1990

Audits of voluntary health and welfare organizations as of December 31, 1990; Industry audit guide; Audit and accounting guide

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

AICPA Industry Audit Guide

AUDITS OF VOLUNTARY HEALTH AND WELFARE ORGANIZATIONS

As of December 31, 1990

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American Institute of Certified Public Accountants

Published for the
American Institute of
Certified Public Accountants
by
COMMERCE CLEARING HOUSE, INC.
4025 W. Peterson Ave.
Chicago, Illinois 60646

234567890 AccS 9987654321

NOTICE TO READERS

The industry audit guide presents recommendations of the AICPA Committee on Voluntary Health and Welfare Organizations on the application of generally accepted auditing standards to audits of financial statements of voluntary health and welfare organizations. This guide also presents the committee's recommendations on and descriptions of financial accounting and reporting principles and practices for voluntary health and welfare organizations. AICPA members should be prepared to justify departures from this guide.

This edition includes *Audit Risk Alert—Not-for-Profit Organizations Industry Developments—1991.*

Preface

This audit guide has been prepared to assist the independent public accountant in auditing and reporting on financial statements of voluntary health and welfare organizations. Voluntary health and welfare organizations take many forms and have been developed under many and varied auspices. Basically, they are 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 nonprofit 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. As used in this audit guide the term "not-for-profit" is not intended to imply that a voluntary health and welfare organization cannot obtain revenues in excess of its expenses in any particular period; rather, it implies that the organization is not operated for the financial benefit of any specific individual or group of individuals.

Prior to 1964, there existed no formal, industry-wide accounting or reporting practices for voluntary health and welfare organizations. Accounting and reporting for these organizations followed practices generally employed for trusts, foundations, hospitals, educational institutions, or other kinds of organizations to which some of them may have been indirectly related. In 1964, the National Health Council and its member agencies, and the National Social Welfare Assembly (presently the National Assembly for Social Policy and Development) and its affiliated organizations, published a guide for accounting and financial reporting by voluntary health and welfare organizations entitled *Standards of Accounting and Financial Reporting for Voluntary Health and Welfare Organizations.* That publication constituted the first definitive literature in the field and is widely accepted by voluntary health and welfare organizations throughout the United States and by many governmental and regulatory bodies.

Recognizing the need for parallel direction to the profession in its performance of services for this industry, in 1966 the American Institute of Certified Public Accountants published an audit guide entitled *Audits of Voluntary Health and Welfare Organizations.*

This revised audit guide has been prepared by the Committee on Voluntary Health and Welfare Organizations of the American Institute of Certified Public Accountants, in consultation with the Joint Liaison Committee formed by the National Health Council, the National Assembly for Social Policy and Development and the United Way of America, and supersedes the audit guide previously issued in 1966.

This revised audit guide describes generally accepted accounting principles applicable to financial reporting by health and welfare organizations. In most instances, these principles are compatible with those set forth in the *Standards of Accounting and Financial Reporting for Voluntary Health and Welfare Organizations.* The National Health Council and the National Assembly have advised the Committee that it is their intent to revise the *Standards,* as necessary, to achieve maximum possible uniformity with this guide.

Since financial statements of voluntary health and welfare organizations present financial position, results of operations, and changes in fund balances, the Committee on Voluntary Health and Welfare Organizations unanimously concludes that they should be prepared in accordance with generally accepted accounting principles. Accordingly, Statements of Financial Accounting Standards, Accounting Principles Board opinions, Accounting Research Bulletins, and other authoritative pronouncements of the profession should be applied in reporting on such financial statements unless they are inapplicable.

Accounting adjustments that may be required to conform with the accounting and reporting procedures set forth in this guide should be retroactively applied to prior period financial statements. The resulting effects of the prior period adjustments should be disclosed in notes to the financial statements for the year in which such adjustments are made.

Effective Date

Because certain of the accounting and reporting procedures set forth in this guide may differ from present practices, it is recognized that a period of adaptation may be necessary. Therefore, while adoption of positions set forth in this guide is encouraged and recommended at the earliest possible date, the Committee on Voluntary Health and Welfare Organizations believes that implementation should not be required for reporting on fiscal years prior to those beginning after June 30, 1974.

The Committee on Voluntary Health and Welfare Organizations wishes to express its appreciation to the members of the Joint Liaison Committee for their untiring assistance in completing this audit guide.

Committee on Voluntary Health and Welfare Organizations

September 1973

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Chapter 1

Fund Accounting

General

1.01 The value of services provided by most voluntary health and welfare organizations cannot be quantitatively measured by monetary data contained in financial statements. The measurement of this value must be made in terms of human needs and public good. A fundamental purpose of the financial statements, therefore, should be to disclose how the entity's resources have been acquired and used to accomplish the objectives of the organization. Thus, the organization's financial statements should, to the extent possible, reflect the total resources available to carry out the various program services to which it is committed and the use made of those resources.

1.02 While in some cases the organization's total resources may be available to finance its program activities, in many cases restrictions have been placed on certain of the assets by the donor, by law, or by other external authority, which prohibit their use directly or currently for operating purposes. Where such conditions exist, separate systems of accounts are often used to give recognition to the restrictions. For this reason, most voluntary health and welfare organizations have adopted fund accounting. Under the fund accounting concept, separate accounting entities, or funds, are established as needed to achieve a proper segregation and fair presentation of those resources available for use at the discretion of the governing board (unrestricted funds) and of those resources over which the board has little, if any, discretion as to use because of externally imposed restrictions (restricted funds). The most commonly used funds are discussed in the paragraphs which follow.

Types of Funds

1.03 The *current unrestricted fund* accounts for all resources over which the governing board has discretionary control to use in carrying on the operations of the organization in accordance with the limitation of its charter and bylaws except for unrestricted amounts invested in land, buildings and equipment that may be accounted for in a separate fund.

1.04 The principal sources of unrestricted funds are contributions, bequests, program service fees, dues, investment income, and sales of goods and services. Decreases in unrestricted funds generally result from expenses incurred for program services and supporting services conducted by the organization.

1.05 The board may designate portions of the current unrestricted fund for specific purposes, projects, or investment as an aid in the planning of expenditures and the conservation of assets.[1] The organization may wish to maintain separate accounts for such designations within the current unrestricted fund and to segregate the designated and undesignated portions of the fund within the fund-balance section of the unrestricted fund-balance sheet.

1.06 It should be recognized that the board has the authority to change or reverse its own action. Accordingly, amounts designated by the board should not be included with donor-restricted funds and the term restricted should not be used in connection therewith.

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[1] Such designations have at times been referred to as appropriations or allocations.

1.07 *Current restricted funds* are often established to account for those resources currently available for use, but expendable only for operating purposes specified by the donor or grantor. Such resources may originate from gifts, grants, income from endowment funds, or other similar sources where the donor has specified the operating purpose for which the funds are to be used.

1.08 *Land, building and equipment fund* (often referred to as plant fund) is often used to accumulate the net investment in fixed assets and to account for the unexpended resources contributed specifically for the purpose of acquiring or replacing land, buildings, or equipment for use in the operations of the organization. Mortgages or other liabilities relating to these assets are also included in this fund. When additions to land, buildings, or equipment used in carrying out the organization's program and supporting services are acquired with unrestricted fund resources, the amount expended for such assets should be transferred from the unrestricted fund to the plant fund and should be accounted for as a direct addition to the plant fund balance. Gains or losses on the sale of fixed assets should be reflected as income items in the plant fund accounts. The proceeds from the sale of fixed assets that are not legally required to be reinvested in fixed assets should be transferred to the unrestricted fund; such transfers should be reflected as direct reductions and additions to the respective fund balances.

1.09 *Endowment funds* represent the principal amount of gifts and bequests accepted with the donor-stipulation that the principal be maintained intact in perpetuity, until the occurrence of a specified event, or for a specified period, and that only the income from investment thereof be expended either for general purposes or for purposes specified by the donor. Net gains or losses from the sale of the specific investments or other property donated to the organization should be accounted for in this fund. (See Chapter 2 for additional discussion.) If endowment income is subject to donor-restriction as to use, it should be credited, as earned, to the appropriate restricted fund and thereafter treated accordingly. If endowment income is not subject to donor-imposed restrictions, it should be credited, as earned, to the appropriate revenue account of the unrestricted fund.

1.10 When restrictions on endowment fund principal lapse, the resources released should be transferred to the unrestricted fund or to a specific restricted fund, according to the terms of the original gift or bequest.

1.11 *Custodian funds* are established to account for assets received by an organization to be held or disbursed only on instructions of the person or organization from whom they were received.

1.12 Since custodian funds are not assets of the organization, the receipt of such funds or the income that might be generated from them should not be considered as a part of the organization's revenue or support.

1.13 *Loan and annuity funds* are usually not significant; where they are material, these funds should be shown separately.

Financial Statement Considerations

1.14 The balance sheet should show the unrestricted fund and the various types of restricted funds that have been established in response to donor or grantor restrictions. In addition to the balance sheet, the financial statements should contain a statement of support, revenue, and expenses and changes in fund balances to reflect the activity within each fund, and a statement of functional expenses in support of the total program and supporting services expenses for the period. If the governing board has designated portions of the unrestricted fund for various specific purposes, it may wish to also include a supplemental schedule of changes in such designations.

Auditing Considerations

1.15 The independent auditor should be concerned that the unrestricted resources of the organization were used in accordance with its bylaws and stated purposes and the actions of its governing board, that restricted gifts or grants have been properly segregated and used in accordance with the restrictions or designations imposed by the donor or grantor, and that all restricted funds are clearly reported as such.

1.16 An increasing number of governmental (principally federal) agencies that grant or advance funds to private organizations to carry out programs for which the agencies are responsible require periodic audits of financial reports of such organizations. Generally, the purpose of these audits is to obtain assurance that the private organizations are administering the funds in compliance with the provisions of the grants or advances and the rules and regulations promulgated by the agencies. Where an organization has received such grants or advances, the independent auditor should familiarize himself with their provisions and consider the granting agency's reporting requirements in establishing the scope of his audit.

Chapter 2

Investments

2.01 Voluntary health and welfare organizations may carry investment portfolios of the following types:

1. Investment of unrestricted funds to earn additional income until such time as the funds are to be used for program or other purposes.
2. Investment of endowment and other restricted funds.

2.02 Investments included in the portfolio may have been purchased by or donated to the organization. The donation of investments that have been restricted as to use should be included as contributions to the endowment or other restricted funds, whereas unrestricted donations of investments should be reported as contributions in the current unrestricted fund.

Bases of Valuation

2.03 Investments purchased by voluntary health and welfare organizations should be recorded at cost, which includes brokerage fees, taxes, and other charges directly applicable to the purchase. Securities donated to the organization should be recorded at their fair market value at the date of the gift. If the market value of the investment portfolio is below the recorded value, it may be necessary to reduce the carrying value of the portfolio to market, or to provide an "allowance for decline in market value." If it can be reasonably expected that the organization will suffer a loss on disposition of the investment, provision therefor should be made during the period in which the decline in value occurs.

2.04 Although presently the prevalent basis of valuation is cost, the carrying of investments at market value is also deemed acceptable.[2] If investments are carried at market, the unrealized appreciation (or depreciation) should be separately identified and included in revenues (or other expenses) of the appropriate fund in the statement of support, revenue, and expenses and changes in fund balance.

2.05 The basis of carrying investments should be the same in all funds and should be clearly disclosed in the financial statements. Where investments are carried at cost, the total market value of investments at the date of the statements should be shown parenthetically (for each fund), or set forth in the footnotes. Likewise, where investments are carried at market value, the cost of the investments should be disclosed parenthetically (for each fund), or set forth in the footnotes. In either event, the unrealized appreciation (or depreciation) in such investments at the beginning and end of the year should be disclosed in the footnotes.

2.06 Where assets held by one fund are transferred to another fund because of the lapse of restrictions, or where the assets transferred are to be sold by the recipient fund, such assets should be transferred at market value and gains or losses on such assets recorded by the fund making the transfer. The market value of the assets transferred becomes the basis for the fund receiving such assets.

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[2] At the time this guide was originally issued in 1974, carrying investments at market value was deemed acceptable pending further study and the issuance of an authoritative pronouncement by the FASB. In December 1975, the FASB issued FASB Statement No. 12, *Accounting for Certain Marketable Securities.* That statement does *not* apply to not-for-profit organizations.

Income and Realized (and Unrealized) Gains and Losses

2.07 The accounting for income on investments (e.g., dividends, interest) and for realized and unrealized gains and losses on disposal of investments depends upon the fund involved.

2.08 Investment income and realized gains and losses (and unrealized gains and losses, where investments are carried at market value) on investments of unrestricted funds should be reported in unrestricted revenue.

2.09 Income and net realized (and unrealized, where investments are carried at market value) gains on investments of restricted funds, other than endowment funds, should be included in the revenue of the restricted funds unless legally available for unrestricted purposes. In the latter case they should be included in the revenue of the current unrestricted fund. Realized (and unrealized, where investments are carried at market value) losses on investments of restricted funds in excess of gains should be reported as a loss in the statement of support, revenues, and expenses of the restricted fund unless legal restrictions require otherwise. For example, there may be cases where losses sustained on the temporary investment of a cash grant received for a research project cannot reduce the amount to be expended for the research; in such cases, it may be necessary that the loss be reflected in the statement of support, revenues, and expenses of (and be reimbursed by) the current unrestricted fund.

2.10 Investment income of endowment funds, unless restricted to a specific purpose by the donor of the endowment gift, is available for unrestricted purposes and should be included in the revenues of the current unrestricted fund. Where the donor has restricted the use of the income from the investment of the endowment gift, such income should be included in the revenue of the appropriate restricted fund.

2.11 Traditionally, realized gains and losses on investments of endowment funds have been considered as principal transactions and all restrictions that pertain to the original corpus of the fund have been deemed to apply to the net realized gains. Only when the endowment instrument has specifically stated that such gains and losses were not so restricted, have these amounts been considered as income.

2.12 The statutes of certain states now provide that certain not-for-profit organizations subject to their jurisdiction may, in certain circumstances, consider net realized (and, in some cases, unrealized) gains on investments of endowment funds to be available for unrestricted use. The law of one state, for example, provides that the amount of such funds to be made available for unrestricted use may include so much of the realized appreciation of principal as the governing board may deem prudent, provided that the amount of fair value of the remaining principal shall not be less than the fair value of the original assets at the time received. Under this approach a portion of the realized (and, in some cases, unrealized) capital appreciation in endowment funds is made available for operating purposes, and assets equal to this amount are transferred to the unrestricted fund. Where permitted by law, the designated amount of appreciation to be transferred to the unrestricted fund should be reflected as a transfer of fund balances. Amounts of realized (and, where applicable, unrealized) investment gains included in endowment funds that are available for transfer to the unrestricted fund at the discretion of the governing board should be disclosed in the financial statements; the authority on which such funds may be transferred should also be disclosed.

Investment Pools

2.13 To obtain investment flexibility, voluntary health and welfare organizations frequently pool investments of various funds. Because the realized and unrealized gains (losses) and income are not identified with the specific funds participating in the pool, it is of paramount importance that realized and unrealized gains (losses) and income be allocated equitably. To accomplish an equitable allocation, investment pools should be operated on the market value method. Under this method, each fund is assigned a number of units based on the relationship of the market value of all investments at the time they are pooled. Periodically, the pooled assets are valued and new unit values assigned. The new unit value is used to determine the number of units to be allocated to new funds entering the pool, or to calculate the equity of funds withdrawing from the pool. Investment pool income should be allocated to participating funds based on the number of units held by each fund. In cases where the income of one or more of the participating funds has been restricted by the donor for specified purposes, it may be necessary to account for gains and losses (due to market price changes) separate from other investment pool income (i.e., interest and dividends) since gains and losses may revert to the corpus of the restricted fund.

2.14 An illustration of an investment pool may be found in Appendix A.

Auditing Considerations

2.15 The auditing procedures to be considered in the audit of investments held by voluntary health and welfare organizations are similar to those that would be employed in the audit of investments held by business organizations. The internal control structure considerations which are appropriate in other organizations are appropriate for a voluntary health and welfare organization. Good internal control requires that securities be adequately safeguarded and that responsible persons be assigned the custodial and accounting duties therefor. The custodial and accounting duties, however, should not be under the control of the same person.

2.16 The independent auditor should satisfy himself that securities owned by the organization are actually in existence. This can be accomplished by examining the certificates owned or, if the certificates are held by others in safekeeping, by obtaining written confirmation of this fact from the custodian. Sales and purchases of securities may be tested by examining brokers' advices, and income from investments and market values may be tested against other independent sources. The independent auditor may also examine internal documentation to satisfy himself that such transactions were properly authorized.

2.17 The independent auditor should be satisfied that investment income and gains (or losses) have been recorded in the appropriate fund. He should consider whether gains (or losses) that are available for unrestricted use are appropriately reported in the unrestricted fund. He should be familiar with the provisions of any donor restrictions and state laws that are significant and relevant to the organization's investments. With respect to investment pools, the independent auditor may make tests of the calculations involved in determining equity percentages of the various funds used in making additions to or distributions from the pool and in allocating income and realized gains and losses to the participating funds. In reviewing pooled investments, consideration should be given to any legal instruments that prescribe the nature of the investment policy to be followed or that restrict or prevent the assets of certain funds from being pooled for investment purposes. In some cases, the independent auditor may wish to review these matters with the organization's legal counsel.

Chapter 3

Land, Buildings and Equipment and Depreciation

Background

3.01 The general practice of voluntary health and welfare organizations is to record transactions involving fixed assets used in connection with their program or supporting services in a separate land, buildings and equipment fund. Amounts contributed by donors specifically for the purchase of fixed assets are normally included in a subdivision of this fund.

3.02 Depreciation practices have varied among organizations. While some organizations have not followed the practice of recording depreciation on fixed assets, others have restricted the recognition of depreciation to those assets expected to be maintained or replaced from unrestricted fund revenues. Thus, in the case of the latter group, depreciation has generally not been recorded on assets expected to be replaced by special contributions from the public or from supporting groups. Financial Accounting Standards Board Statement No. 93, *Recognition of Depreciation by Not-for-Profit Organizations,* as amended, requires not-for-profit organizations to recognize the cost of using up the future economic benefits or service potential of their long-lived tangible assets—depreciation and to disclose:

a. Depreciation expense for the period
b. Balances of major classes of depreciable assets, by nature or function, at the balance sheet date
c. Accumulated depreciation, either by major classes of depreciable assets or in total, at the balance sheet date
d. A general description of the method or methods used in computing depreciation for major classes of depreciable assets.

The statement is effective for fiscal years beginning on or after January 1, 1990.

Basis of Fixed Assets

3.03 Generally accepted accounting principles require purchased fixed assets to be carried at cost and donated assets to be recorded at their fair value at the date of the gift.

3.04 The receipt of donated fixed assets that are to be held for use by the organization should be recorded as a contribution in the land, buildings and equipment fund. The value of donated fixed assets on which donor-imposed restrictions or conditions prevent their being immediately disposed of or currently used in carrying out the organization's normal program or supporting services should be recorded as contributions in a donor-restricted fund; at such time as the restrictions lapse or the specified conditions have been met, the assets should be transferred to the land, buildings and equipment fund if the assets are to be used in the organization's normal operations or to the unrestricted fund if they are to be held for resale or other use.

3.05 The receipt of donated fixed assets on which the donor has placed no restriction as to use or disposition and which will be held for conversion to cash or for the production of income should be recorded as support within, and as an asset on the balance sheet of, the unrestricted fund.

3.06 In the absence of adequate cost records, appraisals of historical cost or fair value at date of a gift are generally acceptable for financial reporting purposes. The basis of such valuation should be clearly described in the financial statements. Where such appraisals are used, the independent auditor should satisfy himself as to their propriety.

Depreciation

3.07 In its Accounting Terminology Bulletin No. 1, the Committee on Terminology of the AICPA defined depreciation accounting as follows:

> Depreciation accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation. Depreciation for the year is the portion of the total charge under such a system that is allocated to the year. Although the allocation may properly take into account occurrences during the year, it is not intended to be a measurement of the effect of all such occurrences.

3.08 The above definition properly identifies depreciation as a means of allocating the cost, or other carrying value, of tangible capital assets to expense over the useful life of such assets, rather than as a means of funding their replacement. Arguments against depreciation charges in not-for-profit organizations are largely based on the concept of replacement accounting. The means of replacing such assets and the degree to which replacement should be currently funded (i.e., by increasing or decreasing expenditures made in relation to the public support and revenues received and by setting aside cash or other liquid assets) are financing decisions to be made by the governing board and do not *directly* affect the *cost* of providing program or supporting services.

3.09 The definition is consistent with the concept of measuring the costs of the effort expended toward achieving the goals of voluntary health and welfare organizations (e.g., provision of various public services). Services performed for others generally involve a sacrifice or commitment of some type of resource which must be diverted from an alternative use. Although the achievement of such goals often may not be measurable in accounting terms, the public should have the opportunity to compare the results of such efforts, which are often intangible, to the costs involved in such efforts.

3.10 The relative effort being expended by one organization compared with other organizations and the allocation of such efforts to the various programs of the organization are indicated in part by cost determinations. Whenever it is relevant to measure and report the cost of rendering current services, depreciation of assets used in providing such services is relevant as an element of such measurement and reporting process. Although depreciation can be distinguished from most other elements of cost in that it requires no current equivalent cash outlay, it is not optional or discretionary. Assets used in providing services are both valuable and exhaustible. Accordingly, there is a cost expiration associated with the use of depreciable assets, whether they are owned or rented, whether acquired by gift or by purchase, and whether they are used by a profit-seeking or by a not-for-profit organization.

3.11 Where depreciation is omitted, the cost of performing the organization's services is understated. Depreciation expense, therefore, should be recognized as a cost of rendering current services and should be included as an element of expense in the statement of support, revenue, and expenses of the fund in which the assets are recorded and in the statement of functional expenditures.

3.12 In some cases, an organization may receive grants, allocations, or reimbursements from other organizations on the basis of the costs associated with its program and supporting services. The recording of depreciation as an element of cost does not dictate that it be included in the base upon which grants, allocations, or reimbursements will be determined. Whether the base upon which the amount of the grant or reimbursement is determined includes or excludes depreciation will depend upon the agreement or understanding that has been reached between the two organizations.

Auditing Considerations

3.13 The auditing procedures generally applied in the audit of land, buildings and equipment and depreciation expense are also applicable in the case of voluntary health and welfare organizations. In addition, the independent auditor should satisfy himself that donations of fixed assets are recorded in the manner described in this chapter.

Chapter 4

Cash Donations and Pledges

4.01 Cash donations and pledges from the public usually constitute the major source of support for voluntary health and welfare organizations. Whether received directly as an unrestricted gift, a restricted gift for operating purposes, a restricted gift for the acquisition of fixed assets, a restricted endowment (the income from which provides operating revenue), or indirectly through an agency which provides fund-raising services for participating organizations, such support and capital additions are essential to the continuity of the organization. If portions of the donations (including pledges) received during the period are specified by the donor for use in future periods, such portions should be recorded as a deferred credit in the balance sheet of the appropriate fund and recorded as support in the year in which they may be used. In the absence of clear evidence as to a specified program period, donations and pledges should be recorded as support when received.

Means of Obtaining Support

4.02 Some of the more common means of soliciting and obtaining support from the public, together with comments regarding the unusual accounting, recording, and auditing aspects of each, are itemized below.

1. *Direct Mail Campaigns.* Under this method the organization maintains or buys (or a combination of the two) mailing lists of contributors and potential contributors to whom solicitations are sent. Two employees should be assigned the function of jointly controlling incoming mail and preparing a record of amounts received. This record usually takes the form of multicopy prenumbered receipts, or a "day book" listing of amounts received, which is totaled and initialed by these employees. This record should be routinely compared with bank deposits, preferably by someone not having access to the donations.

4.03 It should be recognized that possible alternatives exist if dual control of incoming mail cannot be established. In some localities, banks provide a service whereby all mail directed to a participating agency is controlled by the bank, and authenticated deposit slips and a list of deposits are furnished the organization. Alternatively, test mailing of "contributions" made by protective agencies or others can be subsequently traced into the records.

4.04 The independent auditor may wish to select a sample from the mailing list as a means of testing the subsequent receipt of solicited contributions. Since the names on the mailing list represent the universe from which the independent auditor's sample will be drawn, control over the list should be established prior to the mailing of the solicitations. When the solicitation has been completed, the independent auditor should, for the sample selected, note the contributions received and observe whether acknowledgments have been sent to the contributors. As a means of testing the organization's receipt and acknowledgment procedures, the independent auditor may wish to circularize the names included in his sample to obtain confirmation of whether contributions were made and, if so, the amount and date of such contributions.

2. *Door-to-Door Solicitation.* Under this method, the organization establishes a volunteer group with area chairmen, division and neighborhood captains, and door-to-door solicitors, each in turn reporting to and remitting funds collected to the next higher level.

Control over the flow of promotional material, reports, and donations through the various organizational levels outlined below will generally result in providing reasonable assurance that all contributions received are recorded. Collections should be deposited at the earliest practical level of the organization.

4.05 Typically, a door-to-door solicitor has ten to twenty family units to contact. A neighborhood captain is responsible for about ten door-to-door solicitors, and a division captain is responsible for about ten neighborhood captains, etc. Each solicitor is provided a kit including some form of identification authorizing him to solicit contributions in the name of the organization, printed material to aid in soliciting donations, envelopes or receipt forms for contributions, and forms for reporting the response of each family unit assigned to him and the amount collected from each. These kits are distributed to the solicitors on the basis of organizational reports showing the number of volunteers required to cover the neighborhood. The organizational reports are usually checked against a detailed street map and city directory by the area chairman to ascertain that all sources are being covered.

4.06 The amount of currency collected by any one door-to-door solicitor will usually be small; larger donations are usually made by check and are often sent directly to the organization. The requirement that the solicitor report the response of each family unit assigned to him will usually provide reasonable assurance that there has been no material diversion of donations at this level.

4.07 The neighborhood captain should be given the responsibility of obtaining a signed report from each door-to-door solicitor, and of summarizing and submitting the individual and summary reports to the division captain. The division captain should be responsible for checking the neighborhood captain's report to the supporting detail and proving the amount of collections turned in. The division captain should also determine that reports have been received from all solicitors and should prepare a summary report of all amounts collected in his area.

4.08 Separation of the control over the donations received from control over the reports should be made as soon as practicable. The use of depository bank accounts in the field that are subject to withdrawal only by designated organization personnel enhances the control over donations and provides greater assurance that all contributions received will be properly accounted for. All donations received, or copies of the deposit slips for donations deposited in local depository bank accounts, should be forwarded to the organization's treasurer, with copies of the reports summarizing the donations received. The original reports and supporting detail should be turned over to the area chairman. The area chairman should ascertain that a report is received from each person to whom solicitation material was supplied. The original reports should be recapitulated and forwarded to the organization's controller. At that point the total contributions reflected in these reports should be compared to the amounts reported as deposited by the treasurer and traced to the bank deposits.

3. *Radio and Television Solicitation.* Since, under this method, the universe from which contributions may be received cannot be defined, controls must be established over donations. It is essential that a record of all contributions and pledges received be established at the earliest practicable moment. Collection of pledges should be made promptly. The responsibility for collection and the custodianship of amounts collected should be separated at the earliest possible point.

4. *Street Sales and Solicitation.* Under this method, each person authorized to solicit funds will normally have access to a limited amount of cash. If procedures similar to those mentioned above for door-to-door solicitation are designed to assure that each solicitor makes a report, and if controls over the cash collected and the accounting therefor are separated at this point, reasonably good control over this type of solicitation can be established.
5. *Contributions From Uncontrolled Organizations.* Under this method, money is received from other organizations such as United Way or community-wide drives, or from federal and other governmental groups. Solicitation for such funds is generally performed by an unrelated agency which acts as a conduit for funds to the organization.

4.09 The independent auditor should satisfy himself by obtaining written confirmation, review of distribution formulae, etc., that the amounts due the organization and any liabilities to the fund-raising agency have been recorded and that any restrictions placed upon the use of the funds have been recognized.

6. *Special Events.* As the name implies, special events encompass a variety of activities to raise revenue and may include fund-raising dinners, dances, theatre parties, or other social events for which tickets are sold to donors. Persons handling collections should be required to account for all tickets, and gross receipts should be reconciled to the tickets sold.

4.10 Detailed records of the costs of each event should be kept since the organization has the responsibility of advising the donor of the income tax deductible portion of the ticket price (the excess of the ticket price over the per-ticket cost of the event).

4.11 In all cases, it is essential that the initial record of amounts received be subsequently verified against the amounts deposited in the depository of the organization.

Pledges

4.12 Since there are no basic accounting differences between the receipt of cash donations and the receipt of pledges, the amount of all pledges should be recorded when obtained. The principles to be followed in recording amounts pertaining to pledges should be identical with those used for cash donations. Provisions should be made for uncollectible pledges based on the organization's collection policy and past experience; the length of time that the pledge has been outstanding, current economic conditions, and other matters should also be taken into consideration in arriving at the provision to be made. The allowance for uncollectible pledges and the net amount of pledges receivable should be disclosed in the financial statements of the organization.

4.13 For donations arising from United Way campaigns or collected by other agencies, any amounts allocated but not received at the balance-sheet date should be recorded in the same manner as pledges receivable.

Auditing Considerations

4.14 One of the independent auditor's objectives in his audit of the financial statements of a voluntary health and welfare organization is to obtain satisfaction that the amounts reported as contributions are properly stated. The voluntary nature of the sources of support and, in many cases, the geographic dispersion of the sources and means of solicitation of support create internal control, accounting and auditing problems not usually found in other kinds of organizations. There cannot be complete assurance that all such contributions are received by the organization; however, controls can usually be established to provide reasonable satisfaction that contributions are not materially misstated.

4.15 The independent auditor should consider whether the internal control structure policies and procedures relating to voluntary contributions are appropriate in the circumstances and are operating effectively. His objective should be to satisfy himself that the organization has taken all practicable steps to insure that all contributions intended for it have been received and recorded. If he can be satisfied in this regard he should be able, if other circumstances permit, to give an unqualified opinion on the financial statements taken as a whole. If he cannot be so satisfied, he should consider giving a qualified opinion or disclaiming an opinion on the financial statements (see Statement on Auditing Standards No. 58, *Reports on Audited Financial Statements,* paragraphs 40-44).

4.16 Procedures for auditing the balance of pledges receivable are similar to those employed in the examination of accounts receivable, although certain modifications are necessary because of the lack of invoicing and an absence of the normal debtor/creditor relationship. Procedures which may be considered include the following:

1. Test the extent and effectiveness of internal controls.
2. Review the aging and the estimated collectibility of pledges receivable, and determine the adequacy of the allowance for uncollectible pledges.
3. On a test basis, circularize pledges receivable to establish that they are bona fide and to obtain confirmation of certain information, such as possible restrictions and the period over which the pledges become due. The confirmations should be carefully worded to avoid any implication that the donor is being requested to pay the amount pledged.

Chapter 5

Donated Material and Services[3]

Donated Material

5.01 Donated materials of significant amounts should be recorded at their fair value when received, if their omission would cause the statement of support, revenue, and expenses to be misleading and if the organization has an objective, clearly measurable basis for the value, such as proceeds from resale by the organization, price lists, or market quotations (adjusted for deterioration and obsolescence), appraisals, etc. Such recording is necessary to properly account for all transactions of the organization, as well as to obtain stewardship control over all materials received.

5.02 If the nature of the materials is such that valuations cannot be substantiated, it is doubtful that they should be recorded as contributions; used clothing received as contributions and subsequently given away might, for example, fall into this category. There is, of course, no valuation problem where donated materials are converted into cash soon after receipt, since the net cash received measures the contribution.

5.03 When donated materials are used in rendering the service provided by the organization, the cost of such materials included in the service is based on the value previously recorded for the contribution. If donated materials pass through the organization to its charitable beneficiaries and the organization merely serves as an agent for the donors, the donation normally would not be recorded as a contribution.

5.04 If significant amounts are involved, the value of the materials recorded as contributions and expenditures should be clearly disclosed in the financial statements. Free use of facilities and other assets useful in fulfilling the organization's purposes should also be recorded as contributions, based on criteria similar to those outlined above. The basis of valuation should also be disclosed.

Donated Services

5.05 The extent and nature of donated services received will vary among organizations and may range from a limited participation of many individuals in fund-raising activities, both in the business and residential communities, to an active participation in the organization's program services. Because of the difficulty of placing a monetary value on donated services, and the absence of control over them, the value of these services often is not recorded as contributions and expense. Where significant, however, donated services should be recorded when the following circumstances exist:

1. The services performed are a normal part of the program or supporting services and would otherwise be performed by salaried personnel.
2. The organization exercises control over the employment and duties of the donors of the services.
3. The organization has a clearly measurable basis for the amount.

5.06 Services which generally are not recorded as contributions, even though such services might constitute a significant factor in the operation of the organization, include the following:

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[3] Donated securities and fixed assets are discussed in Chapters 2 and 3.

1. Supplementary efforts of volunteer workers, which are provided directly to beneficiaries of the organization. Such activities may comprise auxiliary activities or other specific services which would not otherwise be provided by the organization as a part of its operating program.
2. Periodic services of volunteers needed for concentrated fund-raising drives. The activities of volunteer solicitors are not usually subject to a sufficient degree of operating supervision and control by the organization to enable it to have a proper basis for measuring and recording the value of the time devoted. However, if individuals perform administrative functions in positions which would otherwise be held by salaried personnel, consideration should be given to recording the value of these services.
3. Professional personnel engaged in research and training activities without pay or with a nominal allowance. This type of work, although usually performed in connection with grants made by the organization to other agencies, universities, or institutions for specific research projects, is not normally under the direct supervision and control of the granting organization. Accordingly, it is ordinarily considered not practicable to compute a value for these services.

5.07 The financial statements should disclose the methods followed by the organization in evaluating, recording, and reporting donated services and should clearly distinguish between those donated services for which values have been recorded and those for which they have not been recorded.

Auditing Considerations

5.08 The scope of the audit of donations of materials and services will depend upon his evaluation of the extent and effectiveness of the organization's accounting procedures and internal control. The auditing procedures outlined below are intended only as examples and are not all-inclusive nor will all procedures be applicable to every organization.

5.09 *Donated Material.* The audit of donated materials is similar to the audit of inventories for other types of organizations and, where a large volume of transactions is encountered, the accounting procedures and system of internal control become particularly important.

5.10 Procedures which may be considered in the audit of donated materials include the following:

1. Test the extent and effectiveness of the accounting procedures and internal control.
2. Review the basis of valuation.
3. Compare contributions and expenditures of materials with the budget or with prior years.
4. If significant contributions are received from relatively few sources, it is ordinarily desirable to obtain confirmation of the amounts from the donors.

5.11 Donated materials recorded as contributions and on hand at the balance sheet date constitute assets which would be subject to audit procedures normally applicable to inventories.

5.12 *Donated Services.* Procedures which may be considered in the audit of donated services include the following:

1. Obtain a listing of recorded amounts, including name and position of person rendering the services, gross annual valuation of the services, amount paid in cash (if any), and net contribution recorded.
2. Review on a test basis the time records, scheduling sheets, or other evidence to substantiate the services rendered.
3. Review for reasonableness the listing of the gross annual valuation for each position in relation to the local labor market, and determine that the positions listed are applicable to the operating program and are appropriate to be recorded as contributions.
4. Compare the total of the listing to the amount recorded as contributions.
5. Inquire of appropriate organization officials as to other volunteer help which might be considered as taking the place of salaried personnel.

Chapter 6 *

Program and Supporting Services

Functional Classification of Expenses

6.01 A wide variety of persons and groups are interested in the reported expenses of voluntary health and welfare organizations. The first group to be considered is the organization's contributors, who have given money, services, or material. The second group represents the organization's trustees or directors, who have a fiduciary responsibility to conserve and expend its assets for the organization's stated objectives. The third interested group is the compensated executives of the organization, who have the responsibility of carrying out the stated policies of the organization's governing board. The fourth group is made up of those governmental jurisdictions that have authority to control charitable solicitation through legislation and the local, state, and federal governments which grant tax exemptions to charitable organizations.

6.02 Although each of these groups may be interested in information about particular types of expenses, the cost of providing various services or other activities is of greater importance and becomes apparent only when the expenditures are summarized on a "functional" basis. The functional classifications used by most organizations include specific "program services" which describe the organization's social service activities, and "supporting services" under which management (or administrative) and general expenses and fund-raising costs are shown as separate items.

6.03 Expenditures for program services should be segregated from fund-raising and management and general expenditures, and the amount of each should be clearly disclosed in the financial statements.

Program Services

6.04 The functional reporting classifications for program services will vary from one organization to another depending upon the type of services rendered. For some organizations, a single functional reporting classification may be adequate to portray the program service provided. In most cases, several separate identifiable services may be provided and in such cases expenditures for program services should be reported by type of service function, or group of functions. Grants to other service agencies and to affiliates for social services rendered by them should be included in the functional categories since these payments are program service expenditures from the standpoint of the organization making the grant.

6.05 The various functions should be adequately described to clearly portray their purpose, and each functional classification should include all of the costs that are applicable to the service described. For instance, where public education is part of the program for which funds are requested, the cost of year-round efforts to inform the community of dangers to the public health or welfare and the need for individual and group precautions should be charged to the program service function of public education. Some costs which normally fall under this function include the following:

1. Direct costs of symposia for the instruction of the public.

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* [Note—This chapter has been amended by SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-For-Profit Organizations That Include a Fund Raising Appeal,* paragraphs 14-22. See Appendix B.]

2. Salaries of employees while preparing, arranging for, and giving talks to groups.
3. Costs of pamphlets, letters, posters, films, and other materials that give technical information.
4. Costs of educational materials that deal with a particular health or welfare problem and are disseminated to groups selected on the basis of need (for example, distributions made to or through tax-supported agencies).

6.06 The costs of the organization that may have some relationship to the function but are primarily directed toward other purposes should not be charged or allocated to this function, except as permitted by SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal.*

6.07 Salaries and other costs that are not normally charged to this function include those relating to:

1. Postage for mass mailing of materials in preparation for or in connection with fund-raising solicitations and the cost of maintaining contributor mailing lists and files.
2. Public meetings to "kick off" a fund-raising solicitation.
3. Purchasing or arranging television and radio announcements that request contributions.
4. Publicity and public relations activities, the primary purpose of which is to keep the organization's name before prospective contributors.
5. Costs of informational materials that are oriented to the organization, that contain only general information regarding the health and welfare problem, or that are distributed to those appearing on lists of potential contributors.

Management and General

6.08 Management and general costs include expenditures for the overall direction of the organization, general record keeping, business management, budgeting, general board activities, and related purposes. (Direct supervision of program services and of fund raising should be charged to those functions.) "Overall direction" will usually include the salaries and expenses of the chief officer of the organization and his staff. If they spend a portion of their time directly supervising fund-raising or program service activities, such salaries and expenses should be prorated among those functions.

6.09 Expenses incurred in keeping a charitable organization's name before the public that are not properly classified as program services or as fund-raising expenses should be classified as management and general expenses. The cost of disseminating information to inform the public of the organization's "stewardship" of contributed funds, the publication of appointments, the annual report, etc., should likewise be classified as management and general expenses.

Fund Raising

6.10 The fund-raising function encompasses more than the solicitation of contributions. Other expenditures that should normally be charged to this function include costs of transmitting appeals to the public (including postage, addressing, and maintenance of mailing lists and other fund drive records) and the salaries of personnel connected with the campaign. An appropriate portion of the salaries of regular staff members who devote time to record keeping for fund raising, whether during the campaign period or not, should be allocated to fund-raising expenses. Fund-raising services and materials received from affiliates should also be charged to this function.

6.11 The cost of printed material used should be charged to program service, management and general, or fund raising on the basis of the use made of the material, determined from the content, the reasons for distribution, and the audience to whom it is addressed. SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal,* recommends that:

- If it can be demonstrated that a bona fide program or management and general function has been conducted in conjunction with an appeal for funds, joint costs of informational materials or activities that include a fund-raising appeal should be allocated between fund-raising and the appropriate program or management and general function.
- All joint costs of informational materials or activities that include a fund-raising appeal should be reported as fund-raising expense if it cannot be demonstrated that a program or management and general function has been conducted in conjunction with the appeal for funds.

SOP 87-2 is included as Appendix B in this guide.

6.12 Fund-raising costs should generally be charged to the current unrestricted fund. However, where fund-raising costs can be specifically identified with a special purpose fund drive, such as a building fund campaign, it may be appropriate to charge such costs to that fund.

6.13 Readers of the financial statements should be able to relate the total fund-raising cost to the total support received. The financial statements, therefore, should clearly disclose the total support received and the related fund-raising cost incurred for the period.

Allocation of Costs Which Pertain to Various Functions

6.14 In some of the larger organizations, individual functions are performed by separate departments, with expenses classified by types within each department. Many other organizations incur costs that apply to more than one functional purpose. In such cases, it may be necessary to allocate these costs among functions. Examples include salaries of those who perform more than one type of service, rental of a building used for various program services, management and general, and fund-raising activities.

6.15 Where employees perform duties that relate to more than one function, the salaries of such individuals, as well as all other expenses which pertain to more than one function, should be allocated to the separate functional categories based on procedures that determine, as accurately as possible, the portion of the cost related to each function. In some cases, and particularly where most of an individual's time is spent on one function, estimates of the time spent on each function may be appropriate. However, in many cases the maintenance of employee time reports will be practical and will result in a more accurate determination of the costs attributed to each function. In cases where the time of employees is spent on various functions and such functions do not vary significantly during each accounting period, the preparation of time reports for selected test periods during the year might be sufficient to determine the allocation of such costs to the related functions.

6.16 A reasonable allocation of an organization's functional expenditures may be made on a variety of bases. The following allocation procedures are illustrative only, but use of these or similar procedures will ordinarily result in a reasonable allocation of an organization's multiple function expenditures:

1. A study of the organization's activities may be made at the start of each fiscal year to determine the best practicable allocation methods. This study should include an evaluation of the preceding year's time records or activity reports of key personnel, the use of space, the consumption of supplies and postage, etc. The results of this study should be reviewed periodically and revised where necessary to reflect significant changes in the nature or level of the organization's current activities.
2. Daily time and expense records may be kept by all employees who spend time on more than one function and may be used as a basis for allocating salaries and related costs. These records should indicate the nature of the activities in which the employee is involved.
3. Automobile and travel costs may be allocated on the basis of the expense or time reports of the employees involved.
4. Telephone expense may be allocated on the basis of use of the extensions, generally following the charge for the salary of the employee using the telephone, after making direct charges for toll calls or other service attributable to specific functions.
5. Stationery, supplies, and postage costs may be allocated based on a study of their use.
6. Occupancy costs may be allocated on the basis of a factor determined from a study of the function of the personnel using the space involved.
7. The depreciation and rental of equipment may be allocated based on asset usage.

Statement of Functional Expenses

6.17 The functional classification of expenses provides an analysis of the cost associated with each of the program services or other activities in which the organization is engaged. In order to show the type of cost involved in providing these services or in carrying out the other activities, the organization's financial statements should contain a statement which sets forth in reasonable detail the nature of the expenses and costs incurred in each functional category of program and supporting services. In many cases, the type of expenditures will be limited to a few line items, such as employee salaries and benefits, awards and grants, supplies, occupancy, etc. The detail to be shown will vary from one organization to another depending upon the activities in which the organization is engaged and the methods followed in carrying out those activities. The financial statements should, however, contain sufficient information to enable the reader to obtain a general understanding of the nature of the costs of carrying out the organization's activities. The level of detail shown in Exhibit B of this guide would generally provide this understanding.

Payments to Affiliated Organizations

6.18 Payments, for unspecified purposes, by local organizations to state and national affiliates should be charged to appropriate accounts maintained for that purpose. Such payments will normally be used for national program service, management and general, and fund-raising expense, but it is generally impractical for an allocation to such specific expense captions to be made. There may be cases where it would be appropriate to report certain types of payments to state or national affiliates as a deduction from total support and revenue in the statement of support, revenue and expenses. The criteria for determining the appropriate method in any case includes the contractual arrangements with the state or national organization, the basis on which the funds were solicited and received from the public, and possibly the uses to be made of the funds transmitted.

Services Rendered by Affiliated Organizations

6.19 If employees of separately governed affiliated organizations regularly perform services other than in an advisory capacity under the direction of the organization being audited or if significant amounts of materials are received from related organizations, an appropriate accounting for such expenses should be made. Since the purpose of recording these transactions is the disclosure of the expense of the organization, the offsetting credit should be to income. A reasonable valuation of such services and materials may have to be determined by correspondence with the separately governed organization.

Auditing Considerations

6.20 Auditing procedures for expenditures in a voluntary health and welfare organization are similar to those used in the audit of business organizations. Such procedures include a review of the internal control over the classification of expenditures and tests to determine that they are classified according to stated policies. The following are illustrations of procedures which may be used by an organization to provide internal control over the classification of expenditures:

1. Preparation of a detailed budget that is reviewed periodically by a committee of directors or trustees.
2. Preparation and maintenance of up-to-date job descriptions and organization charts.
3. Preparation of studies of the services performed by employees who serve more than one function, to determine the bases for allocating their salaries and expenses.
4. Use of employee time reports describing the work done and services performed.
5. Use of written instructions to employees on the preparation of time and expense reports covering the method to be followed in determining and indicating services being performed.

6.21 The auditing procedures which may be considered in connection with the allocation of functional expenditures include the following:

1. Determine that the functional classifications adopted will adequately disclose the use made of resources.
2. Review the method of allocating expenditures involving more than one function to determine that such methods are reasonable.

3. Examine expenditures to determine that the allocation methods were followed. For example, the review of salary and wage allocations might include an examination of program reports, job descriptions, and employee time, activity and expense reports.
4. Ascertain that the allocation and classification methods used were consistent with those used in the preceding year.
5. Compare actual expenditures with budgeted and/or prior year amounts and obtain explanations for significant variations.

6.22 The independent auditor should satisfy himself that any grants to other organizations have been authorized by the governing board and, where appropriate, that the organization has established procedures to ascertain that grants made have been expended for their intended purposes.

Chapter 7

Financial Statements and the Independent Auditor's Report

General

7.01 Financial statements of voluntary health and welfare organizations are generally prepared on one of the following bases:

1. *Accrual basis.* Under this method of accounting, revenues and expenses are identified with specific periods of time and are recorded as incurred, along with acquired assets, without regard to the date of receipt or payment of cash. Financial statements prepared on this basis conform to the practices of business organizations in general, with respect to such items as receivables, inventories, prepayments, and accrual of liabilities.
2. *Cash basis.* Under this method of accounting, revenues and expenses are recorded only when received and paid, respectively, without regard to the period to which they apply. Thus, financial statements prepared on this basis reflect cash receipts and disbursements only.

7.02 An additional basis of accounting, known as the *modified accrual basis,* has been in use by certain types of voluntary health and welfare organizations. Under this method such items as receivables, inventories, and payables may be accounted for on an accrual basis, while other items such as income from investments, insurance, rent, salaries, etc., may be accounted for on the cash basis.

7.03 The accrual basis of accounting is required by generally accepted accounting principles for a fair presentation of financial position and results of operations. Financial statements prepared on a cash basis, or a modified accrual basis, may be considered to present financial position and results of operations in conformity with generally accepted accounting principles only if they do not differ materially from financial statements prepared on an accrual basis; this should be carefully considered by the independent auditor in expressing an unqualified opinion on such financial statements.

7.04 If cash basis statements, or modified accrual basis statements, do not purport to present financial position or results of operations, they may be considered as special reports (see Statement on Auditing Standards (SAS) No. 62, *Special Reports*). The basis on which such statements are prepared should be clearly disclosed.

Form of Financial Statements

7.05 Illustrative financial statements are presented as Exhibits A, B, and C to this guide. Since the information that would normally be presented in a statement of changes in financial position as discussed in Accounting Principles Board Opinion 19* will, in most cases, be readily apparent from other financial statements, such a statement is generally not required. Modifications

* [Note—FASB Statement No. 95, *Statement of Cash Flows,* as amended, supersedes APB Opinion No. 19, *Reporting Changes in Financial Position,* and requires a statement of cash flows as part of a full set of financial statements for all business enterprises in place of a statement of changes in financial position. Not-for-profit organizations are excluded from the scope of FASB Statement No. 95 pending completion of the FASB's project on concepts of financial reporting for not-for-profit organizations.]

to the financial statements illustrated should be made to fit the facts and circumstances of each specific organization.

7.06 Because of the restrictions associated with certain funds, the financial statements should reflect unrestricted and restricted funds separately. All resources that are committed to or currently available for use in carrying out the organization's program and supporting services (except for unrestricted amounts invested in land, buildings and equipment which are accounted for in a separate fund) should be segregated from those that are restricted as to use by the donor, by law, or by other external authority. It is appropriate in such presentations to identify amounts of unrestricted funds that have been designated for specific purposes by the governing board, provided it is clear that they continue to be part of the unrestricted fund and can be made available by board action for general purposes.

Associated Organizations, Independently Governed

7.07 A voluntary health and welfare organization may have other organizations associated with it. A national organization may have state and local chapters which have varying degrees of autonomy, and smaller, local organizations may have auxiliaries whose functions range from the rendering of charitable service to purely fund-raising activities. Sometimes these associated organizations are separate corporate entities; sometimes they are merely unincorporated "boards" or committees. The amounts of their revenues and assets may range from inconsequential to substantial.

7.08 When an independent auditor is engaged to audit the financial statements of an agency having associated organizations, he will have to decide whether to confine his audit to the agency itself or to extend his audit to the records of the associated organizations.

7.09 Essentially, the question of whether to audit the financial statements of associated organizations revolves around the functions performed by them and the extent to which their operations and finances are interlocked with those of the primary organization. If, for example, the client organization is a national health association with its own governing board and is federated with a group of state or local chapters, each independently controlled by its own elected board, the independent auditor ordinarily can confine his audit to the financial statements of the national organization. The following are some indications of independence which might make an audit of the financial statements of other organizations unnecessary:

1. The organization is independently controlled by its own elected board.
2. It is identified as an independent organization on its letterhead and in all its fund-raising activities.
3. A clear disclosure is made of the method of operation in its solicitation material, e.g., that proceeds will be turned over to the client organization only after the affiliate's costs have been deducted.
4. There is no requirement for expenses to be approved by the client organization.
5. Expenses normally borne by the client organization are not arbitrarily paid by the other organization and excluded from the client's accounts.
6. The auxiliary organization, if any,

a. has significant purposes other than those of the primary organization.
b. does not join with the primary organization in the registration or annual filing with any regulatory body or the Internal Revenue Service.

Consolidated or Combined Affiliates

7.10 When reporting on consolidated or combined financial statements, the independent auditor of the parent organization will necessarily have to concern himself with the audit of the chapter financial statements. Where one or more of the affiliated entities are audited by other independent auditors, the standards and procedures applicable to reports on consolidated or combined financial statements, as discussed in Statement on Auditing Standards No. 1, section 543, *Part of Audit Performed by Other Independent Auditors,* are applicable.

7.11 The independent auditor should normally obtain a written representation from officers of the national organization that all transactions with its controlled affiliate organizations have been recorded or reported to the independent auditor. The auditing considerations applicable to an affiliate which has been determined to be controlled by the national organization will be generally the same as those for the national organization.

Illustrative Auditor's Report

7.12 The financial statements of a voluntary health and welfare organization that purport to present financial position and results of operations must be prepared in conformity with generally accepted accounting principles. The independent auditor should exercise his professional judgment in each instance, both as to the form of the financial statements appropriate under the circumstances and as to the opinion, or disclaimer of opinion, to be expressed on them.

7.13 The audit problems peculiar to these organizations, as discussed in this guide, should be considered by the independent auditor in setting the scope of his audit. Particular attention should be given to the comments in Chapter 4 of this guide regarding the degree of satisfaction that the independent auditor should obtain as to voluntary contributions in order to give an unqualified opinion.

7.14 *Unqualified Opinion.* Where the independent auditor concludes that the financial statements present the financial position, results of operations, and changes in fund balance in conformity with generally accepted accounting principles, his report may read as follows:

<u>Independent Auditor's Report</u>

[*Addressee*]

We have audited the accompanying balance sheet of XYZ Health and Welfare Service as of December 31, 19XX, and the related statements of support, revenue, and expenses and changes in fund balances and of functional expenditures for the year then ended. These financial statements are the responsibility of the Service's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements.

An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our 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 Health and Welfare Service as of [*at*] December 31, 19XX, and the results of its operations and the changes in its fund balances for the year then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

7.15 *Qualified Opinion.* If the independent auditor believes the financial statements are at variance with generally accepted accounting principles, and the variance is not sufficiently material to require an adverse opinion on the financial statements taken as a whole, his report should be qualified. (See Statement on Auditing Standards No. 58, *Reports on Audited Financial Statements,* paragraphs 38—66.) An example of such a qualification is as follows:

Independent Auditor's Report

[*Addressee*]

[*Same first and second paragraphs as the standard report*]

XYZ Health and Welfare Service has excluded from land, buildings and equipment and support from the public in the accompanying financial statements, the value of fixed assets received as donations that, in our opinion, should be recorded in order to conform with generally accepted accounting principles. If these fixed assets were recorded, land, buildings and equipment and the fund balance of the land, building and equipment fund would be increased by $____ at December 31, 19XX and public support and the excess of public support and revenue over expenses of the land, building and equipment fund would be increased by $____ for the year then ended.

In our opinion, except for the effects of not recording the value of donated assets as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Health and Welfare Service as of [*at*] December 31, 19XX, and the results of its operations and the changes in its fund balances for the year then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

7.16 If the financial statements do not disclose the functional classification of expenditures, such as fund-raising costs, the independent auditor's opinion should be qualified. An example of such a qualification is as follows:

Independent Auditor's Report

[*Addressee*]

[*Same first and second paragraphs as the standard report*]

During 19X2, the Service incurred costs of approximately $____ in connection with its fund-raising efforts. Such amount is not set forth separately in the accompanying financial statements as required by generally accepted accounting principles, but is included in the amount shown for management and general expenses.

In our opinion, except for the omission of the information mentioned above, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Health and Welfare Service as of [*at*] December 31, 19XX, and the results of its operations and the changes in its fund balances for the year then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

7.17 If the independent auditor has taken all steps that he believes practicable and yet cannot satisfy himself that contributions, if any, beyond those that have been recorded, are not material but has no reason to believe that any unrecorded amounts might be so great as to negate his opinion on the financial statements, he may express an opinion that is qualified as to the effects of any unrecorded contributions. His opinion in this case might be worded as follows:

Independent Auditor's Report

[*Addressee*]

[*Same first paragraph as the standard report*]

Except as discussed in the following paragraph, we conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

No accounting controls are exercised over door-to-door cash collections prior to the initial entry of such contributions in the accounting records. Accordingly, it was impracticable to extend our audit of such receipts beyond the amounts recorded.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had the collections of cash contributions referred to above been susceptible to satisfactory audit tests, the financial statements referred to in the first paragraph above present fairly, in all material respects, the financial position of XYZ Health and Welfare Service as of [*at*] December 31, 19XX, and the results of its operations and the changes in its fund balances for the year then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

7.18 Where the independent auditor, after investigation, has reason to believe that the unrecorded amounts might be so great as to negate his opinion on the financial statements, he should disclaim an opinion.

7.19 *Disclaimer of Opinion.* If the independent auditor has not been able to satisfy himself with respect to the financial statements, a disclaimer of opinion may be required. This might occur, for example, if the independent auditor has been requested not to circularize pledges receivable (and the amounts involved are material), or if he has not been able to examine "sufficient competent evidential matter" with respect to other material amounts. In such case, the independent auditor's report might be worded as follows:

Independent Auditor's Report

[*Addressee*]

We were engaged to audit the accompanying balance sheet of XYZ Health and Welfare Service as of December 31, 19XX, and the related statements of support, revenue, and expenses and changes in fund balances and of functional expenditures for the year then ended. These financial statements are the responsibility of the Service's management.

[*Second paragraph of the standard report should be omitted*]

At the request of the Service's management, we did not request confirmation of pledges receivable by direct correspondence with donors.

Since we did not request confirmation of pledges receivable by direct correspondence with donors, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on these financial statements.

[*Signature*]

[*Date*]

7.20 *Adverse Opinion.* If the independent auditor believes that the organization's financial statements do not present fairly its financial position and results of operations, he should express an adverse opinion, which might read as follows:

Independent Auditor's Report

[*Same first and second paragraphs as the standard report*]

As discussed in Note X to the financial statements, the Service [*brief description of practice at variance with generally accepted accounting principles*]. Generally accepted accounting principles require that [*brief description of applicable generally accepted accounting principle*].

Because of the departure from generally accepted accounting principles identified above, (brief description of the effect of the practice).

In our opinion, because of the effects of the matters discussed in the preceding paragraphs, the financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of XYZ Health and Welfare Service as of [*at*] December 31, 19XX, or the results of its operations and the changes in it's fund balances for the year then ended.

[*Signature*]

[*Date*]

7.21 *Special Report Opinion.* If in the independent auditor's opinion, the financial statements do not purport to present financial position and results of operations, the requirements of Statement on Auditing Standards No. 62, *Special Reports,* apply. In reporting upon such statements, the independent auditor should ascertain that there is a clear representation of what they do present and of the basis on which they have been prepared. As an example, for statements prepared on a cash basis, which may appear to, but do not, present financial position and results of operations, disclosure should be made in the statements or in notes thereto of (a) the fact that the statements have been prepared on a cash receipts and disbursements basis, and (b) the general nature and, where practicable, the net effect of any material items omitted from the statements. In these circumstances, the terms "balance sheet," "statement of operations," or similar titles should not be used.

7.22 The independent auditor's report on cash basis statements might be worded as follows:

Independent Auditor's Report

[*Addressee*]

We have audited the accompanying statements of assets, liabilities and fund balances arising from cash transactions for XYZ Health and Welfare Service as of December 31, 19XX, and the related statement of revenue collected and expenses paid for the year then ended. These financial statements are the responsibility of the Service's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note X, these financial statements were prepared on the basis of cash receipts and disbursements, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets and liabilities arising from cash transactions of XYZ Health and Welfare Service as of [*at*] December 31, 19XX, and its revenue collected and expenses paid during the year then ended, on the basis of accounting described in Note X.

[*Signature*]

[*Date*]

Chapter 8

Illustrative Financial Statements

VOLUNTARY HEALTH AND WELFARE SERVICE

Statement of Support, Revenue, and Expenses and Changes in Fund Balances

Year Ended December 31, 19X2 with Comparative Totals for 19X1

	19X2				Total All Funds	
	Current Funds					
	Unrestricted	Restricted	Land, Building and Equipment Fund	Endowment Fund	19X2	19X1
Public support and revenue:						
Public support:						
Contributions (net of estimated uncollectible pledges of $195,000 in 19X2 and $150,000 in 19X1)	$3,764,000	$162,000	$ —	$ 2,000	$3,928,000	$3,976,000
Contributions to building fund	—	—	72,000	—	72,000	150,000
Special events (net of direct costs of $181,000 in 19X2 and $163,000 in 19X1)	104,000	—	—	—	104,000	92,000
Legacies and bequests	92,000	—	—	4,000	96,000	129,000
Received from federated and nonfederated campaigns (which incurred related fund-raising expenses of $38,000 in 19X2 and $29,000 in 19X1)	275,000	—	—	—	275,000	308,000
Total public support	4,235,000	162,000	72,000	6,000	4,475,000	4,655,000

Revenue:						
Membership dues	17,000	—	—	—	17,000	12,000
Investment income	98,000	10,000	—	—	108,000	94,000
Realized gain on investment transactions	200,000	—	—	25,000	225,000	275,000
Miscellaneous	42,000	—	—	—	42,000	47,000
Total revenue	357,000	10,000	—	25,000	392,000	428,000
Total support and revenue	4,592,000	172,000	72,000	31,000	$4,867,000	$5,083,000
Expenses:						
Program services:						
Research	1,257,000	155,000	2,000	—	$1,414,000	$1,365,000
Public health education	539,000	—	5,000	—	544,000	485,000
Professional education and training	612,000	—	6,000	—	618,000	516,000
Community services	568,000	—	10,000	—	578,000	486,000
Total program services	2,976,000	155,000	23,000	—	3,154,000	2,852,000
Supporting services:						
Management and general	567,000	—	7,000	—	574,000	638,000
Fund raising	642,000	—	12,000	—	654,000	546,000
Total supporting services	1,209,000	—	19,000	—	1,228,000	1,184,000
Total expenses	4,185,000	155,000	42,000	—	$4,382,000	$4,036,000
Excess (deficiency) of public support and revenue over expenses	407,000	17,000	30,000	31,000		
Other changes in fund balances:						
Property and equipment acquisitions from unrestricted funds	(17,000)	—	17,000	—		
Transfer of realized endowment fund appreciation	100,000	—	—	(100,000)		
Returned to donor	—	(8,000)	—	—		
Fund balances, beginning of year	5,361,000	123,000	649,000	2,017,000		
Fund balances, end of year	$5,851,000	$132,000	$696,000	$1,948,000		

(See accompanying notes to financial statements)

VOLUNTARY HEALTH AND WELFARE SERVICE

Statement of Functional Expenses

Year Ended December 31, 19X2
with Comparative Totals for 19X1

	19X2								Total Expenses	
	Program Services					Supporting Services				
	Research	Public Health Education	Professional Education and Training	Community Services	Total	Management and General	Fund Raising	Total	19X2	19X1
Salaries	$ 45,000	$291,000	$251,000	$269,000	$ 856,000	$331,000	$368,000	$ 699,000	$1,555,000	$1,433,000
Employee health and retirement benefits	4,000	14,000	14,000	14,000	46,000	22,000	15,000	37,000	83,000	75,000
Payroll taxes, etc.	2,000	16,000	13,000	14,000	45,000	18,000	18,000	36,000	81,000	75,000
Total salaries and related expenses	51,000	321,000	278,000	297,000	947,000	371,000	401,000	772,000	1,719,000	1,583,000

Professional fees and contract service payments	1,000	10,000	3,000	8,000	22,000	26,000	8,000	34,000	56,000	53,000
Supplies	2,000	13,000	13,000	13,000	41,000	18,000	17,000	35,000	76,000	71,000
Telephone and telegraph	2,000	13,000	10,000	11,000	36,000	15,000	23,000	38,000	74,000	68,000
Postage and shipping	2,000	17,000	13,000	9,000	41,000	13,000	30,000	43,000	84,000	80,000
Occupancy	5,000	26,000	22,000	25,000	78,000	30,000	27,000	57,000	135,000	126,000
Rental of equipment	1,000	24,000	14,000	4,000	43,000	3,000	16,000	19,000	62,000	58,000
Local transportation	3,000	22,000	20,000	22,000	67,000	23,000	30,000	53,000	120,000	113,000
Conferences, conventions, meetings	8,000	19,000	71,000	20,000	118,000	38,000	13,000	51,000	169,000	156,000
Printing and publications	4,000	56,000	43,000	11,000	114,000	14,000	64,000	78,000	192,000	184,000
Awards and grants	1,332,000	14,000	119,000	144,000	1,609,000	—	—	—	1,609,000	1,448,000
Miscellaneous	1,000	4,000	6,000	4,000	15,000	16,000	21,000	37,000	52,000	64,000
Total expenses before depreciation	1,412,000	539,000	612,000	568,000	3,131,000	567,000	650,000	1,217,000	4,348,000	4,004,000
Depreciation of buildings and equipment	2,000	5,000	6,000	10,000	23,000	7,000	4,000	11,000	34,000	32,000
Total expenses	$1,414,000	$544,000	$618,000	$578,000	$3,154,000	$574,000	$654,000	$1,228,000	$4,382,000	$4,036,000

(See accompanying notes to financial statements)

VOLUNTARY HEALTH AND WELFARE SERVICE

Balance Sheets

December 31, 19X2 and 19X1

CURRENT FUNDS

Unrestricted

Assets	19X2	19X1
Cash	$2,207,000	$2,530,000
Investments (Note 2):		
For Long-term purposes	2,727,000	2,245,000
Other	1,075,000	950,000
Pledges receivable less allowance for uncollectibles of $105,000 and $92,000	475,000	363,000
Inventories of educational materials, at cost	70,000	61,000
Accrued interest, other receivables and prepaid expenses	286,000	186,000
Total	$6,840,000	$6,335,000

Liabilities and Fund Balances	19X2	19X1
Accounts payable	$ 148,000	$ 139,000
Research grants payable	596,000	616,000
Contributions designated for future periods	245,000	219,000
Total liabilities and deferred revenues	989,000	974,000
Fund balances:		
Designated by the governing board for:		
Long-term investments	2,800,000	2,300,000
Purchases of new equipment	100,000	—
Research purposes (Note 3)	1,152,000	1,748,000
Undesignated, available for general activities (Note 4)	1,799,000	1,313,000
Total fund balance	5,851,000	5,361,000
Total	$6,840,000	$6,335,000

Restricted

Cash	$ 3,000	$ 5,000	Fund balances:		
Investments (Note 2)	71,000	72,000	Professional education	$ 84,000	$ —
Grants receivable	58,000	46,000	Research grants	48,000	123,000
Total	$ 132,000	$ 123,000	Total	$ 132,000	$ 123,000

LAND, BUILDING AND EQUIPMENT FUND

Cash	$ 3,000	$ 2,000	Mortgage payable, 8% due 19XX	$ 32,000	$ 36,000
Investments (Note 2)	177,000	145,000			
Pledges receivable less allowance for uncollectibles of $7,500 and $5,000	32,000	25,000	Fund balances:		
			Expended	484,000	477,000
Land, buildings and equipment, at cost less accumulated depreciation of $296,000 and $262,000 (Note 5)	516,000	513,000	Unexpended—restricted	212,000	172,000
			Total fund balance	696,000	649,000
Total	$ 728,000	$ 685,000	Total	$ 728,000	$ 685,000

ENDOWMENT FUNDS

Cash	$ 4,000	$ 10,000	Fund balance	$1,948,000	$2,017,000
Investments (Note 2)	1,944,000	2,007,000			
Total	$1,948,000	$2,017,000	Total	$1,948,000	$2,017,000

(See accompanying notes to financial statements)

8.04

VOLUNTARY HEALTH AND WELFARE SERVICE

Notes to Financial Statements

December 31, 19X2

1. *Summary of Significant Accounting Policies.* The financial statements include the accounts of the Service and its affiliated chapters. The Service follows the practice of capitalizing all expenditures for land, buildings, and equipment in excess of $100; the fair value of donated fixed assets is similarly capitalized. Depreciation is provided over the estimated useful lives of the assets. Investments are stated at cost. All contributions are considered to be available for unrestricted use unless specifically restricted by the donor. Pledges for contributions are recorded as received and allowances are provided for amounts estimated to be uncollectible. Policies concerning donated material and services are described in Note 6.

2. *Investments.* Market values and unrealized appreciation (depreciation) at December 31, 19X2 and 19X1 are summarized as follows:

	(Thousands of Dollars)			
	December 31, 19X2		December 31, 19X1	
	Quoted Market Value	Unrealized Appreciation	Quoted Market Value	Unrealized Appreciation (Depreciation)
Current unrestricted fund:				
For long-term purposes	$2,735	$ 8	$2,230	$(15)
Other	1,100	25	941	(9)
Current restricted funds	73	2	73	1
Endowment funds	2,125	181	2,183	176
Land, building and equipment fund	184	7	153	8

Interfund transfers include $100,000 for 19X2, which represents the portion of the realized appreciation ($25,000 realized in the current year and $75,000 realized in prior years) in endowment funds that, under the laws of (a state), were designated by the governing board for unrestricted operations. At December 31, 19X2, $200,000 of realized appreciation was available in endowment funds, which the governing board may, if it deems prudent, also transfer to the unrestricted fund.

If the organization accounts for its investment on the market value basis, the first part of the above note might be worded as follows:

Cost and unrealized appreciation (depreciation) at December 31, 19X2 and 19X1 are summarized as follows:

	(Thousands of Dollars)			
	December 31, 19X2		December 31, 19X1	
	Cost	Unrealized Appreciation	Cost	Unrealized Appreciation (Depreciation)
Current unrestricted fund:				
For long-term purposes	$2,727	$ 8	$2,245	$(15)
Other	1,075	25	950	(9)
Current restricted funds	71	2	72	1
Endowment funds	1,944	181	2,007	176
Land, building and equipment fund	177	7	45	8

3. *Research Grants.* The Service's awards for research grants-in-aid generally cover a period of one to three years, subject to annual renewals at the option of the governing board. At December 31, 19X2, $1,748,000 had been designated by the board for research grants, of which $596,000 had been awarded for research to be carried out within the next year.

4. *Proposed Research Center.* The XYZ Foundation has contributed $50,000 to the Service with the stipulations that it be used for the construction of a research center and that construction of the facilities begin within four years. The Service is considering the construction of a research center, the cost of which would approximate $2,000,000. If the governing board approves the construction of these facilities, it is contemplated that its cost would be financed by a special fund drive.

5. *Land, Buildings and Equipment and Depreciation.* Depreciation of buildings and equipment is provided on a straight-line basis over the estimated useful lives of the assets. At December 31, 19X2 and 19X1, the costs of such assets were as follows:

	19X2	19X1
Land	$ 76,000	$ 76,000
Buildings	324,000	324,000
Medical research equipment	336,000	312,000
Office furniture and equipment	43,000	33,000
Automobiles and trucks	33,000	30,000
Total cost	812,000	775,000
Less accumulated depreciation	296,000	262,000
Net	$516,000	$513,000

6. *Donated Materials and Services.* Donated materials and equipment are reflected as contributions in the accompanying statements at their estimated values at date of receipt. No amounts have been reflected in the statements for donated services inasmuch as no objective basis is available to measure the value of such services; however, a substantial number of volunteers have donated significant amounts of their time in the organization's program services and in its fund-raising campaigns.

7. *Pension Plans.* The organization has a non-contributory pension and retirement plan covering substantially all of its employees. Pension expense for the current year and the prior year was $_____ and $_____, respectively, which includes amortization of prior service cost over _____ year period. The Service's policy is to fund pension cost accrued. At December 31, 19X2, the actuarially computed value of the vested benefits in the plan exceeded the fund balance of the plan by approximately $____.

8. *Leased Facilities.* Most of the buildings used by the organization for its community services programs are leased on a year-to-year basis. At December 31, 19X2, fifteen such buildings were being leased for an annual cost of approximately $12,000.

Paragraph 22 of SOP 87-2 illustrates a note that discloses the allocation of joint costs of informational materials and activities that include fund-raising appeals. See Appendix B.

Appendix A

Illustration of an Investment Pool

1. Three funds (named A, B, and C) combined their cash some years ago into an investment pool by simultaneous contributions (in the portions indicated below) totaling $90,000, which was invested. On December 31, 19XX, the pooled investments on a cost basis were carried at $100,000, which is the amount of the original contributions plus $10,000, representing net realized gains retained by the investment pool.

2. The market value of the pooled assets was calculated to be $150,000. On this basis, the unrealized net gains are $50,000.

3. A new fund (Fund D) invested $100,000 of cash in the investment pool at December 31, 19XX.

4. The following table presents the transactions set forth above and illustrates the calculation of the resulting equity percentages:

Fund	Cash Originally Contributed to Pool	Original Equity Percentage	Value of Pool on December 31, 19XX Cost	Value of Pool on December 31, 19XX Market	Value After Entry of Fund D	New Equity Percentage
A	$40,000	44.44%	$ 44,444	$ 66,667	$ 66,667	26.67%
B	35,000	38.89	38,889	58,333	58,333	23.33
C	15,000	16.67	16,667	25,000	25,000	10.00
D					100,000	40.00
	$90,000	100.00%	$100,000	$150,000	$250,000	100.00%

5. If fund A were to withdraw from the investment pool at this date, it would be entitled to $66,667, rather than $44,444. The equity percentages to be utilized for entries to and withdrawals from the pool are based on market values, even though the accounting records are kept on a cost basis.

Appendix B

Statement of Position 87-2

Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal

August 21, 1987

Amendment to
AICPA Industry Audit Guide
Audits of Voluntary Health and Welfare Organizations

Issued by
Accounting Standards Division

American Institute of
Certified Public Accountants

AICPA

NOTE

This statement of position amends chapter 6 of the AICPA Industry Audit Guide, *Audits of Voluntary Health and Welfare Organizations* and paragraph 97 of SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations.*

Statements of position of the Accounting Standards Division present the conclusions of at least a majority 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. Statements of position do not establish standards enforceable under rule 203 of the AICPA Code of Professional Conduct. However, Statement on Auditing Standards (SAS) No. 5, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report,* as amended by SAS No. 43, *Omnibus Statement on Auditing Standards,* and SAS No. 52, *Omnibus Statement on Auditing Standards—1987,* identifies AICPA statements of position as another source of established accounting principles the auditor should consider. Accordingly, members should be prepared to justify departures from the recommendations in this statement of position.

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SUMMARY

This statement of position recommends the following: If it can be demonstrated that a bona fide program or management and general function has been conducted in conjunction with an appeal for funds, joint costs of informational materials or activities that include a fund-raising appeal should be allocated between fund-raising and the appropriate program or management and general function. All joint costs of informational materials or activities that include a fund-raising appeal should be reported as fund-raising expense if it cannot be demonstrated that a program or management and general function has been conducted in conjunction with the appeal for funds.

Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal

Introduction

1. Many not-for-profit organizations solicit financial support from the public through a variety of fund-raising activities, including direct mail, door-to-door canvassing, telephone solicitation, telethons, and special events. Some of the costs incurred by such organizations are clearly identifiable with fund-raising, such as the cost of fund-raising consulting services. However, organizations often incur joint costs, such as postage and other communication costs, in distributing materials or performing activities that relate to several functions, including program activities, fund-raising, or other supporting services. It is often difficult to distinguish the amounts of joint costs that relate to each function.

2. This statement of position applies only to joint costs of informational materials and activities that include a fund-raising appeal. Allocations of other joint costs are permitted under existing authoritative literature. Also, this statement of position does not address the issue of how to allocate joint costs. A number of cost accounting techniques are available for that purpose.

3. The American Institute of Certified Public Accountants' Industry Audit Guide, *Audits of Voluntary Health and Welfare Organizations* (Audit Guide) and Statement of Position 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations* (SOP 78-10), now included in the AICPA Audit and Accounting Guide, *Audits of Certain Nonprofit Organizations,* and in *Standards of Accounting and Financial Reporting for Voluntary Health and Welfare Organizations* (industry's Standards) [1] provide some guidance on accounting for joint costs of informational materials and activities that include fund-raising appeals. Numerous requests have been received for further guidance.

Background

4. External users of financial statements, including contributors, creditors, accreditation agencies, and regulators, are concerned with the amounts not-for-profit organizations spend to solicit contributions, as well as with the amounts spent for their program purposes and management and general activities.

5. Not-for-profit organizations subject to the Audit Guide and organizations that follow the recommendations in SOP 78-10 and receive significant amounts of contributions from the public are required, in preparing their financial statements, to report separately the costs of program services, management and general activities, and fund-raising efforts.

6. Though some costs are wholly identifiable with one of those basic functions, others are allocated because they are incurred for more than one function. The allocation usually involves no special accounting problems

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[1] National Health Council, Inc., National Assembly of National Voluntary Health and Social Welfare Organizations, Inc., and United Way of America, *Standards of Accounting and Financial Reporting for Voluntary Health and Welfare Organizations,* rev. ed. 1974.

because cost accounting techniques are available. However, special problems are encountered in allocating joint costs of informational materials and activities that include fund-raising appeals.

7. The industry's Standards provides guidance for voluntary health and welfare organizations. As part of its discussion of joint mailings and other "multiple part" information efforts, the industry's Standards requires a concept called *primary purpose,* in which all joint costs involving fund-raising are charged to fund-raising expense except for those incremental costs directly attributable to a separate educational or other informational material or activity. For example, only the incremental costs of joint mailings, such as the direct costs of an educational pamphlet, are charged to functions other than fund-raising; all other costs, such as postage, are charged to fund-raising expense.

8. The primary-purpose concept was originally adopted in 1964 by the voluntary health and welfare industry in the industry's Standards as a practical solution to a credibility problem that existed then. The industry responded to public criticism by not permitting the reported costs of fund-raising to be less than they would otherwise be solely because public education efforts were structured in a way that would absorb fund-raising costs. Many believe, however, that the primary-purpose concept may cause fund-raising expense to be misstated.

9. Although less specific than the industry's Standards, paragraph 6.05 through 6.06 of the Audit Guide indicates that costs of public education should not include costs "that may have some relationship to the function but are primarily directed toward other purposes." Specifically mentioned as a cost normally not charged to public education expense is postage for mass mailing in connection with fund-raising solicitations.

10. Some have interpreted the Audit Guide and SOP 78-10 to be less restrictive than the industry's Standards in the method of allocation of the costs of joint fund-raising and educational programs. The Audit Guide indicates, as part of a discussion of fund-raising costs in paragraph 6.11, that—

> The cost of printed material used should be charged to program service, management and general, or fund-raising on the basis of the use made of the material, determined from the content, the reasons for distribution, and the audience to whom it is addressed.

Paragraph 97 of SOP 78-10 states—

> If an organization combines the fund-raising function with a program function (for example, a piece of educational literature with a request for funds), the costs should be allocated to the program and fund-raising categories on the basis of the use made of the literature, as determined from its content, the reasons for its distribution, and the audience to whom it is addressed.

Present Practice

11. Present practice is diverse because of the diverse guidance. Some not-for-profit organizations (for example, organizations that follow the industry's Standards) do not allocate joint costs of informational materials and activities that include fund-raising appeals. They charge only the incremental cost of educational activities and publications to program expenses or management and general expenses and charge joint costs to fund-raising expense.

12. The activities of some not-for-profit organizations raise consciousness and stimulate action or are primarily educational. Many of them allocate joint costs primarily to expenses for educational programs based on intent as determined from the content of the materials distributed or the activities

conducted. They argue that primary programs of the organizations are to educate the public and that the actions by the recipients of such materials or activities are essential elements of the organization's program goals.

13. Other organizations allocate joint costs to program expenses, fund-raising expenses, or management and general expenses based on the intended purpose of the material or activity, determined from its content, the reason for its distribution, and the audience to whom it is addressed.

Division's Conclusions

14. The following paragraphs present the Accounting Standards Division's conclusions, which amend chapter 6 of the Audit Guide and paragraph 97 of SOP 78-10.

15. All joint costs of informational materials or activities that include a fund-raising appeal should be reported as fund-raising expense if it cannot be demonstrated that a program or management and general function has been conducted in conjunction with the appeal for funds. However, if it can be demonstrated that a bona fide program or management and general function has been conducted in conjunction with the appeal for funds, joint costs should be allocated between fund-raising and the appropriate program or management and general function.

16. Demonstrating that a bona fide program or management and general function has been conducted in conjunction with an appeal for funds requires verifiable indications of the reasons for conducting the activity. Such indications include the content of the non-fund-raising portion of the activity; the audience targeted; the action, if any, requested of the recipients; and other corroborating evidence, such as written instructions to parties outside the organization who produce the activity, or documentation in minutes of the organization's board of the organization's reasons for the activity.

17. Most fund-raising appeals include descriptions of the causes for which the entities exist and the planned uses of the funds, to inform prospective donors why funds are needed and how they will be used. Unless an appeal is designed to motivate its audience to action other than providing financial support to the organization, all costs of the appeal should be charged to fund-raising.

18. In order to accomplish their basic missions, some organizations educate the public and seek the involvement of the public in the attainment of their missions by telling people what they can or should do about particular issues. Those organizations should allocate joint costs to program activities if the informational materials or activities further those program goals.

19. Two examples of situations in which it may be appropriate to allocate such joint costs to program activities follow:

a. A voluntary health and welfare organization describes the symptoms of a disease and the action an individual should take if those symptoms occur.

b. An organization whose purpose is to raise public awareness alerts individuals to a social or community problem and urges their action in seeking changes.

20. The content of the message is an important factor, but content alone may not be a conclusive indication of the reason for the activity. For example, if an audience is selected principally because of the organization's perception of its need for or interest in the educational information and not for its capacity to support the organization financially, any accompanying fund-

raising appeal would appear to be incidental and the joint costs of the educational activity would not be required to be allocated. Conversely, if the audience is selected based on its presumed ability to provide financial support without consideration of its need for the educational information, the purpose would appear to be entirely fund-raising, and all joint costs should be considered fund-raising costs regardless of any accompanying educational message.

21. All circumstances surrounding informational materials and activities that include a fund-raising appeal should be examined, and the criteria in paragraphs 15 through 20 of this statement of position should be applied together rather than separately.

22. Not-for-profit organizations incurring joint costs of informational materials and activities that include fund-raising appeals should disclose in their financial statements that such costs have been allocated, the total amount allocated during the period, and the portion allocated to each functional expense category. The following illustrates such disclosure.

Note X. Allocation of Joint Costs

In 19XX, the organization incurred joint costs of ________ for informational materials and activities that included fund-raising appeals. Of those costs, __ was allocated to fund-raising expense, ________ was allocated to Program A expense, ________ was allocated to Program B expense, and ____ was allocated to management and general expense.

Effective Date and Transition

23. The conclusions in this statement of position should be applied to financial statements for fiscal years beginning after December 31, 1987, with earlier application encouraged. The adoption of this statement of position is considered to be a change in the application of generally accepted accounting principles. In the year that this statement of position is first applied, the financial statements should disclose the fact of the change and the effect of the change on the financial statements. Financial statements of prior periods may be, but need not be, restated.

Appendix C

Schedule of Changes Made to Audits of Voluntary Health and Welfare Organizations

Reference	Change	Date
General	The term "examination" has been changed to "audit" to conform to the terminology used in SAS No. 58.	October, 1990
Preface	Reference to Statements of Financial Accounting Standards added to sixth paragraph.	October, 1990
Paragraph 2.04	Footnote 1 added to recognize conclusion of FASB study of carrying investments at market value.	October, 1990
Paragraph 3.02	Reference to FASB Statement No. 93 added.	October, 1990
Paragraph 4.14	Reference to SAS No. 1, section 542 changed to SAS No. 58.	October, 1990
Chapter 6	Reference to SOP 87-2 added.	October, 1990
Paragraph 6.05	Language contrary to SOP 87-2 deleted.	October, 1990
Paragraphs 6.06 and 6.11	Reference to SOP 87-2 added.	October, 1990
Paragraph 7.04	Reference to SAS No. 1, section 620 changed to SAS No. 62.	October, 1990
Paragraph 7.05	Footnote referring to supersession of APB Opinion No. 19 by FASB Statement No. 95 added.	October, 1990
Chapter 7	Illustrative Auditor's Reports conformed to SAS Nos. 58 and 62.	October, 1990
Chapter 8	Reference to SOP 87-2 added to Notes to Illustrative Financial Statements.	October, 1990

Audit Risk Alert

NOT-FOR-PROFIT ORGANIZATIONS INDUSTRY DEVELOPMENTS—1991

UPDATE TO THE AICPA AUDIT AND ACCOUNTING GUIDES, *AUDITS OF CERTAIN NONPROFIT ORGANIZATIONS, AUDITS OF COLLEGES AND UNIVERSITIES,* AND *AUDITS OF VOLUNTARY HEALTH AND WELFARE ORGANIZATIONS*

ISSUED BY THE AUDITING STANDARDS DIVISION

NOTICE TO READERS

This document is intended to provide auditors of financial statements of not-for-profit organizations with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

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Not-for-Profit Organizations Industry Developments—1991

Industry and Economic Developments

.01 Reduced government funding, reduced tax benefits for gifts, and the establishment of new not-for-profit organizations (including organizations referred to as *look-alikes*) have resulted in increased competition for donor contributions. At the same time, unstable financial markets and declining interest rates have made it difficult for many organizations to maintain the rates of return on investment portfolios that they had come to rely on in the past. In addition, not-for-profit organizations are coping with increased litigation, new and complex federal and state regulations, changes in tax laws, and increased scrutiny from revenue agents in their audits, particularly in areas of information reporting and unrelated business income.

.02 Auditors should be aware of these factors and consider their implications in planning and conducting audits. Further, there are a number of accounting and auditing developments, including practice problems, of which auditors should be aware.

Declining Public Support and Revenue

.03 Not-for-profit organizations rely on both government funding and support from individual and corporate donors and foundations for resources to accomplish their missions. Government funding for not-for-profit organizations' activities has been steadily decreasing. Support from private sources has also decreased as tax incentives for making charitable gifts have been reduced in recent years through measures such as the elimination of charitable-contribution deductions for individuals not itemizing their deductions and reductions in marginal income-tax rates.

.04 Not-for-profit organizations also derive revenues from investments, exempt function income such as tuition and fees, special fund-raising events, and unrelated business activities. Such revenues have been adversely affected by generally weak economic conditions.

.05 In response to these pressures, the use of gifts such as annuities, charitable-remainder annuity trusts and unitrusts, pooled-income funds, and lead trusts that provide donors with a means of making tax-deductible gifts while retaining beneficiary interests in the gifted property has increased. Not-for-profit organizations that receive such gifts are faced with the challenge of maintaining the principal of these gifts at levels adequate to support the required payments to donees and beneficiaries as well as reporting the gifts and the activity in such funds properly in their financial statements. Auditors of such organizations should carefully consider the propriety of the organization's accounting for and reporting of such gifts.

The Investment Environment

.06 Within the last decade, some organizations' investment managers have adopted investment strategies that incorporate a variety of sophisticated techniques and specialized financial products to increase investment returns. Such investments may increase the inherent risk in many organizations' investment portfolios. The valuation of nonreadily marketable securities and of real estate investments may be an area of particular audit concern, especially for organizations that present their investments at market value. In planning the audit for a not-for-profit organization, the auditor should possess or obtain an understanding of an organization's investment strategy and policies, and consider their audit risk implications.

Regulatory and Legislative Developments

State and Local Issues

.07 Not-for-profit organizations are frequently subject to state regulation. Many states have enacted laws that include registration or licensing requirements, reporting requirements, or solicitation disclosure requirements, or that place limitations on fund-raising expenses. Also, some jurisdictions have become more aggressive in levying real estate taxes on not-for-profit organizations.

.08 Many not-for-profit organizations conduct activities outside the state of their primary location, for example, through solicitations, branches or chapters, and nonresident employees or agents. State laws concerning such activities are constantly changing. The American Association of Fund-Raising Councils, Inc. (AAFRC) publishes its *Annual Survey of State Laws Regulating Charitable Solicitations and the Legislative Monitor.* Copies of these publications can be obtained by calling (212) 354-5799 or by writing to the AAFRC at 25 West Forty-Third Street, New York, NY 10036.

IRS Activities

.09 The Internal Revenue Service (IRS) has made clear its intent to subject the activities of not-for-profit organizations that claim exemptions from taxation under the Internal Revenue Code (Code) to increased scrutiny.

.10 Recent IRS audits have raised concerns about the following activities of not-for-profit organizations:

- Political activities that may result in loss of exempt status or the imposition of excise taxes, penalties, and interest assessments
- Lobbying activities that may result in loss of exempt status, the tax on disqualified lobbying expenditures, and taxes on not-for-profit organizations' managers
- Unrelated business activities, the income from which may be subject to income tax

.11 In response to these concerns, the IRS has revised its Form 990, "Return of Organization Exempt from Income Tax," to require exempt organizations to categorize income as (1) related income, (2) income excluded from the definition of unrelated business income (UBI) by Code sections 512, 513, or 514, or (3) UBI. Related income must be supported with an explanation of why it is related to an organization's exempt purpose. Income excluded from UBI must be matched with forty exclusion codes set forth in the instructions to Form 990. UBI must be matched with IRS business codes.

.12 Other revisions to Form 990 require exempt organizations to provide information about taxable subsidiaries and transactions with other not-for-profit organizations.

.13 Other recent IRS releases and publications of which auditors of not-for-profit organizations should be aware include—

- Revenue Procedure 90-12, which contains guidelines intended to help charitable organizations advise "their patrons of the deductible amount of contributions under section 170 of the Code when the contributors are receiving something in return for their contributions." Congress has indicated that it expects the IRS to monitor the extent to which charitable organizations furnish this information to their contributors.

- IRS Announcement 90-25, which reminds donors *and charitable organizations* about the filing requirements for Form 8283, "Noncash Charitable Contributions," and Form 8282, "Donee Information Returns," which provide information about noncash charitable contributions.
- IRS Announcement 90-138, which focuses on UBI of social clubs.

.14 Form 9215 is used by IRS agents conducting audits of charitable organizations and focuses on the following:

- The nature of fund-raising activities, including the issue of value received for contributions
- Determining whether noncash contributions are received and, if so, whether a signed acknowledgment was prepared
- Administrative aspects of fund-raising activities, including preparation of receipts, filing Form 8300, and maintaining proper records of the fund-raising activities
- Information concerning the use of professional fund-raisers
- Funds raised through—
  - Games of chance, such as bingo
  - Travel tours
  - Thrift stores

.15 *OMB Circular A-133.* The Office of Management and Budget (OMB) has issued Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions,* to implement a "single audit" requirement for not-for-profit organizations. The Circular generally results in an increased level of testing of internal controls and compliance with applicable laws and regulations in audits of certain organizations that receive money from the federal government.

.16 *Applicability.* The applicability of Circular A-133 depends on (1) the type of institution and (2) the amount of financial awards received by the institution. A-133 does not automatically apply to all of the institutions it covers. Rather, its applicability depends on whether the federal agency granting awards to an institution has amended the regulations governing its programs to require audits performed in accordance with A-133. Many agencies have not yet implemented such rules. Thus, auditors should inquire of institutions about whether the relevant cognizant agency requires A-133 audits.

.17 Institutions covered by Circular A-133 generally include colleges and universities (and their affiliated hospitals) and other institutions, such as voluntary health and welfare organizations and other community-based organizations. Circular A-133 does not apply to—

- Colleges and universities already covered by Circular A-128.
- Hospitals not affiliated with a college or university.
- State and local governments and Indian tribes covered by Circular A-128.

.18 Circular A-133 applies to those institutions described above that receive $100,000 or more a year in federal awards, unless the institution receives $100,000 or more under a single program, in which case it has the option of applying either the requirements of Circular A-133 or the audit requirements of that program. (Circular A-133's definition of financial awards is broader than the term *financial assistance* used in AICPA Statement on Auditing Standards (SAS) No. 63, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance,* since awards also include federal cost-type contracts used to buy goods or services.) Institutions that receive at least $25,000 but less than $100,000 under one or more programs have the option of applying either the requirements of Circular A-133 or the audit requirements of each program in which they participate. Institutions that receive less than $25,000 are exempt from the Circular, although records must be available for review by the appropriate officials.

.19 Circular A-133 applies regardless of whether the institution receives awards directly from a federal agency or indirectly as a subrecipient. Recipients of federal awards that provide $25,000 or more annually to a subrecipient must determine whether the subrecipient has met the requirements of Circular A-133.

.20 *Reporting Requirements.* Circular A-133 requires auditors to issue the following reports:

1. A report on financial statements and a schedule of federal awards received
2. A report on compliance with laws and regulations that have a direct and material effect on the financial statements
3. A report on the internal control structure established to ensure compliance with laws and regulations that have a material impact on the financial statements
4. A report on compliance with specific requirements applicable to major programs
5. A report on compliance requirements applicable to nonmajor program transactions tested
6. A report on compliance with general requirements
7. A report on the internal control structure policies and procedures established to provide reasonable assurance that federal awards are being managed in compliance with applicable laws and regulations

.21 Circular A-133 requires that the auditor perform the audit in accordance with *Government Auditing Standards* (the "Yellow Book") issued by the Comptroller General of the United States (1988 revision). Thus, the reports numbered 2 and 3 above on an institution's compliance with laws and regulations and internal control structure are the same as those issued in audits performed in accordance with the Yellow Book. These two reports focus on an institution as a whole, rather than on individual programs that an institution manages. Reports numbered 4 through 7 above focus on the federally assisted programs. For example, rather than reporting on tests of compliance with laws and regulations that have a direct and material effect on the *financial statements,* the auditor reports on tests of compliance with laws that have a direct and material effect on *each major federal program.* This typically results in a lower level of materiality, since materiality is evaluated at the program level rather than at the financial statement level.

.22 Circular A-133 states that the audit reports may be combined into three parts (a report on the financial statements and a schedule of federal awards, reports on compliance, and reports on internal control) that may be bound together or presented as three separate documents.

.23 *Compliance Supplements.* Circular A-133 notes that the compliance requirements of the largest federal programs are described in two compliance supplements issued by the OMB. Although the *Compliance Supplement for Single Audits of Educational Institutions and Other Nonprofit Organizations* had not been issued at the time of the publication of this document, the *Compliance Supplement for Single Audits of State and Local Governments* is available from the Government Printing Office at (202) 783-3238. If the program under audit is not listed in either of the compliance supplements, the organization needs to determine the applicable requirements by reviewing statutes, regulations, and agreements pertaining to that particular program.

.24 *Effective Date.* Circular A-133, which supersedes the audit provisions of Circular A-110, is effective for audits of fiscal years beginning on or after January 1, 1990. However, the audit provisions of Attachment F to Circular A-110 are to be followed until Circular A-133 is implemented by the institution.

.25 *Implementation Guidance.* The AICPA Auditing Standards Division plans to issue a statement of position being prepared by a subcommittee of its Not-for-Profit Organizations Committee that will provide guidance about Circular A-133's audit requirements. An exposure draft of the statement of position will be issued later this year.

Audit and Accounting Developments

Audit Issues

.26 *Joint Costs.* In 1987, the AICPA issued Statement of Position (SOP) 87-2, *Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal.* The SOP provides guidance for reporting the costs of informational materials that include solicitations for financial support, and requires such costs to be reported as fund-raising expenses if it cannot be demonstrated that a bona fide program or management and general function has been conducted in conjunction with the appeal for funds. If such activities other than appeals for funds can be demonstrated, such costs should be allocated between fund-raising and the related program or management and general function. Certain financial statement disclosures concerning such allocations also are required.

.27 Some state attorneys general have criticized the manner in which some organizations have applied the SOP. They believe some organizations have been too liberal in their allocation of costs to program expenses, especially those costs incurred to educate the public. Not-for-profit organizations and auditors should carefully review the requirements of the SOP and consider the sufficiency of evidence that exists to support any allocations of such joint costs.

.28 *Audits of Federally Funded Student Financial Assistance Programs.* The U.S. Department of Education requires institutions that participate in its student financial assistance programs to engage independent auditors to audit certain aspects of the institution's participation in those programs. Such audits are to be performed in accordance with the standards for financial audits set forth in *Government Auditing Standards,* and the U.S. Department of Education (ED) Audit Guide *Audits of Student Financial Assistance Programs* (March 1990 revision). Among other reports, auditors who perform such audits are required to issue reports on—

- The participating institution's compliance with laws and regulations specified in the ED Audit Guide applicable to its student financial assistance programs. Such a report includes an opinion as to whether the entity complied, in all material respects, with the requirements applicable to the programs. (See example I on page IX-19 of the ED Audit Guide.)

- The internal control structure used by participating institutions in administering the federally funded student financial assistance programs. Such a report includes a description of reportable conditions noted and a statement about whether the auditor believes any of the reportable conditions described are material weaknesses. (See example G on pages IX-16 and IX-17 of the ED Audit Guide.)

.29 Institutions that participate in these programs frequently engage service centers to perform certain functions relating to the administration of those programs. Such functions may include billing and collection of loans, drawdowns of funds, determination of student eligibility, and exercising diligence in collecting loans. The ED Audit Guide requires that the institution's auditor's reports on the internal control structure and on compliance encompass those functions performed by service centers. The guide allows the institution's auditor to obtain a report from the service center's auditor to use as a basis for his or her report on the internal control structure and opinion on compliance with respect to those functions performed by the service center.

.30 There is currently no authoritative guidance either for auditors of service centers who must prepare such reports or for auditors of institutions who must use such reports. As a result, reports being prepared by auditors of service centers that perform such functions are inconsistent and auditors of institutions have questioned how such reports should be used in forming an opinion on compliance and in reporting on an institution's internal control structure.

.31 Because of these inconsistencies in practice and the absence of authoritative guidance in this area, ED representatives have indicated that they will accept reports on the internal control structure and on compliance with laws and regulations at the program level that clearly identify those categories of the internal control structure and those laws and regulations (1) that the institution's auditor was able to test at the institution and (2) that relate to functions performed by service centers and not tested by the institution's auditor. In those circumstances, the institution's auditor needs to opine only on compliance with those laws and regulations tested at the institution, and he or she may disclaim an opinion on compliance with laws and regulations governing the functions performed by the service center. Similarly, the institution's auditor may exclude internal control structure policies and procedures performed by the service centers from his or her reports on the internal control structure used in administering the programs.

.32 Such reports will be accepted only for institutions that have engaged service centers to perform functions that affect their compliance with laws and regulations and if the service center's auditor has issued a report. In addition, such modified reports will be accepted *for fiscal years ended on or before December 31, 1990, only.* Depending on the programs in which the institution participates, these reports are due on March 31, 1991, or June 30, 1991.

.33 An example of an independent auditor's report on compliance with laws and regulations applicable to student financial assistance programs that excludes compliance with laws and regulations that relate to functions performed by a service center and not tested at the institution follows:

We have audited ABC University's compliance with the requirements governing [*identify the program requirements as listed in ED Audit Guide **that were performed at the Institution***] that are applicable to each of its student financial assistance programs for the year ended June 30,1990. The management of ABC University is responsible for compliance with those requirements. Our responsibility is to express an opinion on compliance with those requirements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards, *Government Auditing Standards,* issued by the Comptroller General of the United States, and the March 1990 Audit Guide, *Audits of Student Financial Assistance Programs,* issued by the U.S. Department of Education (ED), Office of Inspector General. Those standards and the ED Audit Guide require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about the University's compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

The results of our audit procedures disclosed instances of noncompliance with the requirements referred to above, which are described in the accompanying schedule of findings and questioned costs. We considered these instances of noncompliance in forming our opinion on compliance, which is expressed in the following paragraph.

In our opinion, ABC University complied, in all material respects, with the requirements governing [*identify the requirements **tested at the Institution** as indicated in the introductory paragraph*] that are applicable to each of its student financial assistance programs for the year ended June 30, 1990.

We did not audit ABC University's compliance with the requirements governing [*identify the program requirements as listed in ED Audit Guide **that are performed at the service center***]. Those requirements govern functions performed by XYZ Service Center. Since we did not apply auditing procedures to satisfy ourselves as to compliance with those requirements, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on compliance with those requirements.

[*Signature*]

[*Date*]

.34 An example of an independent auditor's report on the internal control structure used in administering student financial assistance programs that excludes functions performed at a service center follows:

We have audited the [*financial statements or Student Financial Assistance (SFA) Modified Statement of Cash Receipts and Disbursements*] of ABC University for the year ended June 30, 1990, and have issued our report thereon dated [*date*]. Except as described in the fourth paragraph of this report, as part of our audit, we made a study and evaluation of the internal control systems, including applicable internal administrative controls, used in administering the student financial assistance programs to the extent we considered necessary to evaluate the systems as required by generally accepted auditing standards; *Government Auditing Standards,* issued by the Comptroller General of the United States; and the March 1990 Audit Guide, *Audits of Student Financial Assistance Programs,* issued by the U.S. Department of Education, Office of Inspector General. For the purpose of this report, we have classified the significant internal accounting and administrative controls used in administering student financial assistance programs in the following categories: [*identify control categories*].

The management of ABC University is responsible for establishing and maintaining internal control systems used in administering the student financial assistance programs. In fulfilling that responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of internal control systems used in administering the student financial assistance programs are to provide management with reasonable, but not absolute, assurance that, with respect to student financial assistance programs, resource use is consistent with laws, regulations, and policies; resources are safeguarded against waste, loss, and misuse; and reliable data are obtained, maintained, and fairly disclosed in reports.

Because of inherent limitations in any system of internal accounting and administrative controls used in administering student financial assistance programs, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the systems to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.

Our study included all of the applicable control categories listed above except [*identify categories relating to functions performed at the service center*]. With respect to internal control systems used in administering the student financial assistance programs, our study and evaluation included considering the types of errors and irregularities that could occur, determining the internal control procedures that should prevent or detect such errors and irregularities, determining whether the necessary procedures are prescribed and are being followed satisfactorily, and evaluating any weaknesses.

Our study and evaluation was more limited than would be necessary to express an opinion on the internal control systems used in administering the student financial assistance programs of ABC University. Accordingly, we do not express an opinion on the internal control systems used in administering the student financial assistance programs of ABC University.

However, our study and evaluation and our audit disclosed the following conditions that we believe result in more than a relatively low risk that errors or irregularities in amounts that would be material to the student financial assistance program may occur and not be detected within a timely period. [*A description of the conditions that have come to the auditor's attention would follow; if the study and evaluation and the audit disclose no material weaknesses in relation to a student financial assistance program, this sentence should state, "However, our study and evaluation and our audit disclosed no condition that we believe to be a material weakness in relation to a student financial assistance program at ABC University," and the following paragraph should be omitted.*]

These conditions were considered in determining the nature, timing, and extent of the audit tests to be applied in (1) our audit of the fiscal 1990 financial statements and (2) our audit and review of the University's compliance with laws and regulations, noncompliance with which we believe could have a material effect on the allowability of program expenditures for each student financial assistance program.

This report does not affect our reports on the University's financial statements and on compliance with laws and regulations dated [*date*].

This report is intended solely for the use of management and the U.S. Department of Education and should not be used for any other purpose. This restriction is not intended to limit the distribution of this report, which, upon acceptance by ABC University is a matter of public record.

[*Signature*]

[*Date*]

[*Note: This report is patterned after example 26 in SOP 89-6,* Auditors' Reports in Audits of State and Local Governmental Units. *SOP 90-9,* The Auditor's Consideration of the Internal Control Structure Used in Administering Federal Financial Assistance Programs Under the Single Audit Act, *supersedes that example report for reports on fiscal periods beginning on or after January 1, 1991.*]

.35 *Indirect Overhead Billed to Federal Agencies.* Several federal agencies have announced that they are conducting inquiries of universities that are among the largest recipients of federal research grants. Federal research grants generally represent reimbursement for direct costs related to research projects and indirect costs representing overhead items not directly related to projects. The inquiries are focusing on the nature of the costs billed to the agencies in conjunction with research conducted by the institutions. Auditors should be mindful of the growing concern that indirect cost pools may include costs that might eventually be disallowed.

Accounting Issues

.36 *FASB or GASB Jurisdiction.* In November 1989, the Financial Accounting Foundation decided that whether an entity should follow the standards promulgated by the Financial Accounting Standards Board (FASB) or the Governmental Accounting Standards Board (GASB) should be based on whether the entity is owned by a governmental unit. As a result, governmentally owned entities should follow GASB standards, while other entities should follow FASB standards. Whether an entity is governmentally owned may be unclear in some cases and should be determined before beginning an engagement.

Accounting Pronouncements and Projects

.37 *FASB Statement No. 105,* Disclosure of Information about Financial Instruments with Off-Balance Sheet Risk and Financial Instruments with Concentrations of Credit Risk. FASB Statement No. 105 (issued in March 1990) is discussed in *Audit Risk Alert—1990.* The Statement is effective for fiscal years ending after June 15, 1990. Not-for-profit organizations and their auditors should note that its requirements concerning information about the extent, nature, and terms of financial instruments with off-balance sheet credit or market risk and about concentration of credit risk for all financial instruments apply to not-for-profit organizations just as they apply to commercial organizations.

.38 *FASB not-for-profit organizations project.* The FASB has undertaken a project to consider the specialized accounting principles and practices included in four AICPA Audit and Accounting Guides relevant to not-for-profit organizations. Documents issued by the FASB as a result of this project include the following:

- *FASB Statement No. 93,* Recognition of Depreciation by Not-for-Profit Organizations. FASB Statement No. 93 (issued in August 1987) requires all not-for-profit organizations to recognize depreciation and to disclose information about depreciable assets and depreciation methods. FASB Statement No. 99, *Deferral of the Effective Date of Recognition of Depreciation by Not-for-Profit Organizations* (issued in September 1988) amended FASB Statement No. 93 to defer its effective date to fiscal years beginning on or after January 1, 1990. (GASB Statement No. 8, *Applicability of FASB Statement No. 93,* Recognition of Depreciation by Not-for-Profit Organizations, provides that entities following financial reporting standards of the GASB should not change their reporting as a result of FASB Statement No. 93.)

  Since some not-for-profit organizations were not required to record depreciation expense in the past, they may not have maintained adequate fixed asset records. Paragraph 105 of SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations,* provides guidance for organizations that decide to retroactively capitalize fixed assets. That guidance may be helpful to organizations in adopting the provisions of FASB Statement No. 93.

- *Invitation to Comment, Financial Reporting by Not-for-Profit Organizations: Form and Content of Financial Statements.* The invitation to comment includes a report by an AICPA task force titled

"Display in the Financial Statements of Not-for-Profit Organizations" and addresses the scope, form, and content of required financial statements.

The FASB has formed a task force to assist in its consideration of the project. In March 1990, the task force met with the Board and staff to discuss plans and priorities for addressing issues of financial statement display.

- *Exposure Draft,* Accounting for Contributions Received and Contributions Made and Capitalization of Works of Art, Historical Treasures, and Similar Assets. The exposure draft concludes that contributions, which include unconditional pledges, generally should be recognized as revenues (or gains) in a donee's financial statements when received and as expenses (or losses) in a donor's financial statements when made. Contributed services received would be recognized if they (1) create or enhance other assets, (2) are provided by entities that normally perform those services for compensation, or (3) are substantially the same as services normally purchased by the recipient. Contributions of works of art, historical treasures, and similar assets would be recognized if those assets or similar assets are of a kind that are intended to be sold or for which markets exist in which they are or could be sold or exchanged. Contributions would be measured at the fair value of the item transferred.

  The proposed statement would be effective for financial statements issued for fiscal years beginning after May 15, 1992, except for capitalization of works of art, historical treasures, and similar assets acquired in prior periods, for which the effective date would be three years later. The comment period for this exposure draft ended on May 1, 1991. A public hearing is scheduled for July 17, 18, and 19, 1991.

.39 *FASB project on consolidations and related matters.* The FASB project entails considering various issues concerning the reporting entity, including those relating specifically to not-for-profit entities. The FASB's timetable for this project is indefinite.

.40 The following AICPA projects concern financial reporting and audits of not-for-profit organizations:

- *Application of the Requirements of Accounting Research Bulletins; Opinions of the Accounting Principles Board; and Statements, Interpretations, and Technical Bulletins of the Financial Accounting Standards Board to Not-for-Profit Organizations.* A draft SOP states that such pronouncements should be applied by not-for-profit organizations, unless such pronouncements specifically exclude them, are not relevant to the kinds of transactions entered into by not-for-profit organizations, or pertain to topics also addressed in the AICPA Audit and Accounting Guides, *Audits of Certain Nonprofit Organizations, Audits of Colleges and Universities, Audits of Providers of Health Care Services,* or *Audits of Voluntary Health and Welfare Organizations.*
- *Reporting of Related Entities by Not-for-Profit Organizations.* A draft SOP on this issue would amend and make uniform the guid-

ance concerning reporting-related entities in the following AICPA Audit and Accounting Guides and SOP:

— *Audits of Colleges and Universities*
— *Audits of Voluntary Health and Welfare Organizations*
— SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*

It concludes that whether the financial statements of a reporting not-for-profit organization and those of one or several other entities (either not-for-profit organizations or business entities) should be consolidated and the extent of disclosure that should be required, if any, should be based on the relationship of the entities to each other and on whether the nature of their activities is such that consolidated or combined financial statements would be the more meaningful presentation. The guidance in the draft SOP focuses on (1) investments in majority-owned for-profit subsidiaries and (2) financially interrelated not-for-profit organizations.

- *Revision of Current Audit and Accounting Guides.* The AICPA Not-for-Profit Organizations Committee is drafting a new Audit and Accounting Guide to revise and combine the current Audit and Accounting Guides, *Audits of Certain Nonprofit Organizations, Audits of Colleges and Universities, and Audits of Voluntary Health and Welfare Organizations.*

AUDIT RISK ALERT—1990

GENERAL UPDATE ON ECONOMIC, INDUSTRY, REGULATORY, AND ACCOUNTING AND AUDITING MATTERS

ISSUED BY THE AUDITING STANDARDS DIVISION

NOTICE TO READERS

This audit risk alert is intended to provide auditors with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. This document has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

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Audit Risk Alert—1990*

Introduction

.01 This alert is intended to help auditors in finalizing their planning for 1990 year-end audits. Successful audits are a result of a number of factors, including acceptance of clients with integrity, adequate partner involvement in planning and performing audits, an appropriate level of professional skepticism, and the allocation of sufficient audit resources to high-risk areas. Addressing these factors in each audit engagement requires substantial professional judgment based, in part, on a knowledge of professional standards and current developments in business and government.

.02 It is important to make sure that written audit programs are *adequately tailored* to reflect *each client's circumstances,* including areas of greater *audit risk.* This alert identifies areas that, based on current information and trends, may be relevant to many 1990 year-end audits. Although it does not provide a complete list of risk factors to be considered, and the items discussed do not affect risk in every audit, this alert can be used as a planning tool for considering matters that may be especially significant for 1990 audits.

Economic Developments

The Current Economic Downturn

.03 Dramatic events in the Persian Gulf and around the world have raised many questions and concerns for American companies. Rising oil prices, lower consumer demand, and reduced availability of capital are just *some* of the factors affecting companies in all industries. Auditors should take these economic factors into consideration and be aware of the ways in which clients have been affected by them as well as of the potential, if any, of a going-concern problem.

Business Failures on the Rise

.04 The current illiquidity in the junk-bond market, coupled with the continuing tightening of credit by lenders throughout the country, have made it substantially more difficult for prospective borrowers to obtain financing, particularly for highly leveraged companies. A recent article in the *Wall Street Journal* called attention to increases in bankruptcy filings, particularly in the real estate, apparel, retailing, and construction industries, due in large part to the weakening cash flow of many businesses as well as the more cautious credit environment. Some industries are becoming very risky undertakings. For example, in 1990, the number of restaurant closings exceeded the number of openings; increased competition has made it nearly impossible to raise menu prices, while costs have continued to increase, especially those for energy, insurance, and wages.

.05 The effects of the economic slowdown will vary across geographic regions and industries, and among companies even within the same industry. Therefore, auditors need to focus specifically on the environment of each client and address each client's particular issues accordingly. Nevertheless, many companies will be unable to pass on increased costs (particularly increased oil prices and medical expenses) due, in part, to increasing competition and softening demand for their products. This could make it difficult for companies to report favorable operating results for the year. With this in mind,

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*This Audit Risk Alert was published in the December 1990 issue of the AICPA's *CPA Letter.*

auditors should be even more sensitive this year to ongoing issues that affect operating results, such as the collectibility of receivables and the potential obsolescence and realizability of inventories.

.06 Highly leveraged companies are particularly vulnerable to a downturn in business activity and the other factors discussed above. Auditors should consider these circumstances when evaluating the ability of highly leveraged clients to continue as going concerns.

Economic Considerations Relating to Debt

.07 Adverse developments in the economy in general, or in a particular financial institution, may cause an institution to refuse to renew loans, to exercise demand clauses (such as the due-on-demand clause), or to decline to waive covenant violations. In addition, these developments may make it more difficult for companies to obtain alternate sources of financing than in the past. In these cases, the auditor should consider the borrower's classification of the liability, potential going-concern issues, management's plans (such as those for alternate financing or asset disposition), and the adequacy of disclosures in the borrower's financial statements. Securities and Exchange Commission (SEC) rules contain specific disclosure requirements in Management's Discussion and Analysis (MD&A) about liquidity and material uncertainties.

Regulatory and Legislative Developments

Environmental Liabilities

.08 The Environmental Protection Agency is empowered by law (through the Superfund legislation) to seek recovery from anyone who ever owned or operated a particular contaminated site, or anyone who ever generated or transported hazardous materials to a site (these parties are commonly referred to as potentially responsible parties, or PRPs). Potentially, the liability can extend to subsequent owners or to the parent company of a PRP.

.09 In connection with audit planning, the auditor should consider making inquiries of management about whether a client (or any of its subsidiaries) has been designated as a PRP or otherwise has a high risk of exposure to environmental liabilities. If a client has been designated as a PRP, the auditor should consider whether any amount should be accrued for cleanup costs and assess the need for disclosure and, possibly, for the inclusion of an explanatory fourth paragraph in the audit report citing the uncertainty, if management is unable to make reasonable estimates of the costs. In addition, for public entities, disclosure should be made in MD&A of estimates of cleanup costs or the reasons why the matter will not have a material effect.

.10 Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies,* and Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss,* provide guidance for the accounting and disclosure of loss contingencies, including those related to environmental issues. The FASB's Emerging Issues Task Force (EITF) reached a consensus in Issue 90-8, *Capitalization of Costs to Treat Environmental Contamination,* that, generally, the costs incurred to treat environmental contamination should be expensed and may be capitalized only if specific criteria are met.

Notification of Termination of Auditor-Client Relationship

.11 The SEC staff has observed instances in which CPA firms have not notified the SEC's Chief Accountant when an auditor-client relationship ends. Under a rule effective May 1, 1989, member firms of the SEC Practice Section of the AICPA Division for Firms must notify the SEC directly by letter *within* *five business days* after the auditor resigns, declines to stand for reelection, or is dismissed.

New Auditing Pronouncements

Implementing SAS No. 55 on Internal Control

.12 AICPA Statement on Auditing Standards (SAS) No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit,* is effective for audit periods beginning on or after January 1, 1990. Auditors who did not apply its provisions early are faced with implementation for December 31, 1990, year-end audits.

.13 To help auditors with questions that may arise, the Auditing Standards Board (ASB) issued the Audit Guide, *Consideration of the Internal Control Structure in a Financial Statement Audit.* The guide presents two preliminary audit strategies for assessing control risk and uses three hypothetical companies ranging from a small, owner-managed business to a large public company to illustrate how the strategies affect the nature, timing, and extent of procedures. Particularly helpful is a series of exhibits that includes sample workpapers documenting the hypothetical companies' compliance with SAS No. 55.

New Financial Institutions Confirmation Form

.14 The AICPA will replace the existing 1966 Standard Bank Confirmation Inquiry. The new form will provide only confirmation of *deposit* and *loan* balances. To confirm other transactions and arrangements, auditors will have to send a separate letter, signed by the client, to a financial institution official responsible for the financial institution's relationship with the client or knowledgeable about the transactions or arrangements. Anyone ordering the new standard form from the AICPA Order Department will receive a copy of a notice to practitioners, which describes the revisions to the process of confirming information with financial institutions, and illustrative letters for confirming some of these types of transactions or arrangements. The new form should be used for confirmations mailed on or after March 31, 1991. Practitioners should neither use the new form before March 31, 1991, nor use the old form on or after that date.

New SAS on Internal Auditing

.15 In April 1991, the ASB issued SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements,* that provides practitioners with expanded and revised guidance on considering the work of internal auditors. Many internal audit activities are relevant to an audit of financial statements because they provide evidence about the design and effectiveness of internal control structure policies and procedures or provide direct evidence about misstatements of financial data contained in financial statements. The SAS is effective for audits of financial statements for periods ending after December 15, 1991, and includes guidance to assist auditors in obtaining an understanding of the internal audit function, assessing the competence and objectivity of internal auditors, and determining the extent to which they may consider work performed by internal auditors. The SAS supersedes SAS No. 9, *The Effect of an Internal Audit Function on the Scope of the Independent Audit,* and incorporates the terminology and concepts of more recent SASs, particularly SAS No. 55.

Forthcoming Guidance on Circular A-133

.16 On March 8, 1990, the Office of Management and Budget (OMB) issued Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions.* The purpose of Circular A-133 is to establish audit requirements and to define federal responsibilities for implementing and monitoring audit requirements for institutions of higher education and other nonprofit institutions receiving federal awards. Institutions covered by Circular A-133 generally include colleges and universities (and their affiliated hospitals) and other not-for-profit organizations, such as voluntary health and welfare organizations and other civic organizations.

.17 The circular applies to nonprofit institutions that receive $100,000 or more in federal awards. (Circular A-133's definition of *financial awards* is broader than the term *financial assistance* used in SAS No. 63, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance.*) Nonprofit institutions that receive at least $25,000 but less than $100,000 in federal financial assistance have the option of applying either the requirements of Circular A-133 or separate program audit requirements. For institutions receiving less than $25,000, records must be kept and made available for review, if requested, but the provisions of the circular do not apply.

.18 In the first quarter of 1991, the AICPA's Auditing Standards Division plans to expose a statement of position, prepared by a subcommittee of the AICPA Not-for-Profit Organizations Committee, that will provide guidance about compliance-auditing requirements in Circular A-133. Circular A-133 is effective for audits of fiscal years beginning on or after January 1, 1990. Since the circular permits biennial audits, some institutions may not be required to follow its requirements until the audit of their financial statements for the fiscal year ending June 30, 1992.

Audit Reporting and Communication Issues

Reporting on Uncertainties

.19 Some auditors have issued an unqualified report with an additional paragraph about the existence of an uncertainty in situations when a qualified or adverse opinion should have been issued.

.20 SAS No. 58, *Reports on Audited Financial Statements,* requires an auditor to add an explanatory paragraph (after the opinion paragraph) to the standard report when a matter is expected to be resolved at some future date, at which time sufficient evidence about its outcome is likely to be available. Examples of such uncertainties include lawsuits against the entity and tax claims by tax authorities when precedents are not clear. Because its resolution is prospective, sometimes management cannot estimate the effect of the uncertainty on the entity's financial statements. However, those uncertainties have, in some cases, been confused with other situations in which management asserts that it is unable to estimate certain financial statement elements, accounts, or items.

.21 Generally, matters whose outcomes depend on the actions of management and relate to typical business operations are susceptible to reasonable estimation and, therefore, are estimates inherent in the accounting process, not uncertainties. Management's inability to estimate in these situations should raise concerns about the possible use of inappropriate accounting principles or scope limitations. If the auditor believes that financial statements are materially misstated because of the use of inappropriate accounting principles, a qualified or adverse opinion is required due to the GAAP departure. A scope limitation should result in a qualified opinion or a disclaimer of opinion.

Going-Concern Matters

.22 When an auditor concludes that there is substantial doubt about an entity's ability to continue as a going concern, SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,* requires the auditor to include an explanatory paragraph (following the opinion paragraph) in the report to reflect that conclusion. Auditors have issued reports in which it is unclear whether they are expressing a conclusion that there is substantial doubt about an entity's ability to continue as a going concern.

.23 For situations in which the auditor expresses such a conclusion, the ASB recently amended SAS No. 59 to require the use of the phrase "substantial doubt about the entity's ability to continue as a going concern" (or similar wording that includes the terms *substantial doubt* and *going concern*) in the required explanatory paragraph.

Required Communications to Audit Committees and Others Having Oversight Responsibility

.24 Instances have been noted in which auditors have overlooked the communication requirements of SAS No. 61, *Communication With Audit Committees.* This statement requires auditors to ensure that certain matters are communicated to audit committees or other groups with responsibility for oversight of the financial reporting process. SAS No. 61 applies to—

- Entities that have an audit committee or a formally designated group having oversight responsibility for financial reporting (for example, a finance or budget committee).
- All SEC engagements as defined in footnote 1 of the statement.

.25 In considering the communications required by SAS No. 61, the auditor should also not overlook the communications required by the following:

- SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities.*
- SAS No. 54, *Illegal Acts by Clients* (see discussion below).
- SAS No. 60, *Communications of Internal Control Structure Related Matters Noted in an Audit.*

Illegal Acts

.26 SAS No. 54 provides guidance for communications with clients of possible illegal acts. The auditor has a responsibility to detect and report misstatements resulting from illegal acts having a direct and material effect on financial statement line-item amounts. Auditors may also become aware of other illegal acts that have, or are likely to have, occurred and that may not have a direct and material effect on financial statement amounts.

.27 Auditors should assure themselves that all illegal acts that have come to their attention, unless clearly inconsequential, have been communicated to the audit committee or its equivalent (the board of trustees or an owner-manager) in accordance with SAS No. 54.

Recurring Audit Problems

Questionable Accounting Practices

.28 Managements of companies—public or private—might feel pressure to report favorable results—for example, to maintain a trend of growth in earnings, support or improve the price of the company's stock, obtain or maintain essential financing, or comply with debt covenants. This pressure is most likely to affect public companies, but auditors should not underestimate the pressures on nonpublic companies to "stretch" earnings or report a favorable financial condition—particularly in light of the current credit crunch. In most cases, the actions taken are well-intentioned and believed to be appropriate by the company. However, in certain cases, the result is an inappropriate accounting practice.

.29 The downturn in the economy may have an effect on the way a client conducts its business and carries out its revenue recognition policies. Auditors should be alert to facts and circumstances relating to revenue recognition policies that may not be appropriate, such as—

- Changes in standard sales contracts permitting, for example, continuation of cancellation privileges.
- Situations in which the seller has significant continuing involvement or the buyer has not made a sufficient financial commitment to demonstrate an intent or ability to pay.
- Certain sales with a "bill and hold" agreement.

.30 Revenue should not be recorded until it is realized or clearly realizable, the earnings process is complete, and its collection is reasonably assured.

.31 The following are some other accounting practices that distort operating results or financial position:

- Improperly deferring typical period costs and expenses (for example, personnel, training, and moving costs) or costs for which a specific quantifiable future benefit has not been determined.
- Adjusting reserves without adequate support.
- Nonaccrual of losses (for example, environmental liabilities) or inadequate disclosure in accordance with FASB Statement No. 5, *Accounting for Contingencies.*
- Inadequate recognition of uninsured losses (for example, increased deductibles for workers' compensation or medical care).
- Using improper LIFO accounting practices, including inappropriate pools and intercompany transactions.

.32 Competent and sufficient audit evidence continues to be the foundation for the auditor's opinion. Insufficient professional skepticism, illustrated by "auditing by conversation," or failing to obtain solid evidence to back up management's representations, can lead to audit problems. In the final analysis, auditors need to step back and ask one of auditing's most fundamental questions: Does it make sense?

.33 Problems also can occur due to errors in recording relatively straightforward transactions, particularly in those situations where cost-reduction and restructuring programs have reduced the number and quality of accounting personnel. The importance of principal audit procedures (for example, sales and inventory cut-off tests, searches for unrecorded liabilities, and follow-up on errors noted during tests) cannot be overemphasized. These types of procedures are fundamental and critical to the audit process.

.34 Although clients may impose fee pressures or tight deadlines on auditors, these pressures do not change the professional responsibility to understand and audit the facts and situations carefully and to make professional, knowledgeable decisions.

Communications Between Predecessor and Successor Auditors

.35 SAS No. 7, *Communications Between Predecessor and Successor Auditors,* establishes requirements for communications between predecessor and successor auditors when a change of auditors has taken place or is in process. It has been observed that the guidance provided by SAS No. 7 is sometimes not followed. It is essential that both predecessor and successor auditors are aware of, and adhere to, the requirements of SAS No. 7. For example, the predecessor auditor should respond promptly and fully to the successor's reasonable inquiries unless he or she indicates that the response is limited.

Part of Audit Performed by Other Independent Auditors

.36 In accordance with SAS No. 1 (AICPA, *Professional Standards,* vol. 1, AU section 543), in no circumstances should an auditor state or imply that an audit report making reference to another auditor is inferior in professional standing to a report without such a reference. When a principal auditor decides not to make reference to the work of another auditor, the extent of additional procedures to be performed by the principal auditor may be affected by the other auditor's quality-control policies and procedures (see auditing interpretation "Part of Audit Performed by Other Auditors: Auditing Interpretations of AU Section 543" [AICPA, *Professional Standards,* vol. 1, AU section 9543.18]).

Attorney's Responses

.37 A letter of audit inquiry to the client's lawyer is the auditor's primary means of corroborating information furnished by management concerning litigation, claims, and assessments. Auditors should carefully read all letters from attorneys and ensure that all matters discussed are understood. Ambiguous and incomplete responses should be appropriately resolved with client management and attorneys, and conclusions should be properly documented. An auditing interpretation of SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments,* presented in the AICPA's *Professional Standards,* vol. 1, AU section 9337.18, discusses what constitutes an acceptable reply. Additional inquiries may be needed if replies are not dated sufficiently close to the date of the audit report.

Pitfalls for Auditors

.38 Each year-end seems to abound with pitfalls for auditors. The following reminders are intended to alert auditors to some of these pitfalls.

- Watch out for large, unusual, one-time transactions, especially at or near year-end, that may be designed to ease short-term profit and cash flow pressures. Scrutinize each transaction to ensure validity of business purpose, timing of revenue or profit recognition, and adequacy of disclosure.
- In performing analytical procedures (for example, analyzing accounts, changes from period to period, and differences from expectations), maintain an attitude of objectivity and professional skepticism. Do not assume that the accounts or client explanations are

right. Rather, question, challenge, and compare new information with what is already known about the client and of business in general.

- Make sure that receivables that are supported by real estate as collateral reflect the softening of the market. Increases in the allowance for uncollectibles may be needed. Recognize that assets acquired through foreclosure may be overvalued and difficult to sell.
- Pay special attention to the collectibility of significant receivables from debtors that have recently gone through a leveraged buyout (LBO). A company is not the same entity that it was before an LBO.

Accounting Developments

Financial Instruments Disclosure

.39 In March 1990, the FASB issued Statement No. 105, *Disclosure of Information About Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk,* effective for fiscal years ending after June 1, 1990. It applies to all entities, including small businesses (due to its requirement to disclose significant concentrations of credit risk arising from all financial instruments, including trade accounts receivable).

.40 The statement applies to all financial instruments with off-balance-sheet risk of accounting loss and all financial instruments with concentrations of credit risk, with some exceptions that are detailed in paragraphs 14 and 15 of the statement. It requires all entities with financial instruments that have off-balance-sheet risk to disclose the face, contract, or underlying principal involved; the nature and terms of the financial instrument; the accounting loss that could occur; and the entity's policy regarding collateral or other security and a description of the collateral.

Postretirement Benefits Other Than Pensions

.41 The FASB issued Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions,* in December 1990. The statement significantly changes the prevalent current practice of accounting for postretirement benefits on the "pay as you go" (cash) basis by requiring accrual, during the years that employees render services, of the expected cost of providing those benefits to employees and their beneficiaries and covered dependents. This statement is effective for calendar-year 1993 financial statements. An additional two-year delay is provided for plans of non-U.S. companies and certain small employers.

.42 In the SEC Staff Accounting Bulletin (SAB) No. 74, *Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period,* the SEC staff expressed its belief that disclosure of *impending* accounting changes is necessary to inform readers about expected effects on financial information to be reported in the future and should be made in accordance with existing MD&A requirements. The SEC staff provided supplemental guidance regarding SAB No. 74 in the November 1990 EITF minutes.

Reporting When in Bankruptcy

.43 Statement of Position (SOP) 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code,* provides guidance for entities that have filed petitions with the Bankruptcy Court and expect to reorganize as going concerns under Chapter 11.

.44 The SOP recommends that all such entities report the same way while reorganizing under Chapter 11, with the objective of reflecting their financial evolution. To do that, their financial statements should distinguish transactions and events that are directly associated with the reorganization from the operations of the ongoing business as it evolves.

.45 The SOP generally becomes effective for financial statements of enterprises that have filed petitions under the Bankruptcy Code after December 31, 1990.

Audit Risk Alerts

.46 The Auditing Standards Division is issuing Audit Risk Alerts to advise auditors of current economic, industry, regulatory, and professional developments that they should be aware of as they perform year-end audits. The following industries are covered:

- Airlines (022071)
- Agribusiness (022073)
- Banking (022063)
- Casinos (022070)
- Construction contractors (022066)
- Credit unions (022061)
- Employee benefit plans (expected to be available in March 1991) (022055)
- Federal government contractors (022068)
- Finance companies (022060)
- Investment companies (022059)
- Life and health insurance companies (022058)
- Nonprofit organizations, including colleges and universities and voluntary health and welfare organizations (expected to be available in March 1991) (022074)
- Oil and gas producers (022069)
- Property and liability insurance companies (022072)
- Providers of health care services (022067)
- Savings institutions (022076)
- Securities (022062)
- State and local governmental units (expected to be available in June 1991) (022056)

.47 Copies of these industry updates may be purchased from the AICPA Order Department. They are also included in this service.

Call toll free: (800) 334-6961 (USA)
(800) 248-0445 (NY)

AICPA Services

Technical Hotline

.48 The AICPA Technical Information Service answers inquiries about specific audit or accounting problems.

Call toll free: (800) 223-4158 (USA)
(800) 522-5430 (NY)

Ethics Division

.49 The AICPA's Ethics Division answers inquiries about the application of the AICPA Code of Professional Conduct. Auditors may call at any of the following numbers:

(212) 575-6217
(212) 575-6299
(212) 575-6736

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