efforts to accomplish specific objectives. Some activities include producing and distributing materials. For example, if an entity undertakes a mass mailing that includes a letter and a pamphlet, producing and distributing the letter and pamphlet are part of the activity. Other activities may include no materials, such as an annual dinner or a radio commercial.

**affiliate.** A party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an enterprise (FASB Statement No. 57, *Related Party Disclosures*, paragraph 24(a).)

**agent.** An entity or individual that acts for and on behalf of another. Although the term agency has a legal definition, the term is used in FASB Statement No. 136 with a broader meaning to encompass not only legal agency, but also the relationships described in FASB Statement No. 136. A recipient organization acts as an agent for and on behalf of a donor if it receives assets from the donor and agrees to use those assets on behalf of or transfer those assets, the return on investment of those assets, or both to a specified beneficiary. A recipient organization acts as an agent for and on behalf of a beneficiary if it agrees to solicit assets from potential donors specifically for the beneficiary's use and to distribute those assets to the beneficiary. A recipient organization also acts as an agent if a beneficiary can compel the organization to make distributions on its behalf. (FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, paragraph 10.)

**annuity gift.** A transfer of assets to a not-for-profit organization in connection with a split-interest agreement that is in part a contribution and in part an exchange transaction. The organization accepts the contribution and is obligated to make periodic stipulated payments to the donor or a third-party beneficiary for a specified period of time, usually either a specified number of years or until the death of the donor or third-party beneficiary.

**annuity trust.** See *charitable remainder trust.*

**board designated.** See *designated net assets* and *endowment fund.*

**charitable lead trust.** A trust established in connection with a split-interest agreement, in which the not-for-profit organization receives distributions during the agreement's term. Upon termination of the trust, the remainder of the trust assets is paid to the donor or to third-party beneficiaries designated by the donor.

**charitable remainder trust.** A trust established in connection with a split-interest agreement, in which the donor or a third-party beneficiary receives specified distributions during the agreement's term. Upon termination of the trust, a not-for-profit organization receives the assets remaining in the trust.

**collections.** Works of art, historical treasures, or similar assets that are (*a*) held for public exhibition, education, or research in furtherance of public

service rather than financial gain, (*b*) protected, kept unencumbered, cared for, and preserved, and (*c*) subject to an organizational policy that requires the proceeds of items that are sold to be used to acquire other items for collections.

**compensation or fees.** Reciprocal transfers of cash or other assets in exchange for services performed.

**conditional promise to give.** A promise to give that depends on the occurrence of a specified future and uncertain event to bind the promisor.

**contribution.** An unconditional transfer of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner.

**corpus.** The principal amount of a gift or trust. Usually refers to the portion of a split-interest gift or an endowment fund that must be maintained over a specified period or in perpetuity.

**costs of joint activities.** Costs of joint activities are costs incurred for a joint activity. Costs of joint activities may include joint costs and costs other than joint costs. Costs other than joint costs are costs that are identifiable with a particular function, such as fund raising, program, management and general, and cost of sales. For example, some costs incurred for printing, paper, professional fees, and salaries to produce donor cards are not joint costs, although they may be incurred in connection with conducting joint activities.

**designated net assets.** Unrestricted net assets subject to self-imposed limits by action of the governing board. Designated net assets may be earmarked for future programs, investment, contingencies, purchase or construction of fixed assets, or other uses.

**donor-imposed condition.** A donor stipulation that specifies a future and uncertain event whose occurrence or failure to occur give the promisor a right of return of the assets it has transferred or releases the promisor from its obligation to transfer its assets.

**donor-imposed restriction.** A donor stipulation that specifies a use for the contributed asset that is more specific than broad limits resulting from the nature of the organization, the environment in which it operates, and the purposes specified in its articles of incorporation or bylaws, or comparable documents for an unincorporated association. A restriction on an organization's use of the asset contributed may be temporary or permanent.

**endowment fund.** An established fund of cash, securities, or other assets to provide income for the maintenance of a not-for-profit organization. The use of the assets of the fund may be permanently restricted, temporarily restricted, or unrestricted. Endowment funds generally are established by donor-restricted gifts and bequests to provide a permanent endowment, which is to provide a permanent source of income, or a term endowment, which is to provide income for a specified period. The portion of a permanent endowment that must be maintained permanently—not used up, expended, or otherwise exhausted—is classified as permanently restricted net assets. The portion of a term endowment that must be maintained for a specified term is classified as temporarily restricted net assets. An organization's governing board may earmark a portion of its unrestricted net

assets as a board-designated endowment (sometimes referred to as funds functioning as endowment or quasi-endowment funds) to be invested to provide income for a long but unspecified period. A board-designated endowment, which results from an internal designation, is not donor-restricted and is classified as unrestricted net assets.

**equity.** See *net assets.*

**functional classification.** A method of grouping expenses according to the purpose for which the costs are incurred. The primary functional classifications are program services and supporting activities.

**funds functioning as endowment.** Unrestricted net assets earmarked by an organization's governing board, rather than restricted by a donor or other outside agency, to be invested to provide income for a long but unspecified period. A board-designated endowment, which results from an internal designation, is not donor-restricted and is classified as unrestricted net assets. The governing board has the right to decide at any time to expend the principal of such funds. (Sometimes referred to as quasi-endowment funds.) See also *designated net assets.*

**fund raising activities.** Activities undertaken to induce potential donors to contribute money, securities, services, materials, facilities, other assets, or time. They include publicizing and conducting fund-raising campaigns; maintaining donor mailing lists; conducting special fund-raising events; preparing and distributing fund-raising manuals, instructions, and other materials; and conducting other activities involved with soliciting contributions from individuals, foundations, governments, and others.

**funds held in trust by others.** Resources held and administered, at the direction of the resource provider, by an outside trustee for the benefit of the organization, frequently in connection with a split-interest agreement or permanent endowment.

**gift annuity.** See *annuity gift.*

**help accomplish the organization's mission.** Actions that help accomplish the organization's mission are actions that either benefit the recipient (such as by improving the recipient's physical, mental, emotional, or spiritual health and well-being) or benefit society (by addressing societal problems).

**intermediary.** An entity or individual that acts as a facilitator for the transfer of assets between a potential donor and a potential beneficiary (donee) but is neither an agent or trustee nor a donee and donor as contemplated by FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made.* (FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, paragraph 8.)

**joint activity.** A joint activity is an activity that is part of the fund-raising function and has elements of one or more other functions, such as programs, management and general, membership development, or any other functional category used by the entity.

**joint costs.** Joint costs are the costs of conducting joint activities that are not identifiable with a particular component of the activity. For example, the cost of postage for a letter that includes both fund-raising and program components is a joint cost. Joint costs may include the costs of salaries, contract

labor, consultants, professional fees, paper, printing, postage, event advertising, telephones, airtime, and facility rentals.

**life income agreement.** A form of split-interest agreement. See *annuity gift* and *charitable remainder trust*.

**life tenant.** One who possesses a life-use right to property, frequently used in connection with a split interest agreement.

**management and general activities.** 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 recordkeeping, 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. Disseminating information to inform the public of the organization's "stewardship" of contributed funds, announcements concerning appointments, and the annual report, among other activities, are management and general activities, as are soliciting funds other than contributions, including exchange transactions (whether program-related or not).

**medium.** A medium is a means of mass communication, such as direct mail, direct response advertising, or television.

**membership-development activities.** Membership-development activities include soliciting for prospective members and membership dues, membership relations, and similar activities. If there are no significant benefits or duties connected with membership, however, the substance of membership-development activities may, in fact, be fund-raising.

**natural expense classification.** A method of grouping expenses according to the kinds of economic benefits received in incurring those expenses. Examples of natural expense classifications include salaries and wages, employee benefits, supplies, rent, and utilities.

**net assets.** The excess or deficiency of assets over liabilities, classified according to the existence or absence of donor-imposed restrictions.

**net asset class(es).** The classification of net assets based upon the existence or absence of donor-imposed restrictions. See also *permanently restricted net assets*, *temporarily restricted net assets*, and *unrestricted net assets*.

**net investment (equity) in land, buildings, and equipment.** The total carrying value (after accumulated depreciation) of all property, plant, and equipment, less directly related liabilities. This amount is exclusive of real properties that are held for investment purposes.

**nonreciprocal transfer.** A transaction in which an entity incurs a liability or transfers an asset to another entity (or receives an asset or cancellation of a liability) without directly receiving (or giving) value in exchange.

**not-for-profit organization.** An entity that possesses the following characteristics that distinguish it from a business enterprise: (*a*) contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return, (*b*) operating purposes

other than to provide goods or services at a profit, and (*c*) absence of ownership interests like those of business enterprises. Not-for-profit organizations have those characteristics in varying degrees ([FASB Statement of Financial Accounting] Concepts Statement No. 4, paragraph 6). Organizations that clearly fall outside this definition include all investor-owned enterprises and entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance companies, credit unions, farm and rural electric cooperatives, and employee benefit plans (FASB Concepts Statement No. 4, paragraph 7).

**permanent restriction.** A donor-imposed restriction that stipulates that resources be maintained permanently but permits the organization to use up or expend part or all of the income (or other economic benefits) derived from the donated assets.

**permanently restricted net assets.** The part of the net assets of a not-for-profit organization resulting (*a*) from contributions and other inflows of assets whose use by the organization is limited by donor-imposed stipulations that neither expire by passage of time nor can be fulfilled or otherwise removed by actions of the organization, (*b*) from other asset enhancements and diminishments subject to the same kinds of stipulations, and (*c*) from reclassifications from (or to) other classes of net assets as a consequence of donor-imposed stipulations.

**promise to give.** A written or oral agreement to contribute cash or other assets to another entity. A promise to give may be either conditional or unconditional.

**program services or program activities.** The activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the organization exists. Those services are the major purpose for and the major output of the organization and often relate to several major programs. For example, a large university may have programs for student instruction, research, and patient care, among others. Similarly, a health and welfare organization may have programs for health and family services, research, disaster relief, and public education, among others.

**quasi-endowment.** See *funds functioning as endowment.*

**reclassifications.** Transfers of amounts from one net asset class to another, usually as a result of the release or lapsing of restrictions.

**remainder trust.** See *charitable remainder trust.*

**remainderman.** The recipient of the corpus (remaining principal) of a trust upon termination.

**restricted support.** Donor-restricted revenues or gains from contributions that increase either temporarily restricted net assets or permanently restricted net assets. See also *unrestricted support.*

**restricted net assets.** Resources whose use is restricted by donors as contrasted with those over which the organization has complete control and discretion. Restricted net assets may be permanently or temporarily restricted.

**spending-rate.** The portion of total return on investments used for fiscal needs of the current period, usually used as a budgetary method of reporting returns of investments. It is usually measured in terms of an amount or a specified percentage of a moving average market value. Typically, the selection of a spending rate emphasizes (*a*) the use of prudence and a systematic formula to determine the portion of cumulative investment return that can be used to support fiscal needs of the current period and (*b*) the protection of endowment gifts from a loss of purchasing power as a consideration in determining the formula to be used.

**split-interest agreement.** Trust or other arrangements initiated by donors under which not-for-profit organizations receive benefits that are shared with either the donor or third party beneficiaries. These gifts include lead interests (see *charitable lead trust*) and remainder interests (see *charitable remainder trust*, *annuity gift*, and *annuity trust*).

**stipulation.** A statement by a donor that creates a condition or restriction on the use of transferred resources.

**supporting activities.** Activities other than program services. The primary supporting activities are management and general, fund raising, and membership development activities.

**temporary restriction.** A donor-imposed restriction that permits the donee organization to use up or expend the donated assets as specified and is satisfied either by the passage of time or by actions of the organization.

**temporarily restricted net assets.** The part of the net assets of a not-for-profit organization resulting (*a*) from contributions and other inflows of assets whose use by the organization is limited by donor-imposed stipulations that either expire by the passage of time or can be fulfilled and removed by actions of the organization pursuant to those stipulations, (*b*) from other asset enhancements and diminishments subject to the same kinds of stipulations, and (*c*) from reclassifications to (or from) other classes of net assets as a consequence of donor-imposed stipulations, their expiration by passage of time, or their fulfillment and removal by actions of the organization pursuant to those stipulations.

**term endowment.** A donor-restricted contribution that must be maintained for a specified term.

**total return.** A measure of investment performance that focuses on the overall return on investments, including interest and dividend income as well as realized and unrealized gains and losses on investments. Frequently used in connection with a spending-rate formula to determine how much of that return will be used for fiscal needs of the current period.

**trustee.** An entity or individual that has a duty to hold and manage assets for the benefit of a specified beneficiary in accordance with a charitable trust agreement. (FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, paragraph 9.)

**unconditional promise to give.** A promise to give that depends only on passage of time or demand by the promisee for performance.

**unrestricted net assets.** The part of net assets of a not-for-profit organization that is neither permanently restricted nor temporarily restricted by donor-imposed stipulations.

**unrestricted support.** Revenues or gains from contributions that are not restricted by donors. See also *restricted support.*

**voluntary health and welfare organizations.** Organizations formed for the purpose of performing voluntary services for various segments of society. They are tax exempt (organized for the benefit of the public), supported by the public, and operated on a "not-for-profit" basis. Most voluntary health and welfare organizations concentrate their efforts and expend their resources in an attempt to solve health and welfare problems of our society and, in many cases, those of specific individuals. As a group, voluntary health and welfare organizations include 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 connected with health, welfare, or community services.

## AICPA RESOURCE: Accounting & Auditing Literature

The AICPA has created a unique online research tool by combining the power and speed of the Web with comprehensive accounting and auditing standards. *AICPA RESOURCE* includes the AICPA, FASB and GASB libraries. You'll find subscriptions to these titles:

- AICPA Professional Standards
- AICPA Technical Practice Aids
- AICPA's Accounting Trends & Techniques
- AICPA Audit and Accounting Guides
- AICPA Audit Risk Alerts
- AICPA Financial Statement Preparation Manual
- AICPA Audit & Accounting Manual
- FASB Original Pronouncements
- FASB Current Text
- EITF Abstracts
- FASB Implementation Guides
- FASB's Comprehensive Topical Index
- GASB Original Pronouncements
- Codification of Governmental Accounting and Financial Reporting Standards
- GASB Implementation Guides
- GASB's Comprehensive Topical Index

Search for pertinent information from both databases by keyword and get the results ranked by relevancy. Print out important *AICPA RESOURCE* segments and integrate the literature into your engagements and financial statements. Available from anywhere you have Internet access, this comprehensive reference library is packed with the A & A guidance you need — and use — the most. All libraries are updated with the latest standards and conforming changes.

**AICPA, FASB and GASB Libraries, one-year individual online subscription**
No. WGLBY12

**AICPA and FASB Libraries, one-year individual online subscription**
No. WFLBY12

**AICPA Library, one-year individual online subscription**
No. WALBY12

AICPA RESOURCE offers over 95 additional subscription options – log onto **www.cpa2biz.com/AICPAresource** for details.

For additional copies of the ***Not-for-Profit Organizations*** **Audit and Accounting Guide** log onto the AICPA Store at www.cpa2biz.com – or to automatically receive an annual update immediately upon its release – call 1-888-777-7077.

# Additional Publications

**Not-for-Profit Organizations Audit Risk Alert** (ARA)
Find out about current economic, regulatory and professional developments before you perform your audit engagement. This ARA will make your audit planning process more efficient by giving you concise, relevant information that shows you how current developments may impact your clients and your audits. 2008 ARA (022428)

**Checklists and Illustrative Financial Statements for Not-for-Profit Organizations**
Contains thorough checklists designed to ensure compliance with all required financial statement disclosures. 2007 (008987)

---------------

**Audit and Accounting Guides – 2008 Industry Guides**
With conforming changes as of March 1, 2008.

- Construction Contractors (012588)
- Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies, and Mortgage Companies (012738)
- Employee Benefit Plans (012598)
- Government Auditing Standards and Circular A-133 Audits (012748)
- Federal Government Contractors (012608)
- Health Care Organizations (012618)
- Investment Companies (012628)
- Not-for-Profit Organizations (012648)
- State and Local Governments (012668)

With conforming changes as of May 1, 2007.

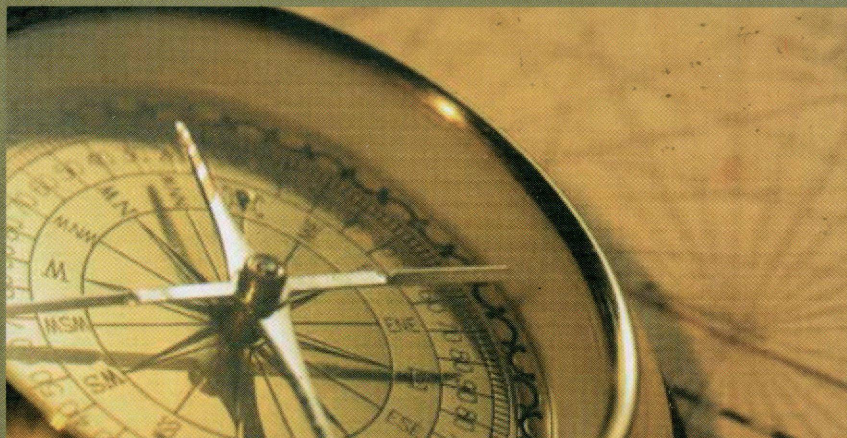
- Agricultural Producers and Agricultural Cooperatives (012687)
- Brokers and Dealers in Securities (012707)
- Casinos (2006) (012716)
- Common Interest Realty Associations (012577)
- Entities With Oil and Gas Producing Activities (012657)
- Life & Health Insurance Entities (012637)
- Property and Liability Insurance Cos. (012677)

---------------

**Audit and Accounting Guides – 2007 General Guides**

- Analytical Procedures (012557)
- Auditing Derivative Instruments, Hedging Activities, and Investments in Securities (012527)
- Auditing Revenue in Certain Industries (012517)
- Personal Financial Statements (012757)
- Prospective Financial Information (012727)
- Service Organizations: Applying SAS No. 70, as Amended (012777)
- Use of Real Estate Appraisal Information (1997) (013159)

**To order** log on to the AICPA Store at **www.cpa2biz.com**
Call the AICPA at **1-888-777-7077** or fax to **1-800-362-5066**



AICPA Member and
Public Information:
**www.aicpa.org**

AICPA Online Store:
**www.cpa2biz.com**

*ISO Certified*

**012648**