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

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EXPOSURE DRAFT

PROPOSED AUDIT AND ACCOUNTING GUIDE

NOT-FOR-PROFIT ORGANIZATIONS

(To supersede AICPA Industry Audit Guides *Audits of Voluntary Health and Welfare Organizations* and *Audits of Colleges and Universities*, Audit and Accounting Guide *Audits of Certain Nonprofit Organizations*, and Statements of Position 74-8, *Financial Accounting and Reporting by Colleges and Universities*, and 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*)

APRIL 14, 1995

Prepared by the Not-for-Profit Organizations Committee
Accounting Standards Division
American Institute of Certified Public Accountants

Comments should be received by August 14, 1995, and addressed to Joel Tanenbaum, Technical Manager, File 3605.AG, Accounting Standards Division AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775

EXPOSURE DRAFT

PROPOSED AUDIT AND ACCOUNTING GUIDE

NOT-FOR-PROFIT ORGANIZATIONS

APRIL 14, 1995

Prepared by the Not-for-Profit Organizations Committee
Accounting Standards Division
American Institute of Certified Public Accountants

This exposure draft has been sent to —

- State society and chapter presidents, directors, and committee chairpersons.
- Individuals, firms, and organizations identified as having an interest in accounting and auditing issues that affect not-for-profit organizations.
- Persons who have requested copies.

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AICPA

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April 14, 1995

Accompanying this letter is an exposure draft of the proposed AICPA Audit and Accounting Guide *Not-for-Profit Organizations* that would supersede the following AICPA Audit and Accounting Guides:

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

It also would supersede the following AICPA Statements of Position (SOPs):[1]

- SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*
- SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*

Summary information about the proposed Guide is provided in the preface of the exposure draft.

The proposed Guide discusses those aspects of accounting and auditing unique to nongovernmental not-for-profit organizations and was developed to assist nongovernmental not-for-profit organizations in preparing financial statements in conformity with generally accepted accounting principles and to assist independent auditors in auditing and reporting on those financial statements.

This exposure draft incorporates new accounting and financial reporting requirements issued by the Financial Accounting Standards Board (FASB) and the AICPA Accounting Standards Executive Committee (AcSEC). Also incorporated in this exposure draft are new auditing standards issued by the AICPA Auditing Standards Board since the issuance of the pronouncements that this Guide would supersede. In particular, relevant provisions of FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, and FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, have been incorporated into the proposed Guide. In developing the proposed Guide, certain issues which are related to, but not explicitly addressed by, those Statements arose. To help facilitate comments on the exposure draft, conclusions on these issues are presented in bold type.

The provisions of the proposed Guide would be effective for financial statements for periods beginning after June 15, 1995, except for organizations with less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date would be for fiscal years beginning after December 15,1995. Earlier application would be permitted. The AICPA Not-for-Profit Organizations Committee recognizes that, for many organizations, the effective date of this Guide would be six months later than the effective dates of FASB Statements No. 116 and No. 117.

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[1] SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, or the SOP that supersedes it, as discussed in Chapter 13, "Expenses, Gains, and Losses," footnote 1; SOP 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards*; SOP 94-2, *The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations*; and SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, include guidance specifically applicable to not-for-profit organizations. The guidance in these SOPs will be included in the final version of this Guide.

The Not-for-Profit Organizations Committee welcomes comments or suggestions on any aspect of the exposure draft. Matters about which specific comments are requested are listed in the exhibit following this letter. In order to facilitate the committee's consideration of comments, please include references to specific paragraph numbers, include reasons for any suggestions or comments, and provide alternative wording with supporting reasoning.

Responses should be addressed to Joel Tanenbaum, Technical Manager, File 3605.AG, Accounting Standards Division, AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775, in time to be received by August 14, 1995.

Written comments on the exposure draft will be available for public inspection at the AICPA library after September 14, 1995, for one year.

Sincerely,

Kenneth D. Williams

Kenneth D. Williams
Chair
Not-for-Profit Organizations
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Gerard L. Yarnall

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EXHIBIT — SPECIFIC ISSUES FOR COMMENT

Comments are specifically requested on the following issues addressed by this exposure draft:

ISSUE 1: VARIANCE POWER AND DONOR-ADVISED PROVISIONS

In conformity with paragraphs 53 and 54 of FASB Statement No. 116, the proposed Guide states that if a not-for-profit organization receives resources over which it has little or no discretion, those resources are accounted for as agency or intermediary transactions, rather than as contributions received and made. (Paragraphs 5.05 to 5.13 of this Guide discuss accounting for agency and intermediary transactions. As discussed in footnote 14 of Chapter 5, "Contributions Received and Agency Transactions," if a contribution is transferred to the ultimate recipient through an agent acting as an intermediary, the ultimate recipient should report the contribution when adequate evidence that the agent has received the promise to give or contribution becomes available.) We understand that not-for-profit organizations, including community foundations, are receiving resources in the following kinds of transactions:

- Some not-for-profit organizations receive resources whereby the resource provider specifies that (1) the resources must be retained in perpetuity and (2) the income of the resources should be given to another organization, as designated by the resource provider. However, the instrument transferring the resources to the not-for-profit organization provides that the not-for-profit organization has variance power over the income of the resources. Variance power permits the not-for-profit organization to withhold or modify distributions to the other organization if, in the sole judgment of the not-for-profit organization, those distributions have become unnecessary, incapable of fulfillment, or inconsistent with the needs of the community.
- Some not-for-profit organizations receive resources whereby the instrument transferring the resources provides that the resources must be retained in perpetuity and that the income of the resources should be given to specified other organizations based on the provider's nonbinding advice. (Such provisions are commonly referred to as *donor-advised* provisions.) However, the instrument provides that the not-for-profit organization may reject the provider's advice and that the not-for-profit organization may determine to whom the resources are distributed.

AcSEC asks that respondents comment concerning the effect of variance power and donor-advised provisions on the accounting for resources received under agreements that have those provisions. In particular, AcSEC asks that respondents consider the following questions:

- Does variance power provide not-for-profit organizations with sufficient discretion to recognize resources received as contributions? Does the not-for-profit organization's history of exercising its variance power affect the answer to this question?
- Do donor-advised provisions, in combination with variance power, provide not-for-profit organizations with sufficient discretion to recognize resources received as contributions? Does the not-for-profit organization's history of deviating from the resource provider's advice affect the answer to this question?
- Can the accounting for the income from resources that must be retained in perpetuity differ from the accounting for the resources held in perpetuity? For example, can the receipt of resources that must be retained in perpetuity be accounted for as a contribution if the income from the resources is accounted for as an agency transaction?

ISSUE 2: FINANCIAL AID PROVIDED BY A COLLEGE AND UNIVERSITY

AcSEC believes that not all financial aid provided by a college and university is a tuition discount. For example, benefits provided in exchange for services, such as free tuition for employees, are expenses rather than discounts. However, the proposed Guide is silent concerning this issue. Respondents are asked to comment specifically on this issue and whether the Guide should be silent concerning it.

Not-for-Profit Organizations Committee
(1993–1994)

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

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PREFACE

PURPOSE

This AICPA Audit and Accounting Guide has been prepared to assist nongovernmental not-for-profit organizations in preparing financial statements in conformity with generally accepted accounting principles (GAAP) and to assist independent auditors in auditing and reporting on those financial statements.[1]

APPLICABILITY

This Guide applies to organizations that meet the definition of a not-for-profit organization included in appendix D of Financial Accounting Standards Board (FASB) Statement No. 117, *Financial Statements of Not-for-Profit Organizations*. Some organizations that have traditionally been considered to be not-for-profit organizations and that have been covered by American Institute of Certified Public Accountants (AICPA) Industry Audit Guides or Audit and Accounting Guides that are superseded by this Guide do not meet the definition of a not-for-profit organization in FASB Statement No. 117. Although FASB Statement No. 117 excludes those organizations from its scope, it nevertheless contains broad guidelines that would enable them to prepare meaningful financial statements. Accordingly, this Guide applies to certain organizations, referred to in this guide as not-for-profit organizations, though those organizations do not meet the definition of a not-for-profit organization in FASB Statement No. 117.

LIMITATIONS

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

IMPACT ON OTHER LITERATURE

This Guide incorporates certain provisions of FASB Statements No. 116, *Accounting for Contributions Received and Contributions Made,* and No. 117. Not all guidance that is included in those Statements, however, is incorporated, repeated, or summarized in this Guide. Accordingly, those Statements should be read in conjunction with this Guide. Like FASB

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[1] In March 1995, the Governmental Accounting Standards Board (GASB) issued an Exposure Draft of a proposed Statement, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities.* The effect of the proposed Statement would be that governmental entities should not change their accounting and financial reporting to apply the provisions of Financial Accounting Standards Board (FASB) Statements No. 116 and No. 117 or of this Audit and Accounting guide. The proposed Statement would permit governmental entities that have applied the accounting and financial reporting principles in SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations,* or the Industry Audit Guide, *Audits of Voluntary Health and Welfare Organizations,* (modified by all applicable FASB pronouncements issued through November 30, 1989, and by most applicable GASB pronouncements) to continue to do so, pending GASB pronouncements on the accounting and financial reporting model for governmental entities. Alternatively, those governmental entities could change to the current governmental financial reporting model.

Statements No. 116 and No. 117, this Guide is directed at not-for-profit organizations in general, and not at specific kinds of such organizations, such as voluntary health and welfare organizations or private colleges and universities. It is expected that various industry associations will publish guidance on applying both the FASB Statements and this Guide to specific kinds of organizations.[2]

This Guide supersedes the following AICPA Audit and Accounting Guides:

- Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations*
- Industry Audit Guide *Audits of Colleges and Universities*[3]
- Audit and Accounting Guide *Audits of Certain Nonprofit Organizations*

It also supersedes the following AICPA Statements of Position (SOPs):[4]

- SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*
- SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*

EFFECTIVE DATE AND TRANSITION

The provisions of this Guide are effective for financial statements for periods beginning after June 15, 1995, except for organizations with less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date is fiscal years beginning after December 15, 1995. Earlier application is permitted.

Unless this Guide is applied retroactively under the provisions of the following paragraph, the effect of initially applying this Guide should be reported as the effect of a change in accounting principle, in a manner similar to the cumulative effect of a change in accounting principle

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[2] As noted in paragraph 1.07, guidance published by industry associations may be considered "other accounting literature" in the hierarchy of sources of accounting principles established by SAS No. 69, *The Meaning of* Present Fairly in Conformity with Generally Accepted Accounting Principles *in the Independent Auditor's Report*.

[3] GASB Statement No. 15, *Governmental College and University Accounting and Financial Reporting Models*, requires governmental colleges and universities to use one of two accounting and financial reporting models. One model, referred to as the "AICPA College Guide Model," encompasses the accounting and financial reporting guidance in the 1973 AICPA Industry Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8 and as modified by applicable FASB pronouncements issued through November 30, 1989, and all applicable GASB pronouncements. (The other model, referred to as the "Governmental Model," is based on the pronouncements of the National Council on Governmental Accounting (NCGA) and the GASB.) The applicability of the Industry Audit Guide *Audits of Colleges and Universities* and SOP 74-8 to governmental colleges and universities that use the "AICPA College Guide Model" is unchanged by this Guide.

[4] SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, or the SOP that supersedes it, as discussed in Chapter 13, "Expenses, Gains, and Losses," footnote 1; SOP 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards;* SOP 94-2, *The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations;* and SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, include guidance specifically applicable to not-for-profit organizations. The guidance in these SOPs will be included in the final version of this Guide.

(Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*, paragraph 19). The amount of the cumulative effect should be based on a retroactive computation. Organizations should report the cumulative effect of a change in accounting on each class of net assets in the statement of activities, after the caption "extraordinary items" (if any) and before the captions "change in unrestricted net assets," "change in temporarily restricted net assets," and "change in permanently restricted net assets."

This Guide may be applied retroactively by restating the opening net assets for the earliest year presented or for the year this Guide is first applied if no prior years are presented. In the period that this Guide is first applied, organizations should disclose the nature of any restatement and its effect on the change in net assets for each period presented.

Chapter 1

INTRODUCTION

SCOPE

1.01 This Guide covers organizations that meet the definition of a not-for-profit organization included in appendix D of Financial Accounting Standards Board (FASB) Statement No. 117, *Financial Statements of Not-for-Profit Organizations*:

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

1.02 Some organizations that have traditionally been considered to be not-for-profit organizations and that have been covered by American Institute of Certified Public Accountants (AICPA) industry audit guides or audit and accounting guides that, as noted in the preface, are superseded by this Guide, do not meet the definition of a not-for-profit organization in FASB Statement No. 117. Although FASB Statement No. 117 excludes those organizations from its scope, it nevertheless contains broad guidelines that would enable them to prepare meaningful financial statements.

1.03 **Accordingly, this Guide applies to nongovernmental organizations of the following kinds, unless they are organized for for-profit purposes, regardless of whether a particular organization meets the definition of a not-for-profit organization in FASB Statement No. 117:**[1]

- **Cemetery organizations**
- **Civic and community organizations**
- **Colleges and universities**
- **Elementary and secondary schools**
- **Federated fund-raising organizations**
- **Fraternal organizations**
- **Labor unions**
- **Libraries**
- **Museums**
- **Other cultural organizations**
- **Performing arts organizations**
- **Political parties**
- **Political action committees**

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[1] This list does not necessarily include all organizations that meet the definition of a not-for-profit organization in FASB Statement No. 117. This Guide applies to all organizations that meet the definition, regardless of whether they are included in this list.

- **Private and community foundations**
- **Professional associations**
- **Public broadcasting stations**
- **Religious organizations**
- **Research and scientific organizations**
- **Social and country clubs**
- **Trade associations**
- **Voluntary health and welfare organizations**
- **Zoological and botanical societies**

Organizations that are covered by this Guide are, for the sake of convenience, referred to as "not-for-profit organizations" even if they do not meet the definition of a not-for-profit organization in FASB Statement No. 117.

1.04 Not-for-profit organizations are exempt from the scope of certain FASB and other pronouncements. Organizations that do not meet the FASB Statement No. 117 definition of a not-for-profit organization, regardless of whether they are within the scope of this Guide, are not not-for-profit organizations and are required to follow generally accepted accounting principles (GAAP) applicable to for-profit entities.[2]

1.05 Certain organizations that meet the definition of a not-for-profit organization in FASB Statement No. 117, as well as some that do not meet that definition but do not have ownership interests like those of business enterprises or have operating purposes other than to provide goods and services at a profit, are the subject of specific AICPA industry audit guides, audit and accounting guides, or statements of position (SOPs) and are not covered by this Guide. These organizations include, among others, pension plans, mutual insurance companies, credit unions, common interest realty associations, and certain providers of health care services.[3]

GAAP HIERARCHY FOR NOT-FOR-PROFIT ORGANIZATIONS

1.06 AICPA Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity with Generally Accepted Accounting Principles *in the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 411), states that the guidance provided by FASB Statements of Financial Accounting Standards, FASB Interpretations, Opinions of the Accounting Principles Board (APB), and Accounting Research Bulletins (ARBs) shall be considered to be established accounting principles applicable to nongovernmental entities pursuant to Rule 203 of

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[2] For example, some entities, such as country clubs, may not meet the definition of a not-for-profit organization in FASB Statement No. 117 (which is also included in FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*) but may nevertheless be required to follow this Guide. However, this Guide includes certain guidance that conflicts with guidance applicable to for-profit entities. For example, chapter 8, "Investments," of this Guide includes guidance on accounting and reporting for investments that conflicts with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, which exempts not-for-profit organizations. Beginning with financial statements issued for fiscal years beginning after December 15, 1994, (the effective date of FASB Statement No. 116 for entities other than not-for-profit organizations), entities that do not meet the FASB Statement No. 117 definition of a not-for-profit organization but are nevertheless required to follow this Guide should follow the guidance on accounting and reporting for investments included in FASB Statement No. 115 rather than the guidance included in chapter 8 of this Guide to the extent that the guidance in chapter 8 conflicts with the guidance in FASB Statement No. 115.

[3] Providers of health care services that meet the definition of a voluntary health and welfare organization in FASB Statement No. 117 should follow this Guide.

the AICPA Code of Professional Conduct. SOP 94-2, *The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations*, states that not-for-profit organizations should follow the guidance in effective provisions of ARBs, APB Opinions, and FASB Statements and Interpretations, unless a specific pronouncement explicitly exempts not-for-profit organizations.

1.07 SAS No. 69 also establishes a hierarchy of sources of GAAP. The hierarchy consists of "established accounting principles" and "other accounting literature." For nongovernmental entities, established accounting principles include FASB Statements of Financial Accounting Standards and Interpretations, APB Opinions, and ARBs, which are in category *a* at the top of the hierarchy, as well as FASB Technical Bulletins, cleared[4] AICPA industry audit and accounting guides and SOPs (category *b*); consensus positions of the FASB Emerging Issues Task Force (EITF) and cleared AICPA Practice Bulletins (category *c*); and AICPA accounting interpretations, implementation guides (Qs and As) published by the FASB staff, and practices that are widely recognized and prevalent either generally or in the industry (category *d*). SOP 94-2 notes that not-for-profit organizations are subject to certain pronouncements included in categories *b–d* and should apply the principles therein that pertain to them. SAS No. 69 notes that in the absence of established accounting principles described in categories *a–d*, the auditor may consider other accounting literature, including pronouncements of other professional associations, depending on its relevance in the circumstances.

FUND ACCOUNTING AND NET ASSET CLASSES

1.08 Fund accounting is a technique used by some not-for-profit organizations for purposes of internal recordkeeping and managerial control and to help ensure that the use of resources is in accordance with stipulations imposed by donors and other resource providers and with self-imposed limitations designated by the organization's governing board. Under fund accounting, resources are classified into funds associated with specific activities and objectives. Prior to implementing FASB Statement No. 117, not-for-profit organizations used fund accounting for financial reporting in conformity with applicable AICPA industry audit guides and audit and accounting guides.

1.09 *Montgomery's Auditing* notes that "as used in nonprofit accounting, a fund is an accounting entity with a self-balancing set of accounts for recording assets, liabilities, the fund balance, and changes in the fund balance. Separate accounts are maintained for each fund to ensure that the limitations and restrictions on the use of resources are observed. Though the fund concept involves separate accounting records, it does not entail the physical segregation of resources. Fund accounting is basically a mechanism to assist in exercising control over the purpose of particular resources and amounts of those resources available for use."[5] Fund accounting is discussed further in chapter 16, "Fund Accounting" of this Guide.

1.10 Paragraph 18, footnote 5, of FASB Statement No. 117 states that "this Statement does not use the terms *fund balance* or *changes in fund balances* because in current practice those terms are commonly used to refer to individual groups of assets and related liabilities rather than to an

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[4] As used in SAS No. 69, *cleared* means that the FASB has indicated that it does not object to the issuance of the Guide or SOP.

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

entity's net assets or changes in net assets taken as a whole." As discussed in chapter 3, "Basic Financial Statements," of this Guide, FASB Statement No. 117 requires that the amounts for each of three classes of net assets (permanently restricted, temporarily restricted, and unrestricted) be displayed in a statement of financial position and that the amounts of change in each of those classes of net assets be displayed in a statement of activities.

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

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

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

Chapter 2

GENERAL AUDITING CONSIDERATIONS

SCOPE OF SERVICES

2.01 The scope of services rendered by independent auditors depends on the kinds of reports to be issued as a result of the engagement. For each audit engagement, the auditor and the not-for-profit organization should establish an understanding, preferably in writing, of the scope of services to be performed and the reports to be issued. The not-for-profit organization, after discussions with the auditor, should be sure that in addition to encompassing the financial statements, the scope of the engagement satisfies all relevant contractual, legal, and regulatory requirements. These requirements may include the tests and reports required by U.S. Office of Management and Budget (OMB) Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions.*[1] The auditor may also be engaged to issue reports that meet requirements found in *Government Auditing Standards* (the Yellow Book) issued by the Comptroller General of the United States.[2] The auditor may also be engaged to prepare special reports on various financial data prepared by the organization, such as those related to bond indentures and other debt instruments and annual state information returns required by state attorneys general.

2.02 Paragraphs 21 to 23 of SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards,* vol. 1, AU sec. 801) provide guidance on the auditor's responsibilities when he or she becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement. SAS No. 74 provides that in that situation "the auditor should communicate to management and the audit committee, or to others with equivalent authority and responsibility, that an audit in accordance with generally accepted auditing standards may not satisfy the relevant legal, regulatory, or contractual requirements." SAS No. 74 also notes that "the auditor should consider how the client's actions in response to such communication relate to other aspects of the audit, including the potential effect on the financial statements and on the auditor's report on those financial statements. Specifically, the auditor should consider management's actions (such as not arranging for an audit that meets the applicable requirements) in relation to the guidance in SAS No. 54, *Illegal Acts By Clients*" (AICPA, *Professional Standards*, vol. 1, AU sec. 317).

INDEPENDENCE

2.03 Members of the AICPA who are engaged to audit the financial statements of not-for-profit organizations in accordance with generally accepted auditing standards are required to be

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[1] OMB Circular A-133 includes requirements that the auditor perform tests and report on compliance with the cost principles and matching or cost-sharing requirements set forth in various other government regulations, such as OMB Circulars A-21, *Cost Principles for Colleges and Universities*; A-110, *Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Nonprofit Organizations*; and A-122, *Cost Principles for Nonprofit Organizations*.

[2] In practice, the standards included in *Government Auditing Standards* (1994 revision) are sometimes referred to as generally accepted government auditing standards (GAGAS). *Government Auditing Standards* includes standards for performance audits as well as standards for financial audits. The references to *Government Auditing Standards* in this Guide pertain only to the standards for financial audits.

independent. In making judgments about whether they are independent, members should be guided by Rule 101, *Independence*, of the AICPA Code of Professional Conduct, its Interpretations, and the Ethics Rulings under it. A number of Ethics Interpretations deal specifically with matters of independence as it relates to not-for-profit organizations.

AUDIT PLANNING

2.04 The first standard of fieldwork requires that the audit be adequately planned. SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312), provides broad guidance about audit risk and materiality at both the financial statement level and at the individual account-balance or class-of-transaction level when the auditor plans and performs an audit. Other authoritative pronouncements provide more specific guidance on planning considerations. This section discusses how that guidance should be applied in audits of not-for-profit organizations.

2.05 SAS No. 47 defines audit risk as "the risk that the auditor may unknowingly fail to appropriately modify his opinion on financial statements that are materially misstated." The auditor plans the audit to obtain reasonable assurance of detecting misstatements that could be large enough, individually or in the aggregate, to be quantitatively material to the financial statements. SAS No. 47 notes that the auditor needs to consider audit risk at the individual account balance or class-of-transaction level to assist in determining the scope of auditing procedures for the balance or class and related financial statement assertions.

2.06 The auditor seeks to restrict audit risk at the individual account balance or class-of-transaction level in such a way as to enable the expression of an opinion on the financial statements taken as a whole at an appropriately low level of audit risk. At the account balance or class-of-transaction level, audit risk consists of inherent risk, control risk, and detection risk, which are defined in SAS No. 47. This section describes inherent risk and control risk factors particularly relevant to the audit of a not-for-profit organization that the auditor should consider in planning the audit. (Later sections of this chapter as well as other chapters in the Guide discuss substantive tests unique to the industry that the auditor of a not-for-profit organization should consider in order to reduce detection risk.)

Industry Characteristics

2.07 The operations of not-for-profit organizations differ from those of for-profit entities in several significant ways, and those differences affect audit planning. Not-for-profit organizations use their resources to accomplish the purpose or mission for which they exist, not to generate net income. These resources often come from contributions, grants, or appropriations, some of which may be subject to limitations on how the resources may be used.[3] These limitations — which may be imposed by donor restrictions, by contractual terms, or by the organization's board of trustees — require that the auditor test expenditures for compliance with relevant limitations.

2.08 Not-for-profit organizations are also required to comply with numerous other provisions of statutes, contractual agreements, terms of grants and trust agreements, and similar limitations. As discussed later in this chapter, the auditor is typically required to test for compliance with

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

some of these provisions as well. Finally, though not-for-profit organizations are usually eligible for tax-exempt status under Section 501 of the Internal Revenue Code (IRC), the auditor should be aware that income from activities not related to a not-for-profit organization's exempt purpose may be subject to tax and that the organization may own or control for-profit subsidiaries. Taxes on unrelated business income and other tax matters that the auditor should consider in planning an audit of a not-for-profit organization are addressed in chapter 15, "Tax Considerations."

2.09 Not-for-profit organizations often have revenue and expenditure transactions that are unique to the industry, and these transactions have attendant implications for audit planning. For example, not-for-profit organizations often solicit contributions from various sources, some receive revenues from grants, and some organizations collect dues from members. Fund-raising may take place through direct mail solicitations, door-to-door solicitations, telethons, and various kinds of special events, to name just a few methods. Some organizations collect substantial amounts of contributions in the form of currency. Each of these sources of cash flows has different kinds of risk associated with it. On the expenditure side, some not-for-profit organizations must also comply with restrictions imposed by resource providers. The revenue and expenditure transaction cycles of not-for-profit organizations may also include transactions that are similar to those entered into by for-profit enterprises — for example, buying and selling merchandise, purchasing investments, property and equipment, and other assets; providing services for fees, and earning income from investments. These cycles may include transactions that do not immediately result in revenues and expenses.

2.10 FASB Statement No. 116 requires not-for-profit organizations to recognize agreements for future nonreciprocal transfers of cash, other assets, and services that are unconditional (that is, promises to give). Chapter 5 of this Guide discusses recognition and measurement principles for the assets and revenues related to such transactions. Applying those principles often involves the use of significant accounting estimates. SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), provides guidance on obtaining and evaluating sufficient competent evidential matter to support those estimates.

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

2.12 Each of these kinds of transactions and reporting requirements creates audit risk that the auditor should address. Each also requires the auditor to consider management's implicit financial statement assertions and to formulate specific audit objectives based on those assertions. Not-for-profit organizations usually have internal controls designed to achieve control objectives related to these transactions. *Internal control* is defined by *Internal Control — Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission and often referred to as the COSO Report.

2.13 Many not-for-profit organizations face financial and operating pressures that are similar to those faced by for-profit enterprises. Not-for-profit organizations may also face pressures that are unique to institutions that seek revenues in the form of contributions and grants, which are often correlated with the state of the economy. These pressures generate operating, financial, and accounting responses by management, and such responses may increase both inherent risk and control risk, which the auditor should recognize and respond to in planning the audit. The following are examples:

- Certain donors may tie contribution allocation formulas to the organization's actual or budgeted revenues, leading management to attempt to *manage* revenues to achieve the largest allocation possible.

- A sluggish economy may reduce contributions and the collection of promises to give that were made in prior years. The reduced receipts may lead the organization to pursue a more aggressive investment strategy involving complex financial instruments. Accounting for these instruments may increase the risk of financial statement misstatements; the auditor should understand the substance of these instruments and determine that they are reported in conformity with GAAP.

- Adverse demographics may lead an organization that charges fees for its services to pursue a more aggressive marketing strategy in its quest for constituents; this could decrease the collectibility of its receivables.

- Shortfalls in unrestricted contributions may induce an organization to use restricted contributions for purposes that violate donor restrictions.

- Acceptance by an organization of federal research and other grants carries with it an obligation to comply with federal regulations when the organization administers those grants. Such regulations include those governing overhead and other costs charged to these grants. The terms of the grants may induce organizations to charge unallowable costs to the grants, possibly resulting in liabilities for fines and repayment of any unallowable costs.

- An attempt to appear as efficient as possible may increase the likelihood of misstatement of the allocation of costs between program services and supporting activities.

Organization Characteristics

2.14 Effective audit planning requires (a) an understanding of the industry in which a particular not-for-profit organization operates and (b) knowledge of the specific entity being audited and its uniqueness in relation to the industry. That knowledge should include understanding the way the entity is organized and its operating characteristics (including the level of involvement and oversight exercised by the governing board), sources of revenues, principal expenditures, accounting policies, methods used to process accounting information, and related control policies and procedures. SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311) provides further guidance on matters that the auditor should consider in planning the engagement.

Internal Control Considerations

2.15 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), describes the elements of an internal control structure and describes how an auditor should consider the internal control structure in planning and performing an audit. SAS No. 55 requires that to plan the audit, the auditor should obtain a sufficient understanding of each of the three elements of the entity's internal control structure to plan the audit. The three elements of an entity's internal control structure are the following:

- the control environment
- the accounting system
- control procedures

SAS No. 55 provides a discussion of each of these three elements.

2.16 The auditor should obtain a sufficient understanding of each of the elements of the internal control structure to plan the audit by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation. The auditor's primary consideration, however, is whether an internal control structure policy or procedure affects financial statement assertions rather than its classification into any particular category.

2.17 The auditor should then assess control risk for the assertions embodied in the financial statements. The auditor may assess control risk at the maximum level (the greatest probability that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the organization's internal control structure) if the auditor believes policies and procedures are unlikely to pertain to an assertion or are unlikely to be effective, or if evaluating their effectiveness would be inefficient. Alternatively, the auditor may obtain evidence from tests of controls about the effectiveness of both the design and operation of a policy or procedure that would support a lower assessed level of control risk. Tests of controls may be performed concurrently with obtaining the understanding (either as a result of audit planning or not), or they may be performed after obtaining an understanding of the internal control structure and the assessed level of control risk in determining the nature, timing, and extent of substantive tests to be performed.

2.18 Certain characteristics of the control structure, particularly in the control environment, may be unique to not-for-profit organizations. SAS No. 55 states that auditors should obtain sufficient knowledge of the control environment to understand management's and the board of directors' attitude, awareness, and actions concerning the control environment. The auditor should consider the following in obtaining an understanding of a not-for-profit organization's control environment:

- The role of management and the board of directors
- The frequency of board meetings
- The qualifications of management and board members
- The board members' involvement in the organization's operations
- The organizational structure
- External influences, including regulatory and other reporting requirements

2.19 The accounting systems and control procedures of not-for-profit organizations may also include characteristics that would not ordinarily exist in for-profit entities. The auditor should obtain sufficient knowledge of the organization's accounting system and control procedures to understand how—

- Restricted contributions are identified, evaluated, and accepted.
- Promises to give are valued and recorded.
- Contributed goods, services, utilities, facilities, and the use of long-lived assets are valued and recorded.
- Compliance with donor restrictions and board designations is monitored.
- Reporting requirements imposed by donors, contractors, and regulators are met.
- Conformity with accounting presentation and disclosure principles, including those related to functional and natural expense reporting and allocation of joint costs, is achieved.

Analytical Procedures

2.20 SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), requires that analytical procedures be applied "to assist the auditor in planning the nature, timing, and extent of other auditing procedures." Analytical procedures are required in the planning and overall review phases of the audit. Analytical procedures applied at the planning stage may be similar to those applied as substantive tests and in the final review stage of the audit, but they generally use more highly aggregated, unaudited data whose reliability is unknown to the auditor because control risk associated with the data has not always been assessed at that stage.

2.21 SAS No. 56 provides examples of sources of information that can be used to develop the necessary expectations for applying analytical procedures. The sources of information that may be unique to not-for-profit organizations are (1) "information regarding the industry in which the client operates" and (2) "relationships of financial information with relevant nonfinancial information." The first of these requires industry-wide data to be used for comparisons (such as data on endowment return, contributions, or operating costs that can be obtained from industry trade and professional associations). The second requires the auditor to formulate relevant relationships that are usually unique to a particular type of not-for-profit organization, such as the relationship that might be expected to exist at a college or university between the number of students registered at standard tuition rates and tuition revenues, the relationship between the number of members in an organization and its dues revenue, and the relationship between stagehand costs and the number of theatrical, dance, orchestral, or similar performances. These analytical procedures may be applied in all phases of the audit.

Related-Party Transactions

2.22 Obtaining knowledge of the client's organization and operations should include performing the procedures in SAS No. 45, *Omnibus Statement on Auditing Standards--1983*, Related Parties (AICPA, *Professional Standards*, vol. 1, AU sec. 334), to determine the existence of related-party relationships and transactions with such parties and to examine those transactions. The auditor of a not-for-profit organization should be aware that the definition of related parties in FASB Statement No. 57, *Related Party Disclosures*, includes an organization's management and members of management's immediate family, as well as affiliated entities. Accordingly, transactions with brother-sister organizations and certain national and local affiliates as well as entities whose officers or directors are members of the not-for-profit organization's governing board may have to be disclosed under FASB Statement No. 57.

2.23 SAS No. 45 provides guidance on, among other matters, procedures that the auditor should consider to identify-related party relationships and transactions and to obtain satisfaction about the related financial statement accounting and disclosure. Obtaining that information will be enhanced if the organization has a policy that requires an annual written disclosure by board members of the details of their transactions and other business involvements with the organization, as well as disclosure of their other board memberships. Some states require that these kinds of disclosures be made on the annual reporting form filed by the organization.

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

Errors and Irregularities

2.25 Adequate audit planning includes considering the risk that the financial statements could be materially misstated as the result of (a) errors, (b) irregularities, or (c) illegal acts having a direct and material effect on the financial statements. SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), provides guidance on the auditor's responsibility for detecting and communicating information about errors and irregularities. SAS No. 53 describes factors that influence the auditor's ability to detect errors and irregularities and provides guidance on communicating detected errors and irregularities both within and outside the entity being audited. Management, engagement, and operating and industry characteristics that may indicate an increased risk of possible errors and irregularities in an audit of the financial statements are described in paragraphs 10 to 14 of SAS No. 53. That risk may be increased for not-for-profit organizations because of the factors discussed earlier in this section under "Industry Characteristics," "Organization Characteristics," and "Internal Control Considerations."

Illegal Acts and Compliance Auditing Under GAAS

2.26 Compliance auditing is designed to determine whether an organization has violated laws, regulations, or contractual requirements. The auditor's responsibilities for performing compliance auditing procedures in an audit of financial statements in accordance with generally accepted auditing standards (GAAS) is described in SAS No. 54. SAS No. 54 prescribes the nature and extent of the consideration the auditor should give to the possibility of illegal acts by a client. It also provides guidance on the auditor's responsibilities when a possible illegal act is detected, including the responsibility to be assured that the audit committee or its equivalent is adequately informed about illegal acts that come to the auditor's attention.

2.27 SAS No. 54 notes that illegal acts vary considerably in their relation to the financial statements. Some laws and regulations — such as sections of the tax law that affect tax provisions and accruals because of unrelated business income, and government regulations that affect the amount of revenue accrued under government contracts — may have a direct and material effect on the determination of financial statement amounts. The auditor's responsibility to detect misstatements resulting from direct-effect illegal acts is the same as for errors and irregularities. Accordingly, management should identify federal, state, and local laws and regulations that may have a direct and material effect on the determination of financial statement amounts. The auditor should assess the appropriateness of that identification and obtain an understanding of the possible effects of those laws and regulations on the financial statements.

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

2.29 Other laws and regulations relate more to an organization's operating aspects than to its financial and accounting aspects, and violations of these laws and regulations have only an indirect effect on the financial statements. (The indirect effect is usually limited to the need to disclose a contingent liability under FASB Statement No. 5, *Accounting for Contingencies*, because of the allegation or determination of illegality and the possibility of fines, penalties, or damages.) Such laws and regulations may concern securities trading, occupational safety and health, food and drug administration, environmental protection, equal employment opportunities, or antitrust violations. An example particular to the not-for-profit environment might be the requirement that an organization inform contributors of the portion of their contributions that is tax deductible; the failure to do so could subject the organization to financial penalties. SAS No. 54 does not require the auditor to design auditing procedures to detect illegal acts that do not have a direct and material effect on the financial statements; SAS No. 54 refers to these acts simply as "illegal acts." SAS No. 54 specifies the auditor's responsibilities when he or she becomes aware of information concerning illegal acts.

Compliance Auditing Under Government Auditing Standards

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

Organization-Wide Audits and Related Considerations

2.31 OMB Circular A-133 also prescribes audit requirements for not-for-profit organizations receiving federal awards. An audit under Circular A-133 is described as an "organization-wide audit."[4] The audit requirements of Circular A-133 vary with the amount of federal awards an organization receives.[5]

2.32 For audits performed in accordance with OMB Circular A-133, the auditor has responsibilities specified in the circular that go beyond GAAS. In such audits, the auditor must perform additional procedures to test and report on compliance with specified laws, regulations, and requirements applicable to both major financial award programs (as defined in the circular) and nonmajor programs. Other requirements of OMB Circular A-133 are reports on the financial statements, on the supplementary schedule of federal awards, and on the internal control structure policies and procedures relevant to federal award programs.

2.33 SAS No. 74, and SOP 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards*, provide guidance on testing and reporting on compliance with laws and regulations in engagements performed under GAAS, the Yellow Book, and OMB Circular A-133. They provide auditors of not-for-profit organizations with a basic understanding of the work they should do and the reports they should issue under the Yellow Book and OMB Circular A-133.

Processing of Transactions by Service Organizations

2.34 In addition to transactions, such as discretionary investment management services and payroll, for which for-profit organizations might use service organizations, not-for-profit organizations may also use such organizations to process transactions, such as student financial aid payments and receipt of contributions, that are unique to that industry. SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), provides guidance on the factors the auditor should consider when auditing the financial statements of an entity that uses a service organization to process certain transactions. The auditor should also consider the not-for-profit organization's compliance with laws, regulations, and contractual agreements that may apply when service organizations are used to process transactions.

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[4] An organization-wide audit is an audit of an entity's financial statements and of compliance with federal regulations relating to federal financial assistance, such as the audits required by the Single Audit Act of 1984 and OMB Circular A-133. (An organization-wide audit is analogous to the single audit concept applied to state and local government grantees under the Single Audit Act of 1984.) A program audit is an audit conducted in accordance with specific federal audit guides, such as the U.S. Department of Education's *Student Financial Aid Guide*.

[5] OMB Circular A-133 requires not-for-profit organizations receiving $100,000 or more in federal financial assistance in a year to have an audit in accordance with the circular. (Organizations receiving $100,000 or more, but under only one program, have the option of having a program-specific audit or an audit in accordance with OMB Circular A-133.) Organizations receiving at least $25,000 but less than $100,000 in federal financial assistance have the option of applying either the requirements of OMB Circular A-133 or separate program audit requirements. Organizations receiving less than $25,000 must maintain records and make them available for review, if requested, but they are exempt from federal audit requirements.

Using the Work of a Specialist

2.35 Organization management or the auditor may engage a specialist to provide special skill or knowledge about complex or subjective matters that are potentially material to the financial statements. Auditors of not-for-profit organizations, for example, may need to use the work of a specialist with respect to the valuation of contributed assets, particularly contributed collection items that the organization capitalizes. SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336), provides guidance to an auditor who uses the work of a specialist.

Planning Stage Materiality

2.36 SAS No. 47 states that "the auditor ordinarily considers materiality for planning purposes in terms of the smallest aggregate level of misstatements that could be considered material to any one of the financial statements." Expenditures of not-for-profit organizations are often tightly controlled and based on the concept of a balanced budget, with relatively small or zero *operating* margins. As a result, the auditor may consider materiality from the perspective of a not-for-profit organization's various net asset classes, changes in those net asset classes, total revenues, revenues of each net asset class, total expenses, or other measures — such as total unrestricted contributions, total program expenses, the ratio of program expenses to total expenses, and the ratio of fund-raising expenses to contributions.

2.37 In an audit of compliance with requirements governing major federal award programs in accordance with OMB Circular A-133, materiality should be considered in terms of each major program.[6] For example, materiality could be considered in relation to the separate assets, revenues, or expenditures of each program that is being reported on.

AUDIT OBJECTIVES AND AUDIT PROCEDURES

2.38 The auditor's work in forming an opinion on financial statements consists of obtaining and evaluating evidential matter concerning management's assertions embodied in the financial statements. Those assertions may be either explicit or implicit and can be classified according to the following broad categories: existence and occurrence, completeness, rights and obligations, valuation and allocation, and presentation and disclosure. The assertions also serve as broad audit objectives.

2.39 The purpose of the specific audit objectives, examples of control procedures, and examples of auditing procedures in the tables presented in the auditing sections of several of the following chapters is to assist the auditor in understanding the control structure, assessing control risk, and performing auditing procedures. The tables include only those matters that are unique to not-for-profit organizations. Accordingly, they should not be considered a complete listing of all of the audit objectives, control procedures, and auditing procedures that the auditor should consider when auditing a not-for-profit organization. In addition, the absence of examples of selected control procedures related to a particular financial statement assertion is intended to indicate that the assertion does not ordinarily lend itself to specific control procedures that would provide reasonable assurance that the related audit objective has been achieved.

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[6] Paragraph 13(c)(3) of OMB Circular A-133 discusses this matter further.

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

2.41 Many of the illustrative control procedures are premised on the existence of certain essential characteristics of an internal control structure, for example, authorization of transactions, segregation of duties, documentation, supervision and review, and timeliness of procedures. To avoid repetition, these characteristics have not been explicitly incorporated in the tables.

COMPLETING THE AUDIT

2.42 The procedures involved in completing the audit include the following:

- Performing final analytical procedures
- Summarizing and evaluating possible audit adjustments
- Obtaining legal letters
- Reviewing for subsequent events
- Obtaining written management representations
- Evaluating the organization's ability to continue as a going concern
- Preparing the auditor's reports
- Communicating reportable conditions, errors and irregularities, illegal acts, and other matters that may be required by SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380)

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

Client Representations

2.43 SAS No. 19, *Client Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), requires the auditor to obtain certain written representations from management. In addition to the representations contained in the illustrative letter in SAS No. 19, the auditor should consider obtaining representations about the following matters, if applicable, when auditing not-for-profit organizations:

- Compliance with contractual agreements, grants, and donor restrictions

- Maintenance of an appropriate composition of assets in amounts needed to comply with all donor restrictions

- Taxation and tax-exempt status

- Reasonableness of bases for allocation of functional expenses

- Inclusion in the financial statements of all assets and liabilities under the entity's control

- Adequacy of internal controls over the receipt and recording of contributions

- Propriety of reclassifications between net asset classes

2.44 Paragraph 7 of SAS No. 74 notes that an auditor who has been engaged to audit an organization that receives government funds that make it subject to government-imposed compliance testing and reporting requirements of the Yellow Book should consider obtaining written representations from management concerning the completeness of management's identification of laws and regulations that have a direct and material effect on the determination of financial statement amounts.

2.45 SOP 92-9 lists representations that should ordinarily be obtained in an organization-wide audit required by OMB Circular A-133.

Going-Concern Considerations

2.46 SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), provides guidance to the auditor in meeting the responsibility to evaluate whether there is substantial doubt about the client's ability to continue as a going concern for a reasonable period of time not to exceed one year beyond the date of the balance sheet. SAS No. 59 gives examples of conditions and events that might indicate that there could be substantial doubt about the entity's continued existence. Additional examples of such conditions and events that are particularly applicable to not-for-profit organizations include the following:

- Insufficient unrestricted revenues to provide supporting services to activities funded by restricted contributions

- A high ratio of fund-raising expenses to contributions received or a low ratio of program expenses to total expenses

- Insufficient funds to meet donor's restrictions. (This may result from the use of restricted net assets for purposes that do not satisfy the donor's restrictions, sometimes referred to as interfund borrowing.)

- Activities that could jeopardize the organization's tax-exempt status and thus endanger current contribution levels

- Concerns expressed by governmental authorities regarding alleged violations of state laws governing an organization's maintenance or preservation of certain assets, such as collection items

- A loss of key board members or volunteers
- External events that could affect donors' motivations to continue to contribute
- Decreases in revenues contributed by repeat donors
- A loss of major funding sources

Chapter 3

BASIC FINANCIAL STATEMENTS

INTRODUCTION

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

3.02 A set of financial statements of a not-for-profit organization should include information required by GAAP, except for principles included in authoritative pronouncements that specifically exempt not-for-profit organizations,[2] including information required by applicable specialized accounting and reporting principles and practices, such as those specified in this Guide. The requirements of FASB Statement No. 117 are generally no more stringent than the requirements for for-profit organizations; accordingly, although FASB Statement No. 117 does not specify the degree of aggregation and the order of presentation in financial statements of not-for-profit organizations, they should be similar to what is required or permitted for for-profit organizations. An appendix to FASB Statement No. 117 includes financial statements that illustrate some of the ways in which the requirements of the Statement can be met.

STATEMENT OF FINANCIAL POSITION

3.03 A statement of financial position should focus on the organization as a whole and should report the amounts of its assets, liabilities, and net assets. Assets and liabilities should be aggregated into reasonably homogeneous groups. Assets need not be disaggregated on the basis of the presence of donor-imposed restrictions on their use; for example, cash available for unrestricted current use need not be reported separately from cash received with donor-imposed restrictions that is also available for current use.[3] However, cash or other assets that have been received with donor-imposed restrictions that limit their use to long-term purposes should not be aggregated with cash or other assets that are available for current use. **For example, cash or other assets that have been received with donor-imposed restrictions limiting their use to the acquisition of long-lived assets should be reported under a separate caption, such as "cash [or assets] restricted to investment in property and equipment," and displayed near the section of the statement where property and equipment is displayed. The kind of asset should be described in**

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

[2] Chapter 1 discusses SOP 94-2.

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

the notes to the financial statements if its nature is not clear from the description on the face of the statement of financial position.

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

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

b. Classifying assets and liabilities as current and noncurrent, as defined by ARB No. 43, Chapter 3A, "Working Capital — Current Assets and Current Liabilities"

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

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

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

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

3.07 In the absence of donor-imposed restrictions, net assets should be classified as unrestricted. Paragraph 16 of FASB Statement No. 117 permits organizations to disclose self-imposed limitations on the use of unrestricted net assets (such as board-designated endowments) in the notes to the financial statements or on their face, provided that total unrestricted net assets are displayed. **Contractual limitations on the use of particular assets (such as cash held on deposit as a compensating balance) should be disclosed either on the face of the balance sheet or in the notes to the financial statements.**

STATEMENT OF ACTIVITIES

3.08 A statement of activities should focus on the organization as a whole and should report the amount of the change in net assets for the period, using a descriptive term such as *change in net assets* or *change in equity.* The statement should report the amounts of the changes in permanently restricted net assets, temporarily restricted net assets, unrestricted net assets, and total net assets. Revenues, expenses, gains, and losses should be classified by net asset class.

Events that simultaneously increase one net asset class and decrease another (reclassifications) should be reported as separate items. Classification of revenues, expenses, gains, and losses and reclassifications are discussed in greater detail in subsequent chapters of this Guide.

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

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

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

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

3.13 Accordingly, an intermediate measure of operations, such as an excess or deficit of operating revenues over expenses, may be reported in a statement of activities, as long as the use of the term *operations* is clear either from the details provided on the face of the statement or from a description contained in a note to the financial statements. If an intermediate measure of operations is reported, it must be in a financial statement that, at a minimum, reports the change in total unrestricted net assets for the period. **If an intermediate measure of operations is reported, revenues and expenses that are an integral part of an organization's programs or mission and supporting activities should be included in that measure. Expenses related to revenues included in an intermediate measure of operations should also be included in that measure.**

Reporting Expenses

3.14 To help users assess an organization's service efforts, including the costs of its services and how it uses resources, a statement of activities or the notes to the financial statements should report expenses by their functional classification, such as major programs and supporting activities. Voluntary health and welfare organizations[4] are required to report that information, together with information about expenses by their natural classification in a matrix format in a separate financial statement. A natural classification of expenses would include expense categories such as salaries, rent, electricity, interest expense, depreciation, awards and grants to others, and professional fees. **To the extent that those expenses are reported by other than their natural classification (such as salaries included in cost of goods sold), they should be reported by their natural classification if information about expenses by their natural classification is presented. For example, salaries, wages, and fringe benefits that are part of the cost of goods sold should be included with other salaries, wages, and fringe benefits on the separate financial statement (matrix).** FASB Statement No. 117 encourages, but does not require, other not-for-profit organizations to provide information about expenses by their natural expense classification.

3.15 **As discussed in paragraph 1.03, this Guide applies to certain kinds of organizations regardless of whether a particular organization meets the definition of a not-for-profit organization in FASB Statement No. 117. Except as discussed in the following sentence, however, this Guide does not extend to those organizations the requirements in paragraph 26 of FASB Statement No. 117 for reporting (a) information about expenses reported by their functional classification and (b) information about expenses by both functional and natural classifications in a matrix format in a separate financial statement. For organizations that do not meet the FASB Statement No. 117 definition of a not-for-profit organization but that normally receive significant amounts of contributions from the general public,[5] this Guide —**

- **Requires that the statement of activities or notes to the financial statements provide information about expenses reported by their functional classification.**

- **Encourages, but does not require, reporting information about expenses by both their functional and natural classification in a matrix format in a separate financial statement.[6]**

Organizations that provide information about expenses reported by their functional classification or provide information about expenses by both their functional and natural classifications in a matrix format in a separate financial statement, either because they are required to do so or because they elect to do so, should follow the guidance in FASB Statement No. 117 and this Guide concerning that information.

STATEMENT OF CASH FLOWS

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

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[4] *Voluntary health and welfare organizations* are defined in appendix D of FASB Statement No. 117.

[5] **For purposes of this Guide, the *general public* excludes governmental entities.**

[6] Chapter 13, "Expenses, Gains, and Losses," provides additional guidance on classifying and reporting expenses.

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

3.18 FASB Statement No. 117 expands the description of financing activities in FASB Statement No. 95 to encompass receipts of resources that are donor-restricted for long-term purposes. As discussed in paragraph 3.03 of this Guide, cash received with donor-imposed restrictions limiting its use to long-term purposes should not be aggregated with cash or other assets that are available for current use. In order for the statement of cash flows to reconcile beginning and ending cash and cash equivalents, and to report in conformity with FASB Statement No. 95, as revised by FASB Statement No. 117, the receipt of a cash contribution that is restricted for the acquisition of equipment should be reported as a cash flow from financing activities (using a caption such as "contributions restricted for acquiring equipment"), **and it should be simultaneously reported as a cash outflow from investing activities (using a caption such as "acquisition of assets restricted to investment in property and equipment" or, if the equipment was purchased in the same period, "acquisition of equipment").[7] If the recipient organization uses the indirect method of reporting cash flows from operating activities (see paragraph 3.19), an adjustment to reconcile the change in net assets to net cash used or provided by operating activities would also be needed if the contributed asset is not classified as "cash or cash equivalents" on the statement of financial position. If the equipment is purchased in a subsequent period, both the proceeds from the sale of assets restricted to investment in the equipment and the acquisition of the equipment should be reported as cash flows from investing activities.**

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

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

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[7] Paragraphs 3.03 and 3.20 of this Guide discuss the classification on a statement of financial position of cash received with donor-imposed restrictions limiting its use to long-term purposes.

COMPARATIVE FINANCIAL INFORMATION

3.21 **Not-for-profit organizations sometimes present comparative information for a prior year or years only in total rather than by net asset class. Such summarized information may not include sufficient detail to constitute a presentation in conformity with GAAP. If the prior year's financial information is summarized and does not include the minimum information required by FASB Statement No. 117 and this Guide (for example, if the statement of activities does not present revenues, expenses, gains, and losses by net asset class), the nature of the prior-year information should be described by the use of appropriate titles on the face of the financial statements and in a note to the financial statements.[8,9] The use of appropriate titles includes a phrase such as "with summarized financial information for the year ended 19PY," following the title of the statement or column headings that indicate the summarized nature of the information. Labeling the prior-year summarized financial information "for comparative purposes only" without further disclosure in the notes to the financial statements would not constitute the use of an appropriate title.**

3.22 **An example of a note to the financial statements[10] that describes the nature of the prior-period(s) information would be as follows:**

> **The financial statements include certain prior-year summarized comparative information in total but not by net asset class. Such information does not include sufficient detail to constitute a presentation in conformity with generally accepted accounting principles. Accordingly, such information should be read in conjunction with the organization's financial statements for the year ended June 30, 19PY, from which the summarized information was derived.**

REPORTING OF RELATED ENTITIES

3.23 In September 1994, the AICPA issued SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*. SOP 94-3 amends and makes uniform the previously existing guidance concerning reporting related entities. The SOP is effective for financial statements issued for fiscal years beginning after December 31, 1994, except for not-for-profit organizations that have less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date shall be for fiscal years beginning after December 31, 1995. Earlier application is permitted. For organizations that adopt FASB Statement No. 117 prior to its effective date, earlier application of the SOP is encouraged. Comparative financial statements for earlier periods included with those for which the SOP is adopted should be restated.

3.24 Some of the conclusions in SOP 94-3 depend on whether the reporting not-for-profit organization has an economic interest in other organizations. The Glossary of SOP 94-3 includes

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

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

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

examples of economic interests. **In addition to the examples included in the Glossary, the following is an example of an economic interest:**

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

FINANCIAL STATEMENT DISCLOSURES NOT CONSIDERED ELSEWHERE

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

Noncompliance With Donor-Imposed Restrictions

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

3.27 FASB Statement No. 5, *Accounting for Contingencies*, provides guidance for accruing and disclosing contingent liabilities. SAS No. 54 addresses disclosure of illegal acts that could lead to a material loss of revenue. SAS No. 59 contains broad guidance on disclosures when there is a substantial doubt about an entity's ability to continue as a going concern.

3.28 **Noncompliance with donor-imposed restrictions should be disclosed if there is a reasonable possibility that a material contingent liability has been incurred at the date of the financial statements or there is at least a reasonable possibility that the noncompliance could lead to a material loss of revenue or could cause an entity to be unable to continue as a going concern.[11] If the noncompliance results from an organization's failure to maintain an appropriate composition of assets in amounts needed to comply with all donor restrictions, the amounts and circumstances should be disclosed.**

Risks and Uncertainties

3.29 SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties,* requires entities to include in their financial statements information about—

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

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[11] As discussed in paragraph 10.09, noncompliance with donor-imposed restrictions may require accrual of a liability in conformity with FASB Statement No. 5.

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

- Certain significant estimates.
- Current vulnerability due to certain concentrations

The provisions of the SOP are effective for financial statements issued for fiscal years ending after December 15, 1995.

Chapter 4

CASH AND CASH EQUIVALENTS

INTRODUCTION

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

4.02 Cash includes currency on hand and deposits held by financial institutions that can be added to or withdrawn without limitation, such as demand deposits. Paragraph 8 of FASB Statement No. 95 defines *cash equivalents* as "short-term, highly liquid investments that are both (a) readily convertible to known amounts of cash and (b) so near their maturity that they present insignificant risk of changes in value because of changes in interest rates."[1] Not-for-profit organizations may invest excess cash in cash equivalents (such as treasury bills, commercial paper, and money-market mutual funds) to earn greater returns.

FINANCIAL STATEMENT PRESENTATION

4.03 **A statement of financial position should include a separate line item, "Cash" or "Cash and Cash Equivalents." Cash and cash equivalents held for others should also be reported as a separate line item.**[2] Cash received with donor-imposed stipulations restricting its use to long-term purposes and cash set aside for long-term purposes should not be classified on a statement of financial position with assets that are available for current use.[3]

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

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[1] Paragraph 8 of FASB Statement No. 95 indicates that, generally, securities originally issued with a maturity of three months or less would qualify.

[2] Chapter 5, "Contributions Received and Agency Transactions," discusses assets received in agency transactions, and chapter 6, "Split-Interest Agreements," provides guidance on accounting for assets held under split-interest and similar agreements.

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

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

4.05 Relevant information about the nature and amount of limitations on the use of cash and cash equivalents should be included on the face of the financial statements or in the notes. Information about the nature and amount of donor-imposed restrictions should also be disclosed in the net asset section of the statement of financial position or in the notes to the financial statements.[4] (Chapter 11, "Net Assets," discusses accounting for net assets.) Disclosure in the notes to the financial statements should also be made if unusual circumstances (such as special borrowing arrangements, requirements imposed by resource providers that cash be held in separate accounts, and known significant liquidity problems) are present, or if the organization has not maintained appropriate amounts of cash and cash equivalents to comply with donor-imposed restrictions.[5]

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[4] Paragraph 94 of FASB Statement No. 117 also permits not-for-profit organizations to disaggregate assets into unrestricted and donor-restricted classes when there are donor restrictions on the use of specific donated assets.

[5] Paragraphs 3.26 to 3.28 of this Guide discuss reporting requirements when the organization is not in compliance with donor-imposed restrictions.

Chapter 5

CONTRIBUTIONS RECEIVED AND AGENCY TRANSACTIONS

INTRODUCTION

5.01 Some not-for-profit organizations receive contributions of cash, other assets, and services from individuals, for-profit organizations, other not-for-profit organizations, and governments. Paragraph 5 of FASB Statement No. 116 defines a contribution as

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

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

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

This chapter provides guidance for distinguishing contributions from other kinds of transactions. It also discusses recognition, measurement, and disclosure principles for contribution revenues[1] and related receivables. Chapter 12, "Revenues and Receivables From Exchange Transactions," of this Guide discusses accounting principles for revenues, gains, and receivables from providing services and from other exchange transactions. Chapter 13, "Expenses, Gains, and Losses," discusses reporting contributions made by not-for-profit organizations.

DISTINGUISHING CONTRIBUTIONS FROM OTHER TRANSACTIONS

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

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

is discussed in paragraphs 5.26 to 5.28. Guidance on differentiating contributions, agency transactions, and exchange transactions is provided in this section.

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

Agency or Intermediary Transactions

5.05 Agency,[2] intermediary, or pass-through transactions are transfers of assets from resource providers to intermediary not-for-profit organizations that act as agents for resource providers in transferring those assets to third-party recipients specified by the resource providers. In some situations, agency transactions can be easily distinguished from other kinds of voluntary asset transfers. For example, some not-for-profit organizations receive assets from resource providers with the stipulation that those assets must be passed on to specific entities identified and selected by the resource providers; such transfers are agency transactions because the not-for-profit organization has no discretion in determining how the assets will be used. If a resource provider allows the not-for-profit organization some but not complete discretion in determining how, when, or to whom the assets are to be distributed, it may be difficult to determine whether the not-for-profit recipient of assets from a resource provider is acting as an agent for the resource provider or has received a contribution from the resource provider.

5.06 In the absence of clear-cut circumstances distinguishing agency transactions from contributions, the organization should assess the extent of discretion that it has in using the assets transferred by a resource provider to determine whether it is acting as an agent or has received a contribution. Table 5.1 provides a list of indicators that may be helpful in distinguishing (a) transactions in which the not-for-profit organization has significant discretion in using the assets provided (which should be reported as contributions) from (b) transactions in which the organization has little or no discretion (which should be reported as agency transactions). Depending on the facts and circumstances, some indicators may be more significant than others; however, no single indicator is determinative of the classification of a particular transaction.

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[2] Though the term *agency* may have a specific legal meaning, the terms *agency*, *agent*, and *intermediary* are used interchangeably in this Guide for purposes of applying the accounting and auditing guidance herein.

TABLE 5.1

INDICATORS USEFUL FOR DISTINGUISHING CONTRIBUTIONS FROM AGENCY TRANSACTIONS

Indicator	Contribution	Agency Transaction
Not-for-profit organization's (NPO's) assertions in soliciting assets	NPO solicits assets in support of its own activities.	NPO solicits assets for the specific purpose of passing them on to a third-party recipient, or NPO is not substantially involved in the solicitation.
Form of assets	NPO changes the form of assets (for example, from cash to goods or services).	NPO passes assets through to a third-party recipient without changing their form.
Legal title to assets	NPO obtains legal title.	NPO never obtains legal title.
Purpose of transfer	NPO regularly carries out the kinds of programs that the assets are intended to support.	NPO does not carry out or intend to carry out such programs.
Knowledge of recipient	Resource provider does not know specific recipient.	Resource provider has knowledge of recipient.
Nature of NPO's operations	NPO has existing programs.	NPO is organized to pass through assets to recipients.
Relation between NPO organization and recipient	NPO and recipient are independent.	NPO and recipient are under common control, have overlapping boards or management, or share facilities or professional advisers.

5.07 **Resources received in transactions in which a not-for-profit organization is acting as an agent, trustee, or intermediary for a resource provider (that is, agency transactions) should be reported as increases in assets and liabilities; distributions to third-party recipients should be reported as decreases in those accounts.**[3] **Cash received and paid in such transactions should be reported as cash flows from operating activities in a statement of cash flows. If the statement of cash flows is presented using the indirect method, cash received and paid in such transactions is permitted to be reported either gross or net. Additional information about such transactions may be required to be disclosed under FASB Statement No. 57.**

5.08 **The following are examples of some typical asset transfers for which the indicators described in Table 5.1 can be used to determine the appropriate classification.**[4]

- **A newly formed organization applies for funds from a foundation. The foundation agrees to transfer the funds, but requires that the organization use an existing not-for-profit organization as a fiscal agent because the recipient has not yet obtained tax-exempt status. The existing not-for-profit organization has no obligation other than to disburse the funds received from the foundation when the new organization receives tax-exempt status. The existing not-for-profit organization is acting as the foundation's fiscal agent and should not recognize the transaction as a contribution.**

- **A foundation has a program to support performing artists. The foundation transfers funds to a not-for-profit performing-arts group and specifies that the funds be used to support performing artists. As part of its regular program, the performing-arts group provides funds to individual artists that it selects. The performing-arts group is not acting as an intermediary for those artists and should recognize the funds received from the foundation as a contribution.**

- **A parents' group has been organized in a private not-for-profit high school to provide extracurricular activities for the students. The group has organized a field trip for students to an environmental learning center; the school collects money for the trip from the students and pays the center for the program. The school is acting as the agent for the parents' group and should not recognize the transactions as contributions.**

- **NPO, a national not-for-profit organization, enters into a joint purchasing arrangement with its affiliates. Under the arrangement, NPO purchases group health insurance coverage for employees of the affiliates. NPO collects the appropriate premiums from the affiliates and remits the premiums to the insurance company that provides the services to the affiliates' employees. The receipt of the affiliates' funds and payment to the insurance company are agency transactions for NPO.**

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

[4] Federal rules specify the classification of certain transactions for purposes other than reporting in conformity with GAAP, such as contractual reporting requirements. For example, certain transactions should be classified as federal awards received and expended by not-for-profit organizations. The examples in this paragraph, as well as other guidance in this Guide, pertain to financial reporting in conformity with GAAP. Classifications in conformity with GAAP may differ from classifications in accordance with federal rules.

- A religious organization sponsors a food collection for the community food bank. The donated food is boxed by the organization's members and is taken directly to the food bank for distribution. The religious organization is functioning as an intermediary between the food donors and the food bank.

- A business organization donates a group of used computer terminals to a not-for-profit jobs-training program. If the equipment can be used in its programs, the not-for-profit organization should recognize the equipment as a contribution.

- A national not-for-profit organization solicits excess food products from major food processors for distribution to local food banks chosen by the national organization. The national organization picks up the food from the processors, prepares a listing of the food available, and sends the listing to local not-for-profit organizations that it identifies as meeting specific criteria. The local food banks order the items they want, and the national organization sends those items to the food banks' facilities. The local food banks inspect, repackage, and label the food and identify appropriate agencies as end recipients; the end recipients do not pay the local food banks. Both the national organization and the local food banks have discretion over who receives the food and, therefore, should recognize it as a contribution.

- A national not-for-profit organization receives excess food products from major food processors for distribution to local food banks specifically designated by the processors. The national organization sends the food to the designated local food banks. The local food banks inspect, repackage, and label the food and identify appropriate agencies as end recipients; end recipients do not pay the local food banks. The national organization is acting as an agent for the food processors and should not report the food as a contribution. The local food banks have discretion over who receives the food and should recognize it as a contribution.

Federated Fund-Raising Organizations

5.09 Federated fund-raising organizations (and similar organizations) solicit and receive assets from resource providers and distribute those assets to other organizations. The primary criterion for determining whether the receipt of assets should be reported as contributions is whether the organization has discretion in distributing those assets to beneficiaries. If a federated fund-raiser receives cash and other assets that have not been designated by donors for specific beneficiaries, receipt of the cash or other assets should be reported as contributions. For example, the receipt of assets by federated fund-raisers are contributions if the assets are received without donor stipulations concerning the ultimate beneficiaries, or if the donors have stipulated only broad categories of beneficiaries (*thematic giving*). Transfers to federated fund-raisers that are designated by donors for specific beneficiaries, including beneficiaries that are part of the federated fund-raiser's network and beneficiaries *checked off* on a list of agencies as those to which a donor is providing specified dollar support, are agency transactions; the federated fund-raisers have no discretion in distributing those assets to the beneficiaries. Paragraphs 5.05 to 5.08 provide further guidance for determining whether funds received by federated fund-raisers are received as agency transactions or as contributions. Amounts retained by federated fund-raisers as fees (such as administrative fees for obtaining assets or for estimated uncollectible accounts) should be classified as revenue other than from contributions. Such fees should not be netted against the expenses of soliciting those funds.

5.10 Federated fund-raisers are permitted to display agency transactions on statements of activities, but the receipt of assets in those transactions should not be reported as revenue. The following are three possible methods of display of the revenue section of the statement of activities for a federated fund-raiser that raises $5,000 of contributions, $100 of other public support, and $5,000 of designated amounts. The federated fund-raiser pays out $4,500 of the designated amounts and retains $500 as an administrative fee.

Method 1

Public support — contributions	$5,000
Other public support	100
Total public support	5,100
Administrative fees for raising amounts on behalf of others	500
Total public support and revenue	$5,600

Method 2

Public support — contributions		$5,000
Other public support		100
Total public support		5,100
Other revenue:		
Amounts raised on behalf of others	$5,000	
Less: amounts remitted to others	4,500	
Administrative fees for raising amounts on behalf of others		500
Total public support and revenue		$5,600

Method 3

Total amounts raised[5]	$10,000
Less: Amounts raised on behalf of others	5,000
Total contributions	5,000
Other revenue	
Public support	100
Administrative fees for raising amounts on behalf of others	500
Total public support and revenue	$5,600

[5] Other terms, such as *campaign results* or *campaign efforts* may be used instead.

Gifts In Kind

5.11 Some not-for-profit organizations receive noncash assets — such as property, equipment, and excess inventory — from resource providers. Reporting these transfers, sometimes referred to as *gifts in kind*, as agency transactions or as contributions depends on whether the not-for-profit recipient has discretion over the use or subsequent disposition of the assets. For example, if a not-for-profit organization receives clothing from a manufacturer with the stipulation that the clothing must be passed on to a specific homeless shelter, the transfer is an agency transaction. If, however, the manufacturer does not specify the beneficiaries of the clothing, the transfer is a contribution. Information about gifts-in-kind transactions may be required to be disclosed under FASB Statement No. 57.

5.12 **Gifts in kind should be measured at fair value.[6] Fair value should be based on the quantity received after any applicable discounts have been considered. If the gifts have no value, as might be the case for certain clothing and furniture that cannot be used or sold by the not-for-profit organization, the item received should not be recognized. If the gift can be used or sold, it should be measured at its fair value.**

5.13 **Not-for-profit organizations may also receive items, such as tickets, gift certificates, works of art, and merchandise, that are to be used for fund-raising purposes by transferring them to other resource providers (the ultimate resource provider or recipient) during fund-raising events. The ultimate resource provider or recipient may acquire the items in transactions that are part exchange transactions and part contributions.[7] Such gifts in kind, which can be linked to asset transfers from the original resource providers to the ultimate resource providers (recipients) because they are, in substance, part of the same transaction cycle, should be reported as contributions and measured at fair value when received by a not-for-profit organization. The difference between the amount received for those items from the ultimate resource providers (recipients) and the fair value of the gifts in kind when originally contributed to the organization should be recognized as contributions when the items are transferred to the ultimate resource providers (recipients). For example, a public radio station receives from the local community theater (the original resource provider) a ticket with a fair value of $75, to be auctioned to the highest bidder; a listener (the ultimate resource provider or recipient) subsequently acquires the ticket at auction for $100. The initial transfer of the ticket to the not-for-profit organization should be reported as a $75 contribution and the ticket should be reported as an asset; an additional $25 contribution should be reported when the ticket is transferred to the listener at auction, and no cost for the ticket should be reported on the statement of activities. If a listener acquires the ticket for $45, rather than $100, a reduction of $30 in contributions should be reported when the ticket is transferred to the listener at auction.**

Exchange Transactions

5.14 Exchange transactions are reciprocal transfers in which each party receives and sacrifices something of approximately equal value. In some situations, exchange transactions can be easily distinguished from contributions. For example, purchases of assets or payments of employees' salaries

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[6] **Fair value would generally not increase when a gift in kind is passed from one not-for-profit organization to another. Any increases should be evaluated to determine whether the not-for-profit organization did, in fact, add to the fair value of the assets.**

[7] Paragraphs 13.17 to 13.21 discuss reporting special events associated with an organization's fund-raising efforts.

clearly are exchange transactions: Each party gives up economic value and receives equivalent economic value. Another example would be donations to a not-for-profit organization's mass fund-raising appeal, which clearly are contributions: Donors provide resources in support of the organization's mission and expect to receive nothing of direct value in exchange.

5.15 The cost of premiums (such as postcards or calendars) given to potential donors as part of mass fund-raising appeals is a fund-raising expense, and the classification of the donations received from the appeal as contributions should not change as a result of the premiums. The premiums are not provided to potential donors in exchange for the assets contributed; they can be kept by all those from whom funds are solicited, regardless of whether a contribution is made. The cost of premiums (such as a coffee mug) that are provided by a not-for profit organization to acknowledge receipt of a contribution and that are nominal in value compared with the value of the goods or services donated by the resource provider should also be reported as fund-raising expenses. For example, a not-for-profit organization may provide a guide to counting fiber in the diet to people making a contribution of $50; the guide costs the organization $1. The organization should recognize contributions of $50 and fund-raising expense of $1.

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

5.17 Table 5.2, on page 36, contains a list of indicators that may be helpful in determining whether individual asset transfers are contributions, exchange transactions, or a combination of both. Depending on the facts and circumstances, some indicators may be more significant than others; however, no single indicator is determinative of the classification of a particular transaction. Several kinds of voluntary asset transfers that may be difficult to classify are discussed in the following four paragraphs.

5.18 Some not-for-profit organizations receive dues from their members. These transfers often have elements of both a contribution and an exchange transaction because members receive tangible or intangible benefits from their membership in the organization. For example, if an organization has annual dues of $100 and the only benefit members receive is a monthly newsletter with a fair value of $25, $25 of the dues are received in an exchange transaction and should be recognized as revenue as the earnings process is completed and $75 of the dues are a contribution and should be recognized as revenue when received. It may be difficult, however, to measure the benefits members receive and to judge whether the value of those benefits is approximately equal to the dues paid by the members. Table 5.3, on page 37, contains a list of indicators that may be helpful in determining whether membership dues are contributions, exchange transactions, or a combination of both. Depending on the facts and circumstances, some indicators may be more significant than others; however, no single indicator is determinative of the classification of a particular transaction.

TABLE 5.2

INDICATORS USEFUL IN DISTINGUISHING CONTRIBUTIONS FROM EXCHANGE TRANSACTIONS

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

TABLE 5.3

INDICATORS USEFUL FOR DETERMINING THE CONTRIBUTION AND EXCHANGE PORTIONS OF MEMBERSHIP DUES

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

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

5.20 Foundations, business organizations, and other types of entities may provide resources to not-for-profit organizations under programs referred to as *grants, awards,* or *sponsorships.*[8] Those asset transfers are contributions if the resource providers receive no value in exchange for the assets transferred or if the value received by the resource provider is incidental to the potential public benefit from using the assets transferred. The asset transfers are exchange transactions if the potential public benefit is secondary to the resource providers' potential direct benefits. For example, a research grant made by a foundation to a university would likely be a contribution if the research program is to be planned and carried out by the university and the university has the right to publish the results. If, however, the grant is made by a pharmaceutical manufacturer that provides potential new medications to be tested in the university's laboratories and retains the right to any patents or other results, the grant would likely be an exchange transaction.

5.21 Some transfers of assets between not-for-profit organizations and governments (such as the sale of goods and services) are exchange transactions. Other transfers of assets between not-for-profit organizations and governments (such as unrestricted support given by state and local governments) are contributions. Other kinds of government transfers (sometimes referred to as *grants, awards,* or *appropriations*) have unique characteristics that may make it difficult to determine whether they are contributions or exchange transactions. The indicators described in Table 5.2 provide guidance on how to classify such transfers. Depending on the facts and circumstances, some indicators may be more significant than others; however, no single indicator is determinative of the classification of a particular transaction.

5.22 As discussed in paragraphs 5.29 to 5.37 and in chapters 3, "Basic Financial Statements," and 11, "Net Assets," classification of net assets and revenues as either unrestricted, temporarily restricted, or permanently restricted depends on the existence or absence of donor-imposed restrictions or contributions. Therefore, resources received in exchange transactions are unrestricted revenues and net assets, even in circumstances in which resource providers place limitations on the use of the resources. For example, resources received from governments in exchange transactions in which those governments have placed limitations on the use of the resources should be reported as unrestricted revenues and net assets, because those limitations are not donor-imposed restrictions on contributions.

RECOGNITION PRINCIPLES FOR CONTRIBUTIONS

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

[8] Such resource transfers may also have the characteristics of agency transactions. Paragraphs 5.05 to 5.08 discuss how to distinguish agency from other kinds of transactions.

obligation to transfer assets in the future. A promise that contains a condition is considered to be unconditional if the possibility that the condition will not be met is remote.[9] For example, a promise that is conditioned on the not-for-profit organization meeting administrative requirements, such as the filing of an annual financial report, should not be considered conditional if the likelihood of not meeting the administrative requirements is remote. A donor-imposed restriction is a stipulation specifying a use for a contribution that is more specific than the broad limits resulting from the nature and purpose of the organization and from the environment in which it operates.

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

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

Donor-Imposed Conditions

5.26 Transfers of assets and promises to give with donor-imposed conditions should be recognized as contribution revenue when the conditions have been substantially met or when the conditions have been explicitly waived by the donor. For example, a contribution of cash or a promise to give cash in support of a proposed program should be recognized when the program is undertaken. Transfers of assets with donor-imposed conditions should be reported as refundable advances until the conditions have been substantially met. Transfers of assets on which resource providers have imposed conditions should be recognized as contributions if the likelihood of not meeting the conditions is remote.

5.27 Some conditions attached to contributions may be substantially met in stages rather than because of a single event. A portion of those contributions should be recognized as revenue as each of those stages is met. For example, a resource provider promises to contribute $1 for each $1 of contributions received by a not-for-profit organization, up to $100,000, over the next six months. As contributions are received from other resource providers, the conditions would be met and the promise would become unconditional. For example, if $10,000 is received in the first month from donors, $10,000 of the conditional promise would become unconditional and should be recognized as contribution revenue. Contributions that are conditioned upon the organization incurring certain qualifying costs, such as certain contributions made by governments, should be recognized as revenue as those costs are incurred.

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

5.28 Unconditional contributions should be recognized as revenue in the period received.[10] Depending on the kind of benefit received, the organization should also recognize (a) an increase in assets (for example, cash, securities, contributions receivable, collections [if capitalized; see chapter 7, "Other Assets," of this Guide], and property and equipment); (b) a decrease in liabilities (for example, accounts payable or notes payable); or (c) an expense (for example, donated legal services).

Donor-Imposed Restrictions

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

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

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

5.32 Unconditional contributions received without donor-imposed restrictions should be reported as unrestricted support that increases unrestricted net assets. Unconditional contributions received with donor-imposed restrictions should be reported as restricted support that increases permanently restricted or temporarily restricted net assets, depending on the nature of the restriction.[11] The permanently restricted classification should be used if the limits imposed on the use of the contributed assets are permanent (for example, contributions of cash or securities that must be invested in perpetuity to provide a permanent source of income for the organization or contributions of permanently restricted collection items or of cash that must be used to purchase permanently restricted collection items). The temporarily restricted classification should be used for contributions if the limitations are temporary (for example, a restriction that contributed assets may be used only after some future date, or for some specific program, or to acquire a specific asset).

5.33 In some situations, an organization may meet donor-imposed restrictions on all or a portion of the amount contributed in the same reporting period in which the contribution is received. In those cases, the contribution (to the extent that the restrictions have been met) may be reported

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[10] Unconditional contributions of services and collections are subject to different recognition criteria. Paragraphs 5.43 and 7.06 discuss those transactions, respectively.

[11] A subsequent event may arise that raises the possibility that the organization may not satisfy a donor-imposed restriction. SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 560), provides guidance on the recognition and disclosure of subsequent events.

as unrestricted support that increases unrestricted net assets if the organization consistently follows such a policy, discloses its policy in notes to the financial statements.

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

5.35 Expenses may be incurred for purposes for which both unrestricted and temporarily restricted net assets are available. If an expense is incurred for a purpose for which both unrestricted and temporarily restricted net assets are available, a donor-imposed restriction is fulfilled to the extent of the expense incurred unless the expense is for a purpose that is directly attributable to another external specific source of revenue. For example, an employee's salary may meet donor-imposed restrictions to support the program on which the employee is working. In those situations, the restriction is met to the extent of the salary expense incurred unless the salary is directly attributable to another specific external source of revenue, such as a conditional promise to give or a cost reimbursement contract. If the salary expense is directly attributable to another specific external source of revenue, the conditional promise to give should be reported as a contribution or the contract revenue should be recognized in accordance with the terms of the contract, respectively.

5.36 Not-for-profit organizations may receive contributions of long-lived assets (such as property and equipment) or of cash and other assets restricted to the purchase of long-lived assets, for which donors have not expressly stipulated how or how long the long-lived asset must be used by the organization or how to use any proceeds resulting from the asset's disposal. An organization may adopt an accounting policy of implying time restrictions on the use of such contributed assets that expire over the assets' expected useful lives. If an organization adopts such a policy, the contributions received should be reported as restricted support that increases temporarily restricted net assets. Depreciation should be recorded over the asset's useful life, and net assets should be reclassified periodically from temporarily restricted to unrestricted as depreciation is recognized. **Long-lived assets that are subject to an accounting policy implying time restrictions on the use of contributed long-lived assets may be sold before the end of their useful life. In those situations, the gains and losses on the disposal of those assets should be reported as changes in unrestricted net assets and a reclassification should be reported for any remaining temporarily restricted net assets.**

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

Promises to Give

5.38 Not-for-profit organizations may enter into written or oral agreements with donors involving future nonreciprocal transfers of cash, other assets, and services.[12] Such agreements between not-for-profit organizations and potential donors should be reported as contribution revenue and receivables if such agreements are, in substance, unconditional promises to give,[13] even if the promise is not legally enforceable.

5.39 Conditional promises to give cash or other assets (such as securities or property and equipment) should be recognized as contribution revenue and receivables when the conditions are substantially met. Unconditional promises to give should be recognized as contribution revenue and receivables in the period in which the promise is received.[14] Depending on the existence and nature of donor-imposed restrictions, unconditional promises to give should be reported either as unrestricted support that increases unrestricted net assets, or as restricted support that increases permanently restricted or temporarily restricted net assets. Use of the *permanently restricted* classification is appropriate if the use of the cash or other assets to be received in future periods will be permanently restricted (for example, donors' promises to give cash or securities that must be invested in perpetuity). Use of the temporarily restricted classification is appropriate if donor-imposed restrictions (a) expire in the time periods in which cash or other assets are received or are due to be received or (b) can be fulfilled or removed by actions of the organization pursuant to donor stipulations. If, however, the donor explicitly stipulates that the promise to give is to support current-period activities or if other circumstances surrounding the promise make it clear that the donor's intention is to support current-period activities, unconditional promises to give should be reported as unrestricted support that increases unrestricted net assets.

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

5.41 Not-for-profit organizations may receive communications that are intentions to give, rather than promises to give. For example, communications from individuals indicating that the

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

[13] The term *promises to give* is defined in paragraph 6 of FASB Statement No. 116 as "a written or oral agreement to contribute cash or other assets to another entity." These items are sometimes referred to as "pledges," a term that FASB Statement No. 116 and this Guide avoid because it may be misinterpreted. If the not-for-profit organization is acting as an agent, trustee, or intermediary for the donor, an agreement to contribute assets in the future should not be considered a *promise to give*. Paragraphs 5.05 and 5.06 discuss this further.

[14] **If a contribution is transferred to the ultimate recipient through an agent acting as an intermediary, the ultimate recipient should report the contribution when adequate evidence that the agent has received the promise to give or contribution becomes available.**

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

5.42 In practice, it may be difficult to determine the nature of donor-imposed conditions and restrictions concerning promises to give. If such a determination is unclear, promises to give should be considered conditional, and hence not be recognized, until the promise is clearly unconditional. Paragraph 70 of FASB Statement No. 116 notes that "promises to give services generally involve personal services that, if not explicitly conditional, are often implicitly conditioned upon the future and uncertain availability of specific individuals whose services have been promised."

Contributed Services

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

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

Examples of situations in which it may be appropriate to recognize contributed services are included in Paragraphs 195 to 206 of FASB Statement No. 116. **Contributed services (and the related assets and expenses) should be recognized if employees of separately governed affiliated organizations regularly perform services (in other than an advisory capacity) for and under the direction of the recipient organization and the recognition criteria for contributed services are met.**[15]

Contributed Utilities, Facilities, and Use of Long-Lived Assets

5.44 **Not-for-profit organizations may receive contributions of the use of electrical, telephone, and other utilities and of facilities (such as a building or office space) in which the donor retains legal**

[15] If the financial statements of the contributor and the recipient are consolidated, the revenue, expense, asset and liability related to the contributed services would be eliminated in consolidation.

title to the facilities. Such transactions should be recognized as contribution revenues and expenses in the period received and used, subject to the following exception. If the transaction is an unconditional promise to give (as described in paragraphs 5.38 to 5.42) for a specified number of periods, the promise should be reported as contributions receivable and as restricted support (at fair value) that increases temporarily restricted net assets. Contributed facilities may be required to be capitalized based on the guidance in FASB Statement No. 13, *Accounting for Leases*. Paragraph 1 of FASB Statement No. 13 defines a lease as "an agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time. It includes agreements that, although not nominally identified as leases, meet the above definition." Therefore, contributions of the use of facilities may be leases. Accordingly, contributed facilities should be capitalized if the conditions for capitalization in FASB Statement No. 13 are met. The notes to the financial statements should include the disclosures required by FASB Statement No. 13, as well as disclosure of any contingent liabilities that may result if a donor terminates the organization's right to use the facilities.

5.45 In some cases, not-for-profit organizations may use facilities under lease agreements that call for lease payments at amounts below the fair rental value of the property. (In some cases, the lease payments are zero or nominal.) Because FASB Statement No. 13 was intended to apply to exchange transactions rather than contributions, the capitalization requirements based on the present value of the minimum-lease payments included in Statement No. 13 may not be meaningful. If the lease payments are below the fair rental value of the property, capitalization should be based on the fair rental value in a comparable exchange transaction.

Contributed Collection Items

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

Split-Interest Agreements

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

MEASUREMENT PRINCIPLES FOR CONTRIBUTIONS

5.48 Contribution revenue and related receivables arising from unconditional promises to give should be measured at the fair value of the assets or services received or liabilities satisfied. Fair value can best be measured by quoted market prices. If such prices are not available, fair value can be estimated based on one of the following:

- Quoted market prices for similar assets
- The asset's replacement cost

- Independent appraisals of the asset's fair value, or

- Other valuation techniques, such as discounting the estimated future cash flows expected from the asset's use

The fair value of contributed services that create or enhance nonfinancial assets should be estimated based on (a) the fair value of the services received or (b) the fair value of the assets created or enhanced, whichever is more readily determinable.

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

5.50 **If a promise to give has not previously been recognized as contribution revenue because it was conditional, the fair value of a contributed asset should be measured when the condition is met. If a promise has previously been recognized as contribution revenue because it was unconditional, the receipt of a contributed asset by the organization should be recognized as a reduction in contributions receivable and an increase in an appropriate asset account or accounts.**

5.51 Unconditional promises to give that are expected to be received within one year of the financial statement date are permitted to be measured at their net realizable value (that is, the gross amount of the promises to give, net of an allowance for uncollectible amounts).[16] Unconditional promises to give cash that are expected to be collected more than one year after the financial statements date should be measured at the present value of estimated future cash flows using a discount rate commensurate with the risks involved. **Unconditional promises to give noncash assets should be measured at the present value, as of the date of the promise's initial recognition, of the assets' fair value at the date the assets are expected to be received if the date is more than one year after the financial statement date. In some cases, it may be difficult to determine the assets' expected fair value at the date the assets are expected to be received. In these cases, current fair value may be the best estimate of the assets' fair value at the date the assets are expected to be received. The discount that arises when measuring a promise to give at present value should be reported as a deduction from contributions receivable either on the face of a statement of financial position or in the notes to the financial statements. No additional revenue should be recognized if the fair value of the contributed asset has increased, beyond increases related to amortization of discounts, between the date the unconditional promise to give is recognized and the date the asset is received. If, however, the fair value of the asset has decreased, the amount of the decrease should be recognized in the period(s) in which the decrease occurred. Such decreases, or increases related to amortization of discounts, should be reported as a change in the net asset class in which the contribution revenue was originally reported or the class in which the net assets are represented.**

5.52 Gross contributions receivable should be reported in a statement of financial position net of an allowance for uncollectible amounts. (Paragraph 21 of FASB Statement No. 116 provides an exception, permitting unconditional promises to give that are expected to be collected in less than one year to be measured at their net realizable value.) The allowance should be based on the receivable's age, the creditworthiness of the other parties, the organization's past collection experience and its policies concerning the enforcement of promises to give, and other factors

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[16] Paragraph 114 and footnote 8 of FASB Statement No. 116 permit an organization to estimate the net realizable value of a portfolio of short-term promises arising from mass fund-raising appeals such as annual campaigns, mail solicitations, telethons, and phonathons by using its prior experience with similar appeals.

concerning the receivable's collectibility. **Contribution revenue should be reported for the gross amount of promises to give, less discounts to reflect the present value of estimated future cash flows. Bad debt expense should be reported for the gross amount of promises to give that are expected to be uncollectible. That bad debt expense should be reported in the net asset class in which the contribution revenue is reported. Any subsequent differences between the estimated and actual uncollectible amounts should be reported in the net asset class in which the contribution revenue was originally reported or in the class in which the net assets are represented.**

5.53 Paragraph 20 of FASB Statement No. 116 states that "the present value of estimated future cash flows using a discount rate commensurate with the risks involved is an appropriate measure of fair value of unconditional promises to give cash." (Paragraph 21 of FASB Statement No. 116 provides an exception, permitting unconditional promises to give that are expected to be collected in less than one year to be measured at their net realizable value.) FASB Statement No. 116 does not, however, provide further guidance in determining the appropriate rate that a not-for-profit organization should use in recording the receipt of such promises.

5.54 **The present value of estimated future cash flows using a discount rate commensurate with the risks involved should be measured as the present value of the amounts expected to be collected, using a risk-free rate of return considering the life of the promise to give. (The donor's borrowing rate would not be relevant to the organization's accounting for the contribution, because, as discussed in paragraph 5.52, the donor's credit rating and other factors affecting the donor's borrowing rate would be considered in determining the amount expected to be collected.) In conformity with paragraph 12 of APB Opinion No. 21, *Interest on Receivables and Payables,* the discount rate should be determined at the time the unconditional promise to give is recognized and should not be revised as market rates change.**

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

FINANCIAL STATEMENT PRESENTATION

5.56 **A statement of activities should include *Contribution Revenue* as a separate line item, or the amount of contributions should be included in a note to the financial statements. Membership dues are permitted to be reported in a single line item on a statement of activities and need not be subdivided between the portion that is an exchange transaction and the portion that is a contribution.[17] A statement of financial position should include, as separate line items, gross contributions receivable less the allowance for uncollectible amounts and unamortized discount, or the amounts should be included in a note to the financial statements.**

[17] The portion of membership dues that is an exchange transaction is accounted for differently from how the portion that is a contribution is accounted for. Paragraph 5.18 discusses revenue recognition principles for membership dues.

5.57 The notes to the financial statements should also include the following:

- The accounting policies adopted by the organization concerning the following:
  - Implying time restrictions on the use of contributed long-lived assets (and contributions of cash and other assets restricted to purchasing them) received without donor stipulations concerning how long the contributed assets must be used
  - Classifying donor-restricted contributions as unrestricted or restricted support if restrictions are satisfied in the same reporting period in which the contributions are received
  - Recognizing contributions of collection items
- Disclosures relating to the liquidity of the organization's contributions receivable. Examples of such information include the following:
  - Contributions receivable pledged as collateral or otherwise limited as to use
  - An aging schedule of unconditional promises to give (showing the total amount separated into amounts receivable in less than one year, in one to five years, and in more than five years) and the related allowance for uncollectible promises receivable, and the unamortized discount
  - The amount of conditional promises to give — in total and, with descriptions, the amount of each group of similar promises (for example, those conditioned upon the development of new programs, upon the purchase or construction of new property and equipment, and upon the raising of matching funds within a specified time period)
- Disclosures required by APB Opinion No. 21

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

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

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

ILLUSTRATIVE DISCLOSURES

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

Example 1 - Donor-Imposed Restrictions

Note X: Summary of Significant Accounting Policies

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

Example 2 - Promises to Give

Note X: Summary of Significant Accounting Policies

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

Note Y: Promises to Give

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

	19X1	19X0
Capital campaign	$1,220	
Restricted to future periods	795	$530
Gross unconditional promises to give	2,015	530
Less: Allowance for uncollectibles	(408)	(16)
Unamortized discount	(58)	(38)
Net unconditional promises to give	$1,557	$476
Amounts due in:		
Less than one year	$1,220	
One to five years	725	
More than five years	70	
Total	$2,015	

Interest rates ranged from 4 percent to 4.5 percent and from 3.5 percent to 4 percent for 19X1 and 19X0, respectively.

In 19X0, the organization received $650 which must be returned if the organization does not receive $1,300 in donations to the capital campaign. The $650 received was recorded on the 19X0 statement of financial position as a refundable advance. In 19X1, the organization received $500 in cash donations and $865 in unconditional promises to give to this campaign. As a result, the $650 was recognized as unrestricted contributions in 19X1.

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

	19X1	19X0
Conditional promise to give upon the establishment of a library program	$100	$100
Conditional promise to give upon obtaining $2,500 in unconditional promises to give to the capital campaign	5,000	

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

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

Example 3 - Accounting Policy for Contributed Property and Equipment

Note X: Summary of Significant Accounting Policies

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

OR

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

Example 4 - Contributed Services

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

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

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

AUDITING

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

5.61 Not-for-profit organizations that receive significant amounts of contributions should have an accounting system, along with control procedures built into that system, for recording the receipt and collection of contributions. The control structure should also provide reasonable assurance that revenues arising from conditional promises to give are recognized when the conditions have been substantially met and that restrictions on contributions are recognized in the appropriate net asset class. The absence of such an accounting system and related control procedures might make it difficult for the auditor to obtain the necessary assurance about the completeness assertion and the presentation and disclosure assertion for contribution revenues and receivables and net assets. Accordingly, the auditor's assessment of control risk with respect to assertions related to contribution revenues and receivables may constitute a major activity in the planning process.

5.62 Paragraph 34 of SAS No. 67, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 330), states that "confirmation of accounts receivable is a generally accepted auditing procedure," and that there is a presumption that the auditor will request the confirmation of accounts receivable except under certain specified circumstances. That paragraph defines *accounts receivable* as "(a) the entity's claims against customers that have arisen from the sale of goods or services in the normal course of business, and (b) a financial institution's loans." **Accordingly, under that definition, contributions receivable are not accounts receivable to which that presumption would apply, though the auditor may nevertheless decide to request confirmation of contributions receivable.**

5.63 Receivables are usually confirmed principally to provide evidence about the existence/occurrence assertion. FASB Statement No. 116 specifies that for a promise to give to be recognized in financial statements, there must be sufficient evidence in the form of verifiable documentation that a promise was received. If the documentation is not present, an asset should not be recognized. **The verifiable documentation required by Statement No. 116 for recognition of promises to give may not be sufficient evidence concerning the existence/occurrence assertion. Confirming recorded promises to give (contributions receivable) may provide additional evidence about the existence of promises to give, the existence or absence of restrictions, the absence of conditions, and the periods over which the promises to give become due. If the auditor confirms promises to give, he or she should follow the guidance in SAS No. 67 concerning the confirmation process.**

AUDIT CONSIDERATIONS

Financial Statement Assertions	Specific Audit Objectives	Examples of Selected Control Procedures	Examples of Auditing Procedures
Contribution Revenues and Receivables			
Existence/ occurrence	Amounts recognized as contribution revenues and related receivables represent valid unconditional contributions and promises to give.	Procedures ensure that only unconditional contributions and promises to give are recognized in the financial statements.	Examine documentation supporting recognition of contribution revenues and promises to give, including information such as absence of conditions and the periods over which the promises to give become due.
Completeness	All unconditional contributions and promises to give are recognized.	Procedures ensure that all unconditional contributions and promises to give are recognized in the financial statements. Procedures ensure that conditional promises to give are recognized when the conditions have been substantially met.	Compare detailed receivables from promises to give with data accumulated and maintained by the fund-raising function and investigate reconciling items.

Valuation	Contribution revenues and related receivables expected to be collected within one year are reported in the financial statements either at their net realizable value or at the present value of estimated future cash flows; contribution revenues and related receivables expected to be collected beyond one year are measured at the present value of estimated future cash flows.	Allowances for uncollectible promises to give are periodically reviewed by management to ensure that promises to give are reported at the present value of estimated future cash flows. Write-offs and allowances for uncollectible promises to give are identified and approved in accordance with the entity's established policy.	Review and test the method used to determine the allowance for uncollectible promises to give. Review and test the method used for valuing promises to give collectible more than one year from the date of the financial statements. Review promises to give for collectibility.

Presentation and Disclosure	Restricted contributions are reported in the proper net asset class. The amounts of the allowance for uncollectible promises to give and of unamortized discount are disclosed. The amount of promises to give collectible in less than one year, in one to five years, and in more than five years is disclosed. The description and amount for each group of conditional promises to give having similar characteristics is disclosed.	Contributions are reviewed for restrictions.	Review documentation underlying contributions and promises to give (including donor correspondence and board minutes) for propriety of classification. Determine the appropriateness of disclosures for conditional and unconditional promises to give.

Contributed Services, Utilities, Facilities, and Use of Long-Lived Assets			
Existence/ occurrence; completeness; valuation; presentation and disclosure	Assets, expenses, and revenues from contributed services, utilities, facilities, and use of long-lived assets meet the appropriate recognition criteria; all such contributions that meet the recognition criteria are recognized and appropriately measured and displayed.	Procedures ensure that only contributed services, utilities, facilities, and use of long-lived assets that meet the appropriate recognition criteria are recognized; procedures ensure that all such contributions that meet the recognition criteria are recognized and appropriately measured and displayed.	Review documentation underlying recognition of contributed services, utilities, facilities, and use of long-lived assets for completeness and propriety of amounts recognized and displayed.

Agency Transactions			
Existence/occurrence; completeness	Assets and liabilities from agency transactions meet the criteria for classification and recognition as agency transactions. All agency transactions are recognized.	Procedures ensure that (1) only resources received and paid in agency transactions are classified and recognized as agency transactions and (2) all such transactions are recognized.	Review documentation underlying the receipt of assets from resource providers that will be transferred to others for propriety of classification and recognition. Review documentation underlying the distribution of assets to others for propriety of classification and recognition. Review historical patterns of distribution of gifts in kind and other assets to determine the extent of the organization's discretion over those distributions.

Chapter 6

SPLIT-INTEREST AGREEMENTS

[Note: This entire chapter consists of guidance that is related to, but not specifically addressed by, FASB Statement Nos. 116 and 117.]

INTRODUCTION

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

TYPES OF SPLIT-INTEREST AGREEMENTS

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

6.03 Under some kinds of agreements, referred to in this Guide as "lead interests," the not-for-profit organization receives the distributions during the agreement's term. In other kinds of agreements, referred to as "remainder interests," the donor (or other individuals or organizations designated by the donor) receives those distributions and the not-for-profit organization receives all or a portion of the assets remaining at the end of the agreement's term. Under either kind of agreement, donors may impose restrictions on the not-for-profit organization's use of all or a portion of any assets received.

RECOGNITION AND MEASUREMENT PRINCIPLES

6.04 Not-for-profit organizations should account for irrevocable split-interest agreements that name them as beneficiaries as part-contribution, part-exchange transactions. Assets received under those agreements should be recorded at their fair value. The contribution portion of an agreement (that is, the part that represents the unconditional transfer of assets in a voluntary

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

nonreciprocal transaction) should be recognized as revenue or gain.[2] Liabilities incurred in the exchange portion of an agreement (usually an agreement to pay an annuity to the donor) should also be recognized.

6.05 In the absence of donor-imposed conditions, not-for-profit organizations should recognize contribution revenue and related assets and liabilities when irrevocable split-interest agreements naming them trustee or fiscal agent are executed. If an unrelated third party (for example, a bank, trust company, community foundation, or private individual) acts as trustee or fiscal agent, a contribution should be recognized when the not-for-profit organization is notified of the agreement's existence. If the third party has substantive discretion over when or to whom benefits are distributed, the agreement should be considered a conditional promise to give. Contribution revenue should not be recognized under such agreements until the right to receive benefits becomes unconditional.

Recognition of Revocable Agreements

6.06 Revocable split-interest agreements should be accounted for as conditional promises to give. Assets received by not-for-profit organizations under revocable split-interest agreements should be recognized at fair value and as refundable advances. Income earned on assets held under such agreements that is not available for the organization's unconditional use, and any subsequent adjustments to the carrying value of those assets, should be recognized as adjustments to the assets and as refundable advances. Contribution revenue should be recognized when the agreements become irrevocable or when assets are distributed to the not-for-profit organization for its unconditional use.

Initial Recognition of Unconditional Irrevocable Agreements

6.07 At the date of initial recognition of a split-interest agreement, contribution revenue should be measured at fair value. Under a lead interest agreement, the fair value of the contribution can be estimated directly based on the present value of the estimated future distributions expected to be received by the not-for-profit organization as a beneficiary. Under a remainder interest agreement, future distributions will be received by the not-for-profit organization only after obligations to other beneficiaries are satisfied. In those cases, the fair value of the contribution may be estimated based on the fair value of the assets contributed by the donor less the present value of the payments expected to be made to other beneficiaries. Any method for measuring the fair value of the contribution must consider (a) the estimated return on the invested assets during the expected term of the agreement, (b) the contractual payment obligations under the agreement, and (c) a discount rate commensurate with the risks involved.[3] Guidance for determining an appropriate discount rate is provided in paragraph 5.54.

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

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

6.08 Contribution revenues recognized under split-interest agreements should be classified as increases in temporarily restricted net assets unless the donor has permanently restricted the organization's use of its interest (lead or remainder) in assets or the donor gives the organization the immediate right to use without restrictions the assets it receives.[4] If the donor has permanently restricted the organization's use of its interest, the contribution should be classified as an increase in permanently restricted net assets. If the organization has the immediate right to use its interest without restrictions, the contribution should be classified as increases in unrestricted net assets.

6.09 When a not-for-profit organization serves as trustee or when the assets contributed by the donor are otherwise under the control of the not-for-profit organization, cash and other assets received under split-interest agreements should be recognized at fair value at the date of initial recognition. If those assets, or a portion of those assets, are being held for the benefit of others, such as the donor or third parties designated by the donor, a liability, measured at the present value of the expected future payments to be made to other beneficiaries, should also be recognized at the date of initial recognition.[5] In some cases, such as under remainder interest agreements, the present value of the expected future payments to be made to other beneficiaries can be estimated directly based on the terms of the agreement. In other cases, such as under lead interest agreements, the future payments will be made by the not-for-profit organization only after the organization receives its benefits. In those situations, the present value of the future payments to be made to other beneficiaries may be estimated by the fair value of the assets contributed by the donor under the agreement less the present value of the estimated benefits to be received by the not-for-profit organization.

6.10 In arrangements in which cash or other assets contributed by donors under split-interest agreements are held by independent trustees or by other fiscal agents of the donors or are otherwise not controlled by the not-for-profit organization, the not-for-profit organization should recognize its beneficial interest in those assets. Contribution revenue and a receivable should be measured at the present value of the estimated future distributions expected to be received by the organization over the expected term of the agreement.

Recognition During the Agreement's Term

6.11 During the term of the agreement, the following transactions and events should be recognized as "changes in the value of split-interest agreements" in a statement of activities and classified as temporarily restricted, permanently restricted, or unrestricted net assets, depending on the classification used when the contribution revenue was recognized initially: (a) accretion of the discounted amount of the contribution, (b) revaluations of the expected future benefits to be

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[4] Under many charitable gift annuity agreements, the assets received from the donor are held by the not-for-profit organization as part of its general assets and are available for its unrestricted use.

[5] Additional annuity reserves may be required by the laws of the state where the not-for-profit organization is located or by the state where the donor resides. In addition, some not-for-profit organizations voluntarily set aside additional reserves as a cushion against unexpected actuarial losses. Legally mandated reserves should be shown on the face of the financial statements or in the notes as a segregated part of the appropriate net asset class. Voluntary reserves should be included as part of unrestricted net assets, but may be disclosed as a separate component, such as board-designated unrestricted net assets (see chapter 11, "Net Assets").

received by the not-for-profit organization, and (c) revaluations of expected future payments to other beneficiaries, based on changes in life expectancy and in other actuarial assumptions.

6.12 When assets held in trust and related liabilities are recognized under lead and remainder interest agreements for which a not-for-profit organization serves as a trustee or fiscal agent, income earned on those assets, gains, and losses (to the extent recognized--see chapter 8, "Investments"), and distributions made to other beneficiaries under the agreements should be reflected in the organization's accounts.

6.13 Amounts should be reclassified from temporarily restricted net assets to unrestricted net assets as distributions are received by not-for-profit organizations under the terms of split-interest agreements, unless those assets are otherwise temporarily restricted by the donor. In that case, they should be reclassified to unrestricted net assets when the restrictions expire.

Recognition Upon Termination of Agreement

6.14 Upon termination of a split-interest agreement, assets and liability accounts related to the agreement should be closed. Any remaining amounts in the asset or liability accounts should be recognized as changes in the value of split-interest agreements and classified as changes in permanently restricted, temporarily restricted, or unrestricted net assets, as appropriate. If assets previously distributed to the not-for-profit organization become available for its unrestricted use upon termination of the agreement, appropriate amounts should be reclassified from temporarily restricted to unrestricted net assets.

FINANCIAL STATEMENT PRESENTATION

6.15 Assets and liabilities recognized under split-interest agreements should be disclosed separately from other assets and liabilities in a statement of financial position or in the related notes. Contribution revenue and changes in the value of split-interest agreements recognized under such agreements should also be disclosed as separate line items in a statement of activities or in the related notes. The notes to the financial statements should include the following disclosures related to split-interest agreements:

- A description of the general terms of existing split-interest agreements.
- The basis used (for example, cost, lower of cost or market, fair market value) for recognized assets.
- The discount rates and actuarial assumptions used in calculating present values.

EXAMPLES OF SPLIT-INTEREST AGREEMENTS

6.16 Many kinds of split-interest agreements have been developed. The examples in this section demonstrate how the recognition and measurement principles discussed in this chapter apply to some common kinds of agreements. The appendix to this chapter, on pages 68 to 73, provides journal entries related to these examples.

Charitable Lead Trust

6.17 A charitable lead trust is an arrangement in which a donor establishes and funds a trust with specific distributions to be made to a designated not-for-profit organization over a specified period. The organization's use of the assets distributed may be restricted by the donor. The distributions may be for a fixed dollar amount, an arrangement called a charitable lead annuity trust (CLAT), or for a fixed percentage of the trust's fair market value as determined annually, a charitable lead unitrust (CLUT). Upon termination of the trust, the remainder of the trust assets is paid to the donor or to the beneficiaries designated by the donor.

6.18 For example, not-for-profit organization A receives cash from a donor under an irrevocable charitable lead annuity trust agreement designating the organization as trustee and lead beneficiary. Under the terms of the trust, organization A will invest the assets and receive a specified dollar amount each year for its unrestricted use until the death of the donor. At that time, the remaining assets in the trust revert to the donor's estate.

6.19 Contribution revenue, assets held in trust, and a liability for amounts held for others should be recognized by organization A in the period in which the trust is established. Revenue should be reported as temporarily restricted support and measured at the present value of the specified dollar amount to be received annually over the expected life of the donor. The assets held in trust by organization A should be recorded at fair value at the date of initial recognition. The difference between the fair value of the assets received and the contribution revenue represents the present value of the liability to pay the donor's estate upon the termination of the trust.

6.20 In subsequent periods, both the income earned on the trust assets and gains and losses should be reflected in the trust asset and liability accounts. Adjustments of the liability to reflect accretion of the discount and revaluations of the future cash flows based on revisions in investment returns and in the donor's life expectancy should be recognized as changes in the value of split-interest agreements and classified as changes in temporarily restricted net assets in a statement of activities. Amounts should be reclassified from temporarily restricted to unrestricted net assets as the annual distributions to organization A are made and recognized during the term of the trust. Upon the death of the donor, the assets are distributed to the donor's estate, the asset and liability accounts are closed, and any difference between the balances in those accounts should be recognized as a change in the value of split-interest agreements in the temporarily restricted net asset class.

6.21 If organization A is not the trustee and does not exercise control over the trust's assets, it should recognize its beneficial interest in those assets as temporarily restricted contribution revenue and as a receivable, measured at the present value of the expected future cash inflows. Distributions from the trust should be reflected as a reduction in the receivable and as reclassifications from temporarily restricted net assets to unrestricted net assets. Accretion of the discount and revaluations of expected future cash flows based on revisions in investment returns and in the donor's life expectancy should be recognized as adjustments to the receivable and as changes in the value of split-interest agreements in the statement of activities in the temporarily restricted net asset class. Any balance in the receivable account remaining upon termination of the trust should be recognized as a change in the value of split-interest agreements in the statement of activities in the temporarily restricted net asset class.

Perpetual Trust Held by a Third Party

6.22 A perpetual trust held by a third party is an arrangement in which a donor establishes and funds a perpetual trust administered by an individual or organization other than the not-for-profit beneficiary. Under the terms of the trust, the not-for-profit organization has the irrevocable right to receive the income earned on the trust assets in perpetuity, but never receives the assets held in trust. Distributions received by the organization may be restricted by the donor.

6.23 For example, a donor establishes a trust with the donor's bank serving as trustee. Funds contributed to the trust are to be invested in perpetuity. Under the terms of the trust, not-for-profit organization B is to be the sole beneficiary and is to receive annually the income on the trust's assets as earned in perpetuity. Organization B can use the distributions from the trust in any way that is consistent with its mission.

6.24 The arrangement represents the receipt of an unconditional promise to give and should be recognized by organization B as contribution revenue and as an asset when the organization is notified of the trust's existence. The fair value of the contribution should be measured at the present value of the estimated future cash receipts from the trust's assets.[6] The contribution should be classified as permanently restricted support, because the trust is similar to donor restricted permanent endowment that the organization does not control, rather than a multiyear promise to give. Annual distributions from the trust are reported as investment income that increases permanently restricted, temporarily restricted, or unrestricted net assets depending on the nature of donor restrictions on distributions. Adjustments to the amount reported as an asset, based on an annual review using the same basis as was used to measure the asset initially, should be recognized as permanently restricted gains or losses.

Charitable Remainder Trust

6.25 A charitable remainder trust is an arrangement in which a donor establishes and funds a trust with specified distributions to be made to a designated beneficiary or beneficiaries over the trust's term. Upon termination of the trust, a not-for-profit organization receives the assets remaining in the trust. The not-for-profit organization may ultimately have unrestricted use of those assets, or the donor may place permanent or temporary restrictions on their use. The distributions to the beneficiaries may be for a specified dollar amount, an arrangement called a charitable remainder annuity trust (CRAT), or for a specified percentage of the trust's fair market value as determined annually, a charitable remainder unitrust (CRUT). Obligations to the beneficiaries are limited to the trust's assets.

6.26 For example, a donor establishes a charitable remainder unitrust, with not-for-profit organization C serving as trustee. Under the trust's terms, the donor's spouse is to receive an annual distribution equal in value to a specified percentage of the fair market value of the trust's assets each year until the spouse dies. The income earned on the trust's assets must remain in the trust until the spouse dies. At that time, the remaining assets of the trust are to be distributed to organization C for use as a permanent endowment.

6.27 Organization C should recognize the contribution in the period in which the trust is established. The assets held in trust by organization C should be recorded at fair value, and the

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[6] That value may generally be measured by the fair value of the assets contributed to the trust.

liability to the donor's spouse should be recorded at the present value of the estimated future payments to be distributed over the spouse's expected life. The amount of the contribution is the difference between these amounts and should be classified as permanently restricted support.

6.28 In subsequent periods, income earned on trust assets, capital gains and losses (to the extent recognized -- see chapter 8), and distributions paid to the spouse should be reflected in the trust's asset and liability accounts. Adjustments to the liability to reflect accretion of the discount, revaluations of the present value of the estimated future payments to the spouse, and changes in actuarial assumptions should be recognized in a statement of activities as a change in the value of split-interest agreements in the permanently restricted net asset class. Upon the death of the spouse, the liability should be closed and any balance should be recognized as a change in the value of split-interest agreements in the statement of activities in the permanently restricted net asset class.

6.29 If organization C is not the trustee and does not exercise control over the assets contributed to the trust, the agreement should be recognized as an unconditional promise to give. Organization C should recognize, as permanently restricted contribution revenue and as a receivable, the present value of the estimated future benefits to be received when the trust assets are distributed. Adjustments to the receivable to reflect accretion of the discount, revaluation of the present value of the estimated future payments to the spouse, and changes in actuarial assumptions during the term of the trust should be recognized as changes in the value of split-interest agreements. Upon the death of the spouse, the receivable is closed, the assets received from the trust are recognized at fair value, and any difference is reported as a change in the value of split-interest agreements in permanently restricted net assets.

Charitable Gift Annuity

6.30 A charitable gift annuity is an arrangement between a donor and a not-for-profit organization in which the donor contributes assets to the organization in exchange for a promise by the organization to pay a fixed amount for a specified period of time to the donor or to individuals or organizations designated by the donor. The agreements are similar to a charitable remainder annuity trust except that no trust exists, the assets received are held as general assets of the not-for-profit organization, and the annuity liability is a general obligation of the organization.

6.31 For example, not-for-profit organization D and a donor enter into an arrangement whereby assets are transferred from the donor to organization D. Organization D agrees to pay a stated dollar amount annually to the donor's spouse until the spouse dies.

6.32 Organization D should recognize the agreement in the period in which the contract is executed. The assets received should be recognized at fair value, and an annuity payment liability should be recognized at the present value of future cash flows expected to be paid to the donor's spouse. Unrestricted[7] contribution revenue should be recognized as the difference between these two amounts.

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[7] The contribution portion of a charitable gift annuity agreement should be recognized as unrestricted support if both (a) the donor does not restrict the use of the assets contributed to the organization and (b) neither the agreement nor state law requires the assets received by the not-for-profit organization to be invested until the income beneficiary's death. If either of these situations exists, the contribution should be classified as restricted and should be reclassified if temporary restrictions or requirements are satisfied.

6.33 In subsequent periods, payments to the donor's spouse reduce the annuity liability. Adjustments to the annuity liability to reflect accretion of the discount and in the life expectancy of the donor's spouse should be recognized in a statement of activities as changes in the value of split-interest agreements in unrestricted net assets. Upon the death of the donor's spouse, the annuity liability should be closed and a change in the value of split-interest agreements should be recognized in the statement of activities.

Pooled (Life) Income Fund

6.34 Some not-for-profit organizations form, invest, and manage pooled (or life) income funds. These funds are divided into units, and contributions of many donors' life income gifts are pooled and invested as a group. Donors are assigned a specific number of units based on the proportion of the fair value of their contributions to the total fair value of the pooled income fund on the date of the donor's entry to the pooled fund. Until a donor's death, the donor (or the donor's designated beneficiary or beneficiaries) is paid the actual income (as defined under the arrangement) earned on the donor's assigned units. Upon the donor's death, the value of these assigned units reverts to the not-for-profit organization.

6.35 For example, a donor contributes assets to not-for-profit organization E's pooled (life) income fund and is assigned a specific number of units in the pool. The donor is to receive a life interest in any income earned on those units. Upon the donor's death, the value of the units is available to organization E for its unrestricted use.

6.36 Organization E should recognize its remainder interest in the assets received as temporarily restricted contribution revenue in the period in which the assets are received from the donor. The contribution should be measured at the fair value of the assets to be received, discounted for the estimated time period until the donor's death. The contributed assets should be recognized at fair value. The difference between the fair value of the assets and the revenue recognized should be recorded as deferred revenue, representing the amount of the discount for future interest.

6.37 Periodic income on the fund and payments to the donor should be reflected as increases and decreases in a liability to the donor. Accretion of the discount should be recognized as a reduction in the deferred revenue account and as a change in the value of split-interest agreements and reported as a change in temporarily restricted net assets. Upon the donor's death, any remaining balance in the deferred revenue account should be closed and a change in the value of split-interest agreements should be recognized. A reclassification to unrestricted net assets is also necessary to record the satisfaction of the time restriction on temporarily restricted net assets.

AUDITING

6.38 Since for-profit organizations do not usually enter into split-interest agreements, the specific audit objectives, selected control procedures, and auditing procedures related to such agreements are unique to not-for-profit organizations and are presented below. See also the discussion regarding confirming receivables in paragraphs 5.62 and 5.63 of chapter 5, "Contributions Received and Agency Transactions," of this guide.

AUDIT CONSIDERATIONS

Financial Statement Assertions	Specific Audit Objectives	Examples of Selected Control Procedures	Examples of Auditing Procedures
Existence/ occurrence	Amounts recognized as (1) contribution revenues, (2) cash, investments, contributions receivable, and other assets held in trust under split-interest agreements, and (3) liabilities for amounts held for others resulting from split-interest agreements represent valid revenues, assets, and liabilities.	Management authorizes split-interest agreements.	Review split-interest agreements and correspondence with donors or trustees.
Completeness	All unconditional split-interest agreements are recognized. All income received under split-interest agreements is recorded.	Procedures ensure that split-interest agreements are known and recorded. Management reviews income distribution terms of split-interest agreements and determines that periodic reports and remittances from trustees conform to those terms.	Review minutes of board and board committee meetings for evidence of split-interest agreements. Compare income distribution terms of split-interest agreements to periodic reports and remittances from trustees; trace periodic reports and remittances from trustees to cash receipts records.

Valuation	Assets and revenues recognized at the inception of split-interest agreements are measured at fair value, and liabilities for amounts held for others are recognized at the present value of the payments expected to be made to other beneficiaries, using appropriate measurement methods. Accretion of the discounted amount of contributions and revaluations of expected future benefits and expected future payments based on changes in actuarial assumptions are recognized during the term of split-interest agreements.	Documentation supports the determination of assets, liabilities, revenues, and changes in the value of split-interest agreements, both at the inception of the agreements and over their term.	Review documentation, including reports of actuaries, supporting the determination of fair value of assets and revenues and the present value of payments expected to be made to other beneficiaries at the inception of split-interest agreements and over their term; consider the need to apply provisions of SAS No. 73, in conjunction with auditing the actuarial calculations.

Rights and obligations; presentation and disclosure	Restrictions on contributions arising from split-interest agreements have been met. Contribution revenues recognized under split-interest agreements are reported in the proper net asset class. Contribution revenues and changes in net assets from accretion of the discounted amount of contributions and revaluations of expected future benefits and expected future payments based on changes in actuarial assumptions that are recognized during the term of split-interest agreements are reported in the proper net asset class. Temporarily restricted net assets are reclassified as unrestricted net assets as assets are distributed to the not-for-profit organization or as restrictions otherwise expire.	Split-interest agreements are reviewed for restrictions.	Review split-interest agreements and donor correspondence. Determine that appropriate reclassifications are made on the statement of activities as assets are distributed to the organization or as restrictions otherwise expire.

APPENDIX - JOURNAL ENTRIES

6A.39 This appendix provides journal entries related to the examples in paragraphs 6.16 to 6.37.

6A.40 Charitable Lead Trust (not-for-profit organization is trustee) (paragraphs 6.17 to 6.20)

Not-for-profit organization (NPO) A enters into an irrevocable charitable lead annuity trust arrangement with a donor whereby:

- The donor establishes a trust, with NPO A serving as trustee.
- The terms of the trust are that NPO A is to receive an annuity of $X per year until the donor's death.
- Distributions received from the trust by NPO A are unrestricted.
- Upon the death of the donor, the remaining balance in the trust passes to the donor's estate

Solution:

Creation of the trust:

dr. Assets Held in Charitable Lead Trust
cr. Liability for Amounts Held for Others
cr. Contribution Revenue — Temporarily Restricted
(Assets measured at fair value; revenue measured at present value of cash flows to be received by NPO over the expected life of the donor)

Over the term of the trust:

dr. Assets Held in Charitable Lead Trust
cr. Liability for Amounts Held for Others
(Trust income and changes in fair value of assets held in trust)

dr. Cash
cr. Assets Held in Charitable Lead Trust
(Distribution of income to NPO)

dr. Temporarily Restricted Net Assets - Reclassifications Out
cr. Unrestricted Net Assets - Reclassifications In
(Reclassification of amounts received by NPO)

dr. Liability for Amounts Held by Others
cr. Change in Value of Split-Interest Agreements — Temporarily Restricted
(Accretion of discount and revaluation based on changes in actuarial assumptions — debit and credit could be reversed)

Termination of the trust:

dr. Liability for Amounts Held for Others
dr. Change in Value of Split-Interest Agreements — Temporarily Restricted (or cr.)
cr. Assets Held in Charitable Lead Trust
(Return of assets to donor's estate)

6A.41 Charitable Lead Trust (NPO is not trustee) (paragraph 6.21)

The fact situation is the same as in the previous example except that the NPO is not the trustee.

Solution:

Creation of the trust:

dr. Contributions Receivable from Perpetual Trust
cr. Contribution Revenue — Temporarily Restricted
(Beneficial interest in trust assets measured at the present value of cash flows to be received by NPO over the expected life of the donor)

Over the term of the trust:

dr. Cash
cr. Contributions Receivable from Lead Trust
(Distribution of income to NPO)

dr. Temporarily Restricted Net Assets — Reclassifications Out
cr. Unrestricted Net Assets — Reclassifications In
(Reclassification of amount received by NPO)

dr. Contributions Receivable from Lead Trust
cr. Change in Value of Split-Interest Agreements — Temporarily Restricted
(Accretion of discount and changes in actuarial assumptions - debit and credit could be reversed)

Termination of the trust:

dr. Change in Value of Split-Interest Agreements — Temporarily Restricted
cr. Contributions Receivable from Lead Trust
(Closeout receivable)

6A.42 Perpetual Trust Held by a Third Party (paragraphs 6.22 to 6.24)

NPO B enters into an irrevocable perpetual trust agreement with donor whereby:

- The donor establishes a trust, with its bank serving as trustee, with a payment to the trust to be invested in perpetuity by the trustee.

- The terms of the trust are that NPO B is to be the sole beneficiary and receive the income on the trust assets as earned in perpetuity with no restrictions on its use.

Solution:

Creation of the trust:

dr. Beneficial Interest in Perpetual Trust
cr. Contribution Revenue - Permanently Restricted
(Assets and revenue measured at present value based on the expected future cash flows to NPO [generally measured by the fair value of assets contributed to the trust])

Each period:

dr. Cash
cr. Investment Income (Unrestricted)
(Income received from trust [net asset class based on stipulations of the trust])

dr. Beneficial Interest in Perpetual Trust
cr. Gain or Loss - Permanently Restricted
(To adjust asset for changes in present value of expected cash flows - debit and credit could be reversed)

6A.43 Charitable Remainder Trust (NPO is trustee) (paragraphs 6.25 to 6.28)

NPO C enters into a charitable remainder unitrust agreement with a donor whereby:

- A trust is established by the donor, to be administered by NPO C.
- The donor 's spouse is to receive an annual distribution of X percent of the fair market value of the trust's assets each year until the spouse dies.
- At the time of death of the donor's spouse, the remaining assets of the trust are to be distributed to NPO C as permanent endowment.

Solution:

Creation of the trust:

dr. Assets Held in Charitable Remainder Trust
cr. Liability Under Unitrust Agreement
cr. Contribution Revenue — Permanently Restricted
(Assets measured at fair value; liability measured at the present value of expected future payment to be made to the beneficiary)

Over the term of the trust:

dr. Assets Held in Charitable Remainder Trust
cr. Liability Under Unitrust Agreement
(Trust income and change in fair value of assets held in trust, to the extent recognized)

dr. Liability Under Unitrust Agreement
cr. Assets Held in Charitable Remainder Trust
(Payment to beneficiary)

dr. Liability Under Unitrust Agreement
cr. Change in Value of Split-Interest Agreements — Permanently Restricted
(Accretion of discount and adjustment of liability to reflect change in actuarial assumptions — debit and credit could be reversed)

Termination of the trust:

dr. Liability Under Unitrust Agreement
cr. Change in Value of Split-Interest Agreements — Permanently Restricted
(To close liability)

dr. Endowment Assets
cr. Assets Held in Charitable Remainder Trust
(To close trust and recognize assets as endowment)

6A.44 Charitable Remainder Trust (NPO is not trustee) (paragraph 6.29)

The fact situation is the same as in the previous example, except that the NPO does not serve as trustee.

Solution:

Creation of the trust:

dr. Contributions Receivable from Remainder Trust
cr. Contribution Revenue — Permanently Restricted
(Beneficial interest measured at the present value of estimated future cash flows expected to be received by the NPO)

Over the term of the trust:

dr. Contributions Receivable from Remainder Trust
cr. Change in Value of Split-Interest Agreements — Permanently Restricted
(Accretion of discount and changes in actuarial assumptions - debit and credit could be reversed)

Termination of the trust:

dr. Endowment Assets
cr. Contributions Receivable from Remainder Trust
cr. Change in Value of Split-Interest Agreements — Permanently Restricted
(NPO receives distribution of trust assets from trustee, measured at fair value; the receivable account is closed and the change in value of split-interest agreements reflects the difference)

6A.45 Charitable Gift Annuity (paragraphs 6.30 to 6.33)

NPO D enters into a charitable gift annuity contract with a donor whereby:

- Assets are transferred to NPO D and are available for unrestricted use by NPO D.

- NPO D agrees to pay a stated dollar amount annually to the donor's spouse until the spouse dies, at which time the remaining assets are available for the unrestricted use of NPO D.

Solution:

Creation of the annuity:

dr. Assets
cr. Annuity Payment Liability
cr. Contribution Revenue — Unrestricted
(Assets measured at fair value, liabilities at the present value of expected future cash flows to be paid to the annuity beneficiary)

Over the term of the annuity:

dr. Annuity Payment Liability
cr. Cash
(Payment to annuity beneficiary)

dr. Change in Value of Split-Interest Agreements — Unrestricted
cr. Annuity Payment Liability
(Accretion of discount on liability and recording of any change in the life expectancy of the beneficiary — debit and credit could be reversed)

Termination of the annuity:

dr. Annuity Payment Liability
cr. Change in Value of Split-Interest Agreements — Unrestricted
(To close the annuity payment liability)

6A.46 Pooled (Life) Income Fund (paragraphs 6.34 to 6.37)

NPO E forms, invests, and manages a pooled income (or life income) fund. The fund is divided into units, and contributions from many donors are pooled. Donors are assigned a specific number of units based on the proportion of the fair market value of the contribution to the total fair market value of the fund. A donor makes a contribution to the fund, is assigned a specific number of units, and will receive the actual income earned on those units until his or her death. The assets contributed must be invested in the fund until the donor's death. At that time, the value of the units assigned to the donor will revert to NPO E, and those assets will be available to NPO E without restriction.

Solution:

Contribution of assets:

dr. Assets of Pooled Income Fund
cr. Contribution Revenue — Temporarily Restricted
cr. Discount for Future Interest (Deferred Revenue)
(Assets and revenue measured at the fair value of assets to be received, discounted for the estimated time period until the donor's death)

Over the term of the agreement:

dr. Assets of Pooled Income Fund
cr. Liability to Life Beneficiary
(Income earned on units assigned to donor)

dr. Liability to Life Beneficiary
cr. Assets of Pooled Income Fund
(Payment to life beneficiary)

dr. Discount for Future Interest (Deferred Revenue)
cr. Change in Value of Split-Interest Agreements — Temporarily Restricted
(Accretion of discount and changes in the life expectancy of the beneficiary)

Termination of the agreement:

dr. Discount for Future Interest
cr. Change in Value of Split-Interest Agreement — Unrestricted
(To close discount upon the death of the life beneficiary)

dr. Cash or Investment Assets
cr. Assets of Pooled Income Fund
(To recognize assets available for use upon the death of the life beneficiary)

dr. Temporarily Restricted Net Assets -- Reclassification Out
cr. Unrestricted Net Assets -- Reclassification In
(Reclassification based on the expiration of the time restriction)

Chapter 7

OTHER ASSETS

INTRODUCTION

7.01 Some assets held by not-for-profit organizations are similar to those held by for-profit entities. This chapter considers assets that are not discussed elsewhere in this Guide and that present accounting issues unique to not-for-profit organizations.

INVENTORY

7.02 Not-for-profit organizations may acquire merchandise inventory for resale, for example, items held for sale by a bookstore, dining service, kitchen, or thrift shop. Merchandise inventory may be acquired by not-for-profit organizations in exchange transactions or from contributions.

7.03 Contributions of inventory should be reported in the period received and should be measured at fair value. Estimates of fair value may be obtained from published catalogs, vendors, independent appraisals, and other sources. **If the gifts have no value, as might be the case for certain clothing and furniture that cannot be sold by the not-for-profit organization, the item received should not be recognized.**

PREPAID EXPENSES, DEFERRED CHARGES, AND SIMILAR COSTS

7.04 Not-for-profit organizations may incur costs that relate to future rather than to current-period activities. Except as discussed elsewhere in the chapter, the recognition and measurement principles for those costs are similar to those used by business organizations. (In conformity with SOP 93-7, *Reporting on Advertising Costs*, advertising costs should not be capitalized unless they are costs of direct-response advertising that is expected to result in future benefits, such as gift shop sales or performance admissions.)

COLLECTIONS

7.05 Appendix D of FASB Statement No. 116 defines *collections* as follows:

> Works of art, historical treasures, or similar assets that are (a) held for public exhibition, education, or research in furtherance of public service rather than financial gain, (b) protected, kept unencumbered, cared for, and preserved, and (c) subject to an organizational policy that requires the proceeds of items that are sold to be used to acquire other items for collections.

7.06 Accounting for collections depends on whether an organization adopts a policy of recognizing collections as assets. When organizations initially adopt FASB Statement No. 116, they may choose to (a) capitalize their collections, including all items acquired in prior periods that have not been previously capitalized and all items acquired in future periods (that is, *retroactive capitalization*); (b) capitalize only those items acquired after initial adoption of FASB Statement No.

116 (that is, *prospective capitalization*), or (c) capitalize no collections. Capitalization of part of the collections (that is, *selective capitalization*) is prohibited.[1]

7.07 If an organization adopts a policy of capitalizing collections, items acquired in exchange transactions should be recognized as assets in the period in which they are acquired and should be measured at cost. Contributed collection items should be recognized as assets and as contributions in the appropriate net asset class[2] and should be measured at fair value. Fair value can be best be measured by the quoted market price of the contributed item. If such prices are not available, quoted market prices for similar items, appraised values, and other techniques may be used to estimate fair value.[3] Major uncertainties about the future service potential or economic benefit of contributed collection items, for example, items acquired for scientific or educational research having no alternative future uses, may indicate that they should not be recognized.

7.08 If an organization adopts a policy of not capitalizing collections, no assets or contributions should be recognized from the acquisition of collection items. Cash flows from purchases, sales, and insurance recoveries of unrecognized, noncapitalized collection items should be reported as investing activities on the statement of cash flows. Additional disclosures described in paragraph 7.13 should be made if an organization elects not to capitalize collections.

7.09 Contributions made by not-for-profit organizations of previously recognized collection items should be reported as expenses and decreases in assets in the period in which the contributions are made, and should be measured at fair value. (A gain or loss should be recognized on contributions made of previously recognized collection items if their fair value differs from their carrying amount.) Contributions of previously unrecognized collection items should not be recognized on the face of the financial statements; disclosure of those contributions should be made in notes to the financial statements.

7.10 Works of art, historical treasures, and similar assets that are not collection items should be recognized as assets. Items acquired in exchange transactions should be measured at cost. Contributions of those items should be measured at fair value at the date of contribution and should be recognized in a statement of activities as support that increases the appropriate net asset classes.

Financial Statement Presentation

7.11 **If an organization adopts a policy of retroactively or prospectively capitalizing collections that meet the definition in FASB Statement No. 116, a statement of financial position should include**

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[1] Initial adoption of FASB Statement No. 116 may be reported by (a) retroactive restatement of opening net assets for the earliest year presented or, if no prior years are presented, for the year in which the statement is first applied, or (b) reporting the effect as a change in accounting principle in conformity with paragraph 19 of APB Opinion No. 20.

[2] Contributions should be classified as increases in unrestricted, temporarily restricted, or permanently restricted net assets, depending on the existence and type of restrictions imposed by donors. Chapter 5, "Contributions Received and Agency Transactions," provides guidance concerning accounting for contributions with donor-imposed restrictions.

[3] For practical reasons, items that are retroactively capitalized on initial application of FASB Statement No. 116 can be recognized at their (a) cost or fair value at the date of acquisition or (b) cost or current market value at the date of initial recognition.

the total amount capitalized on a separate line item, "Collections" or "Collection Items."[4] The amount capitalized for works of art, historical treasures, and similar assets that do not meet the definition should be disclosed separately on the face of the statement of financial position or in the notes.

7.12 A not-for-profit organization that does not recognize and capitalize its collections should report the following on the face of its statement of activities, separately from revenues, expenses, gains, and losses:[5]

- Costs of collection items purchased as a decrease in the appropriate class of net assets
- Proceeds from sale of collection items as an increase in the appropriate class of net assets
- Proceeds from insurance recoveries of lost or destroyed collection items as an increase in the appropriate class of net assets.

Similarly, an entity that capitalizes its collections prospectively should report proceeds from sales and insurance recoveries of items not previously capitalized separately from revenues, expenses, gains, and losses.

7.13 A not-for-profit organization that does not recognize and capitalize its collections or that capitalizes collections prospectively should describe its collections, including their relative significance, and its accounting and stewardship policies for collections. If collection items not capitalized are deaccessed during that period, it also should (a) describe the items given away, damaged, destroyed, lost, or otherwise deaccessed during the period or (b) disclose their fair value. In addition, a line item should be shown on the face of the statement of financial position that refers to the disclosures required by this paragraph. That line item should be dated if collections are capitalized prospectively, for example, "Collections acquired since January 1, 19X1 (Note X)."

Illustrative Disclosures

7.14 This section provides examples of notes to the financial statements that illustrate some of the financial statement disclosures concerning collection items.

<u>Example 1 — Organizations That Capitalized Collections Prior to FASB Statement No. 116</u>

Note X: Summary of Significant Accounting Policies

The organization has capitalized its collections since its inception. If purchased, items accessioned into the collection are capitalized at cost, and if donated, they are capitalized at their appraised or fair value on the accession date (the date on which the item is accepted by the Acquisitions Committee of the Board of Trustees). Gains or losses on the deaccession of collection items are classified on the statements of activities as unrestricted or temporarily

[4] Organizations electing prospective capitalization should also disclose, in a statement of financial position, the date on which they made the election. For example, the line item that includes the collections that have been prospectively capitalized could be labeled "Collection items acquired since January 1, 19XX (see Note X)."

[5] Paragraph 141 of FASB Statement No. 116 illustrates these disclosures.

restricted support depending on donor restrictions, if any, placed on the item at the time of accession.

Example 2 — Organizations That Capitalize Collections Retroactively Upon Initial Adoption of FASB Statement No. 116

Note X: Summary of Significant Accounting Policies

In 19X1, the organization capitalized its collections retroactively in conformity with FASB Statement No. 116. To the extent that reliable records were available, the organization capitalized collection items acquired prior to 19X1 at their cost at the date of purchase or, if the items were contributed, at their fair or appraised value at the accession date (the date on which the item was accepted by the Acquisitions Committee of the Board of Trustees). Other collection items, particularly those acquired prior to 19X1 when detailed curatorial records began to be maintained, have been capitalized at their appraised or estimated current market value. In some cases, collection items held solely for their potential educational value or historical significance were determined to have no alternative use and were not assigned values for the purpose of capitalization. The collection items capitalized retroactively were determined to have a total value of $11,138,100. This amount is reflected as a change in accounting principle on the statement of activities.

Example 3 — Organizations That Capitalize Their Collections Prospectively Upon Initial Adoption of FASB Statement No. 116

Note X: Summary of Significant Accounting Policies

Collection items acquired on or after July 1, 19X0: Accessions of these collection items are capitalized at cost, if the items were purchased, or at their appraised or fair value on the accession date (the date on which the item is accepted by the Acquisitions Committee of the Board of Trustees), if the items were contributed. Gains or losses from deaccessions of these items are reflected on the statements of activities as changes in the appropriate net asset classes, depending on the existence and type of donor-imposed restrictions.

Collection items acquired prior to July 1, 19X0: Collection items accessioned prior to July 1, 19X0, were recorded as decreases in unrestricted net assets, if the items were purchased. No financial statement recognition was made for contributed collection items. Proceeds from insurance recoveries or deaccessions of these items are reflected on the statements of activities as changes in the appropriate net asset classes, depending on the existence and type of donor-imposed restrictions.

Note Y: Accounting Change

In 19X1, the organization adopted FASB Statement No. 116. The organization has determined that the cost to capitalize its collections retroactively would be excessive because records of the cost of purchased items or of the fair value at the date of contribution of donated items are unreliable or do not exist. However, such information is available for current-year acquisitions and will be maintained on an ongoing basis. Therefore, the organization has elected to capitalize prospectively all collection items acquired after July 1, 19X0, the date of initial adoption of FASB Statement No. 116.

Note Z: Collections

The organization's collections are made up of approximately 105,000 artifacts of historical significance, 86,000 scientific specimens, and 225,000 art objects. Each of the items is cataloged for educational, research, scientific, and curatorial purposes, and activities verifying their existence and assessing their condition are performed continuously.

During 19X1, thirty American pioneer artifacts from the 1800s were destroyed while in transit to an exhibition in which they were to be displayed. Since those items were purchased prior to July 1, 19X0, the insurance proceeds of $22,000, which reimbursed the organization in full for the artifacts' fair value, are reflected as an increase in unrestricted net assets on the statement of activities. No other collection items were deaccessioned in 19X1 or 19X0.

Example 4 — Organizations That Do Not Capitalize Collections

Note X: Summary of Significant Accounting Policies

The collections, which were acquired through purchases and contributions since the organization's inception, are not recognized as assets on the statements of financial position. Purchases of collection items are recorded as decreases in unrestricted net assets in the year in which the items were acquired, or as temporarily or permanently restricted net assets if the assets used to purchase the items have been restricted by donors. Contributed collection items are not reflected on the financial statements. Proceeds from deaccessions or insurance recoveries are reflected as increases in the appropriate net asset classes.

Note Z: Collections

The organization's collections are made up of approximately 105,000 artifacts of historical significance, 86,000 scientific specimens, and 225,000 art objects that are held for educational, research, scientific, and curatorial purposes. Each of the items is cataloged, preserved, and cared for, and activities verifying their existence and assessing their condition are performed continuously. The collections are subject to a policy that requires proceeds from their sales to be used to acquire other items for collections.

During 19X1, thirty American pioneer artifacts from the 1800s were destroyed while in transit to an exhibition in which they were to be displayed. These artifacts were contributed in 19XX, with a restriction that limited any future proceeds to acquisitions of artifacts from a similar period. As a result, the insurance proceeds of $22,000, which reimbursed the organization in full for the artifacts' fair value, are reflected as an increase in temporarily restricted net assets on the statement of activities. No other collection items were deaccessioned in 19X1 or 19X0.

AUDITING

7.15 Many audit objectives, control procedures, and auditing procedures for other assets of not-for-profit organizations are similar to those of other organizations. In addition, the auditor may need to consider the specific audit objectives, selected control procedures, and auditing procedures that are unique to not-for-profit organizations and that are presented at the end of this chapter.

Noncapitalized Collection Items

7.16 Examples of auditing procedures that might be applied when collection items are capitalized are presented in the table at the end of this chapter. If collection items are not capitalized, the auditor should understand the organization's procedures for recording accessions and deaccessions, controlling the collections, and periodically physically inspecting them. Those auditing procedures are performed, in part, to provide evidence supporting the disclosures required by paragraph 27 of FASB Statement No. 116. They are also part of the auditor's work in obtaining an understanding of the organization's controls over collection items and contributions of such items. The objective of performing those procedures when the collection is not recognized is not to obtain evidence to corroborate, directly or indirectly, a recorded amount, since no amount has been recorded. Instead, the objective is to help the auditor understand the organization's control environment, which is an element of its internal control structure.

7.17 As noted in chapter 2, "General Auditing Considerations," of this Guide, SAS No. 55 requires the auditor to understand the organization's control environment, an important part of which is management's philosophy and operating style. That philosophy and operating style include management's approach to taking and monitoring business risks, its attitudes and actions toward financial reporting, and the emphasis it places on meeting budget, profit, and other financial and operating goals. The auditor needs to know about management's philosophy and operating style to be able to assess control risk as it relates to the various segments of the audit, for that philosophy and operating style, like other aspects of the control environment, often have pervasive effects on how the auditor plans the entire audit, including those parts that are unrelated to collections and changes in them.

7.18 The necessary understanding of the control environment does not include a requirement to test control procedures that are part of the control environment (or any other control procedures, for that matter), but merely to obtain knowledge about the design of relevant policies, procedures, and records, and whether they have been placed in operation by the entity. What is sometimes referred to as a *transaction review* or *walk-through* of relevant custodial controls would probably be adequate for the auditor to gain the requisite level of knowledge about controls over the collection as part of understanding the control environment.

AUDIT CONSIDERATIONS

Financial Statement Assertions	Specific Audit Objectives	Examples of Selected Control Procedures	Examples of Auditing Procedures
Noncapitalized Collection Items			
Valuation	Noncapitalized works of art, historical treasures, and similar assets meet the definition of "collections" in FASB Statement No. 116	Policies and procedures for determining that noncapitalized assets are "collections"	Review policies and procedures determining the appropriateness of classifying assets as noncapitalized collections.
Presentation and Disclosures	Transactions involving noncapitalized collection items are appropriately displayed in the statement of activities and the statement of cash flows. Appropriate disclosures, referenced in a line item on the face of the statement of financial position, meet the requirements of FASB Statement No. 116		Determine the appropriateness of display and disclosures related to noncapitalized collections.

Existence/occurrence	Collection items exist. Collection items acquired in the current period by purchase and contribution were authorized. Deaccessions from collections occurred and were authorized.	Procedures for controlling collections and periodically physically inspecting them. Procedures to ensure that purchased collection items are authorized, contributed collection items are appropriately accessioned, and deaccessions are authorized.	Review the organization's procedures for controlling collections and physically inspecting them. Consider whether to observe the physical inspection. Review actions taken by management to investigate discrepancies disclosed by the physical inspection and to adjust the records. Review documentation supporting accessions and deaccessions of collection items. Review minutes of board and board committee meetings for authorization of major accessions and deaccessions. Make inquiries of curatorial personnel about deaccessioned collection items.

Rights and obligations	Restrictions on contributed collection items have been met.	Contributions of collection items are reviewed for restrictions and management monitors compliance with restrictions.	Review donor correspondence to determine the presence or absence of restrictions. Review minutes of board and board *committee* meetings for evidence of restrictions. If specific collection items are restricted, review collection item transactions for propriety of use and disposition.

Capitalized Collection Items (Excluding Matters Related to Retroactive Capitalization)			
Existence/occurrence	Collection items exist. Collection items acquired in the current period by purchase and contribution were authorized. Deaccessions from collections occurred and were authorized.	Procedures for controlling collections and periodically physically inspecting them. Procedures to ensure that purchased collection items are authorized, contributed collection items are appropriately accessioned, and deaccessions are authorized.	Review the organization's procedures for controlling collections and physically inspecting them. Consider whether to observe the physical inspection. Review actions taken by management to investigate discrepancies disclosed by the physical inspection and to adjust the records. Review documentation supporting accessions and deaccessions of collection items. Review minutes of board and board committee meetings for authorization of major accessions and deaccessions. Make inquiries of curatorial personnel about deaccessioned collection items.

Completeness; valuation	All collection items acquired in exchange transactions are recognized as assets at cost. All contributed collection items are recognized as assets and as contributions at fair value.	Procedures exist to ensure that all purchases and contributions of collection items are recognized as assets (at cost and fair value, respectively) and that contribution revenues are recognized for contributed collection items.	Review minutes of board and board committee meetings for evidence of current period purchases and contributions. Review documentation and procedures supporting the determination of cost or fair value.
Rights and obligations	Restrictions on contributed collection items have been met.	Contributions of collection items are reviewed for restrictions and management monitors compliance with restrictions.	Review donor correspondence to determine the presence or absence of restrictions. Review minutes of board and board committee meetings for evidence of restrictions. If specific collection items are restricted, review collection item transactions for propriety of use and disposition.
Presentation and disclosure	Contributed and deaccessioned collection items are reported in the appropriate net asset class.		Review documentation underlying collection items for propriety of classification.

Retroactive Capitalization of Collection Items			
Existence/ occurrence; completeness; valuation; rights and obligations; presentation and disclosure	Retroactively capitalized collection items exist, are the property of the organization, are properly valued, and are reported in the appropriate net asset class; all collection items owned by the organization are capitalized.	Procedures for controlling collections and determining their cost or fair value at date of acquisition or their current cost or current market value at date of initial recognition.	Review documents and procedures supporting the determination of cost or fair value at date of acquisition or current cost or current market value at date of initial recognition. Review donor correspondence to determine the presence or absence of restrictions. Review minutes of board and board committee meetings for evidence of restrictions. Review documentation underlying contributed collection items for propriety of classification. Consider the need to apply provisions of SAS No. 73 in conjunction with determining the reliability of carrying values.

Chapter 8

INVESTMENTS

INTRODUCTION

8.01 On March 31, 1995, the FASB issued an exposure draft of a Statement of Financial Accounting Standards, *Accounting for Certain Investments Held by Not-for-Profit Organizations*. The exposure draft addresses various issues concerning investments in equity securities with readily determinable fair value (as that term is used in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*) and all debt securities held by not-for-profit organizations.[1] That exposure draft specifies that those investments should be reported at their fair value. **Accordingly, this Guide also specifies that those investments should be reported at their fair value.**

8.02 The FASB exposure draft does not address measurement issues concerning investments other than investments in equity securities with readily determinable fair value (as that term is used in FASB Statement No. 115) and all debt securities. Investments not covered by the FASB exposure draft are referred to in this Guide as *other investments*. Other investments include, among others, investments in real estate, mortgage notes, venture capital funds, partnership interests, oil and gas interests, and equity securities that do not have a readily determinable fair value. The various AICPA industry audit guides, audit and accounting guides, and statements of position that will be superseded by this Guide include guidance concerning other investments. This Guide retains the measurement guidance for accounting for other investments included in the AICPA publications that will be superseded by this Guide, until such time as the FASB or the Accounting Standards Executive Committee (AcSEC) issues more definitive guidance. **Accordingly, this chapter provides no new measurement guidance on accounting for other investments.[2] Instead, it incorporates the measurement guidance for other investments presently found in the various AICPA publications that will be superseded by this Guide, except as stated in the next sentence. To the extent that the guidance in the AICPA publications that will be superseded by this Guide requires all investments to be measured using the same measurement attribute, only other investments, rather than all investments, are required to be measured using the same measurement attribute. For example, if an AICPA publication that will be superseded by this Guide permits investments to be carried at either cost or fair value, provided that the same attribute is used for all investments, and if equity securities with a readily determinable fair value are carried at fair value in conformity with the guidance in the FASB exposure draft, other investments are permitted to be carried at either cost or fair value, provided that the same attribute is used for all other investments.**

8.03 Not-for-profit organizations acquire various kinds of investments by contribution or purchase. This chapter discusses the accounting recognition, measurement, and disclosure requirements for investments in (a) debt securities, (b) equity securities with a readily determinable fair value not accounted for under the equity method and not required to be consolidated, and (c) other

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[1] Paragraph 8.06 discusses accounting for investments held by organizations that do not meet the FASB Statement No. 117 definition of a not-for-profit organization.

[2] This chapter does, however, contain guidance on displaying investments in financial statements prepared in conformity with FASB Statement No. 117.

investments.[3] Split-interest gifts, including investments held by others, are discussed in chapter 6, "Split-Interest Agreements," of this Guide.

8.04 SOP 94-3 was issued in September 1994. The FASB is also studying the concept of a reporting entity and issues related to consolidations, the application of the equity method of accounting, and accounting for various types of joint ventures.[4] Accordingly, those matters are not covered by this Guide.

8.05 For investments covered by this Guide, this chapter provides accounting and auditing guidance concerning their initial recognition and measurement, the measurement attributes used for subsequent valuation, investment income, realized and unrealized gains and losses, and financial statement display and disclosure. Many of the requirements under GAAP in these areas are the same as those for-profit entities; accordingly, this chapter focuses on those issues that are unique to not-for-profit organizations.

8.06 As discussed in chapter 1, "Introduction," of this Guide, certain organizations that do not meet the FASB Statement Nos. 116 and 117 definition of a not-for-profit organization are included within the scope of this Guide. These organizations are *not* excluded from the scope of FASB Statement No. 115 and should follow the guidance in FASB Statement No. 115, beginning with financial statements issued for fiscal years beginning after December 15, 1994 (the effective date of FASB Statement No. 116 for entities other than not-for-profit organizations). Organizations that meet the FASB Statement No. 117 definition of a not-for-profit organization should follow the guidance included in this Guide.

INITIAL RECOGNITION

8.07 Investments are initially recorded at their acquisition cost (including brokerage and other transaction fees) if they were purchased and at fair value if they were received as a contribution. Chapter 5, "Contributions Received and Agency Transactions," discusses the classification of contributions.

INVESTMENT INCOME

8.08 Investment income includes dividends, interest, rents, royalties, and similar payments and should be recognized as earned. The revenues (usually referred to as income) should be reported as an increase in unrestricted, temporarily restricted, or permanently restricted net assets, depending on donor stipulations on the use of the income. For example, if there are no donor-imposed restrictions on the use of the income, it should be reported as an increase in unrestricted net assets. On the other hand, a donor may stipulate that a gift be invested in perpetuity, with the income to be used to support a specified program. The initial gift creates permanently restricted net assets; the investment income is temporarily restricted for support of the donor-specified program. If the restrictions on the income are met, the statement of activities should report a reclassification from temporarily restricted net assets to unrestricted net assets. **If the restrictions are met in the same reporting period as that in which the temporarily restricted**

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[3] **Cash held temporarily by a custodian for investment purposes may be included as part of investments on a statement of financial position rather than as cash.**

[4] On August 26, 1994, the FASB issued its preliminary views on the major issues related to consolidation policy.

investment income is recognized, however, the organization may report the income as unrestricted.

8.09 FASB Statement No. 117 specifies that a statement of activities should report the gross amounts of revenues and expenses. It also notes, however, that "investment revenues may be reported net of related expenses, such as custodial fees and investment advisory fees, provided that the amount of the expenses is disclosed either in the statement of activities or in notes to financial statements" (paragraph 24 of FASB Statement No. 117). Chapter 13, "Expenses, Gains, and Losses," of this Guide discusses investment expenses.

REALIZED GAINS AND LOSSES

8.10 As is the case with for-profit organizations, realized gains and losses should be recognized when investments are sold or otherwise disposed of. They should be reported as changes in unrestricted net assets unless their use is temporarily or permanently restricted by explicit donor-imposed stipulations or by law.

8.11 Some not-for-profit organizations manage their investments on a total return basis. Under the total return concept, organizations focus on the overall return on their investments, including both investment income and net appreciation. They then use a spending-rate formula to determine how much of that return will be used for current operations. Operating policies based on the total return concept and a spending-rate formula are unaffected by FASB Statement No. 117.

8.12 Under FASB Statement No. 117, however, all investment income and recognized gains and losses must be reported on the statement of activities and classified as unrestricted unless restricted by the donor or applicable law. Although these requirements affect the way that organizations report changes in net assets, the requirements do not preclude the use of the total return concept or a spending-rate formula for operating purposes. Organizations may provide information in the notes to the financial statements on both the total return and the spending rate. Illustrative Note E in appendix C of FASB Statement No. 117 discloses the total return (both the amount and rate) on investments, as well as the amount and rate that, based on the organization's spending policy, was used for current-year activities.

VALUATION SUBSEQUENT TO ACQUISITION

8.13 In conformity with the guidance noted in paragraph 8.01, investments in equity securities with readily determinable fair value (as that term is used in FASB Statement No. 115) and all debt securities should be reported at their fair value. Current practice and AICPA guidance concerning the carrying amounts of other investments subsequent to acquisition are diverse. Organizations that meet the FASB Statement No. 117 definition of a not-for-profit organization should follow the guidance in Appendix A of this chapter for their other investments. That guidance is based on the AICPA industry audit guides, audit and accounting guides, and SOPs that will be superseded by this Guide, and is intended to maintain the status quo for other investments held by each kind of not-for-profit organization covered by that literature until it is changed by the FASB or by AcSEC.

UNREALIZED HOLDING GAINS AND LOSSES

8.14 Unrealized holding gains and losses arise from changes in the fair value of investments exclusive of dividend and interest income recognized but not yet received and exclusive of any write-down of the carrying amount of investments for impairment. Unrealized holding gains and losses are recognized in some circumstances (for example, when the investments are carried at fair value), but not in others (for example, when the investments are carried at cost).

8.15 To the extent that unrealized gains and losses are recognized, they should be reported as increases or decreases in unrestricted net assets unless their use is temporarily or permanently restricted by donors to a specified purpose or future period. Donors or relevant law may require the organization to retain permanently some portion of gains on investments, in which case that amount should be reported as an increase in permanently restricted net assets. Paragraph 129 of FASB Statement No. 117 notes that "in the absence of such a law or a donor's explicit or clear implicit permanent restriction, net appreciation should be reported as unrestricted if the endowment's income is unrestricted or temporarily restricted if the endowment's income is temporarily restricted by the donor."

8.16 Classification of realized and recognized unrealized gains and losses should be based on the underlying facts and circumstances. If donor-imposed restrictions exist that preclude the use of net gains on permanently restricted net assets, either as a result of explicit or clear implicit donor stipulations or by the law of the relevant jurisdiction, the net gains are permanently restricted. Paragraph 125 of FASB Statement No. 117 notes that "because donor stipulations and laws vary, not-for-profit organizations must assess the relevant facts and circumstances for their endowment gifts and their relevant laws to determine if net appreciation on endowments is available for spending or is permanently restricted." The FASB plans to consider how losses on investments of donor-restricted endowment funds should be reported.

8.17 **Realized and unrealized losses on investments may be netted against realized and unrealized gains on a statement of activities.**

INVESTMENT POOLS

8.18 A not-for-profit organization may pool part or all of its investments (including investments arising from contributions with different kinds of restrictions) for portfolio management purposes. The number and the nature of the pools will vary from organization to organization.

8.19 When a pool is established, ownership interests are initially assigned (typically through unitization) to the various pool categories (sometimes referred to as *participants*) based on the market value of the cash and securities placed in the pool by each participant. Current market value is used to determine the number of units allocated to additional assets placed in the pool and to value withdrawals from the pool. Investment income and realized gains and losses (and any recognized unrealized gains and losses) are allocated equitably based on the number of units assigned to each participant.

FINANCIAL STATEMENT PRESENTATION

8.20 FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments,* requires disclosures about derivative financial instruments--futures, forward, swap, and option contracts, and other financial instruments with similar characteristics. It also amends existing requirements of FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk,* and No. 107, *Disclosures about Fair Value of Financial Instruments.*

8.21 FASB Statement No. 119 requires disclosures about the amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105 because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. FASB Statement No. 119 requires additional disclosures about those derivative financial instruments held for trading purposes, those held for purposes other than trading, and those accounted for as hedge anticipated transactions.

8.22 The notes to the financial statements should disclose the following information:

- **The organization's investment objectives and policies, for example, its application of the total-return concept, its goals for investment return, its spending-rate policy (including the amount appropriated to support current activities), tolerance of investment risk, and policies limiting investment turnover, and a discussion of the circumstances leading to a change, if any, in those objectives or policies**

- **The organization's interpretation of relevant law regarding the retention of gains on investment assets**

- **The policy adopted concerning the classification of temporarily restricted investment income whose restrictions are met in the same reporting period**

- **The amount of short-term and long-term investments and related valuation allowances used to apply lower of cost or market**

- **When the investments are carried at cost, their total market value (if available) at the date of the statements; when they are carried at market value, their cost**

- **Securities on loan to others, the market value of securities on loan, the method and amount of collateralization, and the annual income earned by the security-lending program**

- **Securities pledged as collateral**

8.23 For the most recent period for which a statement of financial position is presented, a not-for-profit organization should disclose the following:

- **The contractual maturities of debt securities. Maturity information may be combined into appropriate groupings, such as (a) within 1 year, (b) after 1 year through 5 years, (c) after 5 years through 10 years, and (d) after 10 years. Securities not due at a single maturity date, such as mortgaged-backed securities, may be disclosed separately rather than allocated to several maturity groupings; if they are allocated, the basis for allocation shall be disclosed.**

- **The nature of and carrying amount for each individual investment or group of investments that represents a significant concentration of market risk or risk of physical loss[5]**

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[5] Paragraph 20 of FASB Statement 105 requires organizations to disclose all significant concentrations of credit risk arising from financial instruments, whether from an individual counterparty or groups of counterparties.

8.24 For each period for which a statement of financial position is presented, a not-for-profit organization should disclose the following:

- **The aggregate carrying value of investments by major types, for example, equity securities, U.S. Treasury securities, corporate debt securities, mortgage-backed securities, oil and gas, and real estate**

- **The basis for determining the carrying value for investments other than equity securities with readily determinable fair values and all debt securities**

- **The method(s) and significant assumptions used to estimate the fair values of investments other than financial instruments if those other investments are reported at fair value.[6]**

8.25 For each period for which a statement of activities is presented, a not-for-profit organization should disclose the following:

- **The composition of the investment return including, at a minimum, investment income, realized gains and losses on investments reported at other than fair value, and net gains or losses on investments reported at fair value**

- **A reconciliation of investment return to amounts reported in the statements of activities if some, but not all, of the investment return is included within a measure of operations, together with a description of the policy used to determine the portion of the return that is included in the measure of operations and a discussion of circumstances leading to a change, if any, in that policy.**

AUDITING

8.26 Many audit objectives, control procedures, and auditing procedures for investments of not-for-profit organizations are similar to those of other organizations. In addition, the auditor may need to consider the following specific audit objectives, selected control procedures, and auditing procedures that are unique to not-for-profit organizations.

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[6] Paragraph 10 of FASB Statement 107 requires organizations to disclose the method(s) and significant assumptions used to estimate fair value of financial instruments.

AUDIT CONSIDERATIONS

Financial Statement Assertions	Specific Audit Objectives	Examples of Selected Control Procedures	Examples of Auditing Procedures
Contributed Investments, Investment Income, Gains, and Losses			
Rights and obligations; presentation and disclosure	Restrictions on contributed investments have been met. Restrictions on investment income, net realized gains, and net recognized unrealized gains that are imposed by donors or by law have been met. Investments and related income, gains, and losses are reported in the appropriate net asset class.	Contributions of investments and investment income, gains, and losses are reviewed for restrictions and management monitors compliance with restrictions.	Review donor correspondence to determine the existence of restrictions on, and classification of, investments and related income, gains, and losses. Review minutes of board and board committee meetings for evidence of donor or statutory restrictions on, and classification of, investments and related income, gains, and losses. If specific investments are restricted, review investment transactions for the propriety of dispositions.

Reclassification of Restricted Net Assets			
Presentation and disclosure	Restricted net assets are reclassified as unrestricted net assets in the statement of activities when restrictions are met on investment income restricted for support of donor-specified programs.		Determine that appropriate reclassifications are made in the statement of activities when restrictions are met on investment income restricted for donor-specified programs.

APPENDIX - MEASURING OTHER INVESTMENTS

8A.27 Other investments of institutions of higher education, including colleges, universities, and community or junior colleges, that were acquired by purchase may be reported at cost, and contributed other investments may be reported at their fair market value or appraised value at the date of the gift, unless there has been an impairment of value that is not considered to be temporary. Other investments may also be reported at current market value or fair value, provided that the same attribute is used for all other investments. (Investments in wasting assets are usually reported net of an allowance for depreciation or depletion.) The financial statements or notes should set forth the total performance (that is, investment income and realized and unrealized gains and losses) of the investment portfolio.

8A.28 Voluntary health and welfare organizations should report other investments at cost if purchased and at fair market value at the date of the contribution if contributed. If the market value of the other investments portfolio is below the recorded amount, it may be necessary to reduce the carrying amount of the portfolio to market or to provide an allowance for decline in market value. If it can reasonably be expected that the organization will suffer a loss on the disposition of an investment, a provision for the loss should be made in the period in which the decline in value occurs. Carrying other investments at market value is also acceptable. The same measurement attribute should be used for all other investments and should be disclosed.

8A.29 Not-for-profit organizations (as defined in FASB Statement No. 117) that are not colleges, universities, or voluntary health and welfare organizations (that is, those that have been following the Audit and Accounting Guide *Audits of Certain Nonprofit Organizations* and SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*) should report other investments at either fair value or the lower of cost or fair value. The same measurement attribute should be used for all other investments. Declines in investments carried at the lower of cost or market value should be recognized when their aggregate market value is less than their carrying amount; recoveries of aggregate market value in subsequent periods should be recorded in those periods subject only to the limitation that the carrying amount should not exceed the original cost.

Chapter 9

PROPERTY AND EQUIPMENT

INTRODUCTION

9.01 Not-for-profit organizations use various kinds of property and equipment to provide goods and services to beneficiaries, customers, and members. Property and equipment includes all long-lived tangible assets held by not-for-profit organizations except collection items[1] and assets held for investment purposes.

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

- Land used as a building site not subject to depreciation
- Land improvements, buildings and building improvements, equipment, furniture and office equipment, library books, motor vehicles, and similar depreciable assets
- Leased property and equipment (capitalized in conformity with FASB Statement No. 13)
- Improvements to leased property
- Construction in process
- Contributed use of facilities and equipment (capitalized in conformity with FASB Statement No. 116).[2]

RECOGNITION AND MEASUREMENT PRINCIPLES

9.03 Not-for-profit organizations acquire the use of property and equipment through purchases, trade-ins, self-construction, leases, and contributions. Except as discussed in this chapter, the recognition and measurement principles for property and equipment acquired by not-for-profit organizations in exchange transactions are similar to those used by business organizations.

9.04 **Property and equipment used in exchange transactions, such as federal contracts, (other than lease transactions) in which the resource provider retains legal title during the term of the arrangement should be capitalized by the not-for-profit organization only if it is probable that the organization will be permitted to keep the assets when the arrangement terminates. The terms of such arrangements should be disclosed in notes to the financial statements.** SOP 92-9 discusses property and equipment held by not-for-profit organizations under federal award programs.

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[1] Because of their unique nature, collection items are reported differently from how other long-lived tangible assets are reported. Chapter 7, "Other Assets," of this Guide discusses accounting for collection items.

[2] Paragraph 5.44 discusses how the capitalization requirements in FASB Statement No. 13 apply to contributed assets.

Contributed Property and Equipment

9.05 Contributions of property and equipment (including unconditional promises to give property and equipment) should be recognized at fair value[3] at the date of contribution and, depending on donor restrictions and the organization's accounting policy, should be included in permanently restricted, temporarily restricted, or unrestricted net assets. If the donors stipulate how or how long contributed property and equipment must be used by the organization, the contribution should be reported as restricted support. If the donors do not specify such restrictions, the contribution should be reported as restricted support if the organization has adopted an accounting policy of implying a time restriction on the use of such assets that expires over the assets' useful lives. In the absence of donor restrictions or an organization's policy of implying time restrictions, contributions of long-lived assets should be reported as unrestricted support. Unconditional promises to give property and equipment should be recognized as receivables in conformity with FASB Statement No. 116 and with chapter 5, "Contributions Received and Agency Transactions," of this Guide. Contributions of the use of property and equipment in which the donor retains legal title to the assets are discussed in paragraph 5.44.

9.06 Similarly to items acquired in exchange transactions, the amount initially recognized for contributed property and equipment should include all the costs incurred by the organization to place those assets in use. Examples of such costs include freight and installation costs of contributed equipment and cataloging costs for contributed library books.

Depreciation

9.07 Paragraph 149 of FASB Concepts Statement No. 6, *Elements of Financial Statements*, describes depreciation as a "systematic and rational" process for allocating the cost of using up assets' service potential or economic benefit over the assets' useful economic lives. FASB Statement No. 93, *Recognition of Depreciation by Not-for-Profit Organizations*, requires all not-for-profit organizations to recognize depreciation for all property and equipment except land used as a building site and similar assets and collections.[4] Depreciation should be recognized for contributed property and equipment as well as for plant and equipment acquired in exchange transactions.

9.08 Depreciation expense should be reported in a statement of activities as a decrease in unrestricted net assets. If the property and equipment being depreciated have been contributed to the organization with donor-imposed restrictions on the item's use, temporarily restricted net assets should, over time, be reclassified as unrestricted net assets in a statement of activities because those restrictions expire over the asset's useful life. Reclassifications are also necessary if the not-for-profit organization has adopted an accounting policy that implies a time restriction on contributions of property and equipment that expires over the useful life of the contributed assets. **Reclassifications should be included as "Net Assets Released from Restrictions" in a statement of activities. The amount reclassified may or may not be equal to the amount of the**

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[3] Chapter 5, "Contributions Received and Agency Transactions," discusses alternative methods of measuring the fair value of contributed assets.

[4] The terms of certain grants and reimbursements from other organizations may specify whether depreciation or the entire cost of the asset in the year of acquisition should be included as a cost of activities associated with those grants or reimbursements for contractual purposes (sometimes referred to as *allowable costs*). Those terms should not affect the recognition and measurement of depreciation for financial reporting purposes.

related depreciation. The amount to be reclassified should be based on the length of time indicated by the donor-imposed restrictions while the amount of depreciation should be based on the useful economic life of the asset. For example, a computer with an estimated useful economic life of five years may be contributed by a donor and restricted for a specific use by the organization for three years.

Gains and Losses

9.09 Gains and losses recognized on property and equipment should be classified in a statement of activities as changes in unrestricted net assets unless explicit donor stipulations or law require their use to be temporarily or permanently restricted. In those situations, gains or losses should be classified as increases or decreases in temporarily restricted or permanently restricted net assets, as appropriate.

FINANCIAL STATEMENT PRESENTATION

9.10 A statement of financial position or related notes should include the balances of each major class of property and equipment. The basis of valuation — for example, cost for purchased items and fair value for contributed items — should also be disclosed. Separate disclosure should also be made of the following items:

- Nondepreciable assets
- Property and equipment not held for use in operations, for example, items held for sale or for investment purposes or construction in process
- Assets restricted by donors to investment in property and equipment
- Improvements to leased facilities
- Assets (and related obligations) recognized under capital leases (in conformity with FASB Statement No. 13)
- Capitalized interest (in conformity with FASB Statements No. 34, *Capitalization of Interest Cost*, and No. 62, *Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants*
- Significant accounting policies concerning property and equipment, such as the following:
  - The capitalization policy adopted
  - Whether time restrictions are implied on the use of contributed long-lived assets (and contributions of assets restricted to purchase them) received without donor stipulations concerning how long the contributed assets must be used[5]

[5] Paragraph 5.59 contains examples of how these alternative policies might be disclosed in notes to the financial statements.

- Whether donor-restricted contributions of long-lived assets are reported as unrestricted or restricted support when restrictions are satisfied in the same reporting period in which the contributions are received[6]

- Depreciation methods used

9.11 Accumulated depreciation, either of each major class of property and equipment or in total, should be disclosed (a) as a deduction or parenthetically in a statement of financial position or (b) in the notes to the financial statements. The amount of depreciation expense for the period and the method or methods used to compute depreciation for the major classes of property and equipment should also be disclosed.

9.12 The notes to the financial statements should also include disclosures concerning the liquidity of the organization's property and equipment, including information about limitations on their use. For example, information could be provided about the —

- Property and equipment pledged as collateral or otherwise subject to lien

- Property and equipment acquired with restricted assets where title may revert to another party, such as a resource provider[7]

- Donor or legal limitations on the use of or proceeds from the disposal of property and equipment

AUDITING

9.13 As discussed in chapter 5, "Contributions Received and Agency Transactions," a not-for-profit organization may have access to the use of property or equipment that is neither owned nor leased. For example, property or equipment may be provided by a related organization (such as a religious order), by unrelated organizations under affiliation programs, or by a governmental agency or unit. The auditor should inquire into, and the financial statements should disclose, the nature of any relationship between the organization and the owners of the property or equipment.

9.14 Many audit objectives, control procedures, and auditing procedures for property and equipment of not-for-profit organizations are similar to those of other organizations. In addition, the auditor may need to consider the following specific audit objectives, selected control procedures, and auditing procedures that are unique to not-for-profit organizations.

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[6] Paragraph 5.59 contains examples of how these alternative policies might be disclosed in notes to the financial statements.

[7] Paragraphs 5.26 to 5.28 discuss accounting for contributed assets with donor-imposed conditions.

AUDIT CONSIDERATIONS

Financial Statement Assertions	Specific Audit Objectives	Examples of Selected Control Procedures	Examples of Auditing Procedures
Contributed Property and Equipment			
Valuation	Contributed property and equipment is reported at fair value at the date of contribution.	Procedures ensure that contributions of property and equipment are known and recorded and that documentation supports the determination of their fair value.	Review documentation supporting the determination of fair value.
Rights and obligations	Restrictions on contributed property and equipment have been met.	Contributions of property and equipment are reviewed for restrictions and management monitors compliance with restrictions.	Review donor correspondence to determine the presence or absence of restrictions. Review minutes of board and board committee meetings for evidence of donor restrictions. If specific property or equipment is restricted, review contributed property and equipment transactions for propriety of use and dispositions.
Presentation and disclosure	Property and equipment is reported in the proper net asset class.		Review documentation underlying contributions of property and equipment for propriety of classification.

Property and Equipment Not Held for Use in Operations			
Presentation and disclosure	Property and equipment not used in operations but held as an investment or for sale is separately reported.	Property records segregate property and equipment not used for operating purposes.	Determine that property and equipment not held for operating purposes is reported separately.
Property and Equipment Additions			
Rights and obligations	Appropriate resource provider approvals, if required, have been obtained for property and equipment additions.	Management monitors compliance with resource provider regulations related to additions to property and equipment. Additions are authorized in the capital budget.	Determine compliance with resource provider requirements.
Reclassification of Temporarily Restricted Net Assets			
Presentation and Disclosure	Temporarily restricted net assets are reclassified as unrestricted net assets in the statement of activities over the term of the donor-imposed restrictions.		Determine that appropriate reclassifications are made on the statement of activities over the term of the donor-imposed restrictions.

Chapter 10

DEBT AND OTHER LIABILITIES

INTRODUCTION

10.01 Many obligations of not-for-profit organizations are similar to those of for-profit entities. This chapter considers debt and other liabilities that are not discussed elsewhere in this Guide and that present accounting and auditing issues unique to not-for-profit organizations.

TAX-EXEMPT FINANCING

10.02 Some not-for-profit organizations finance part of their activities from the proceeds of tax-exempt bonds and other obligations issued through state and local financing authorities. Because not-for-profit organizations are responsible for the repayment of those obligations, such financing should be reported as liabilities on their statements of financial position.

CURRENT AND DEFERRED TAX LIABILITIES

10.03 Although not-for-profit organizations are generally tax-exempt under various IRC sections, some may be subject to taxes on various portions of their income, such as federal excise taxes on investment income or federal and state income taxes on unrelated business income.[1] The provisions of FASB Statement No. 109, *Accounting for Income Taxes*, provide guidance on recognizing (a) the amount of taxes payable (or refundable) for the current year and (b) deferred-tax liabilities (and assets) for the estimated future tax consequences of temporary differences and carryforwards.

DEFERRED REVENUE

10.04 Resources received in exchange transactions from customers, patients, and other service beneficiaries for specific projects, programs, or activities that have not yet taken place should be recognized as liabilities to the extent that the earnings process has not been completed. For example, resources received from the advance sale of season theater tickets should be recognized as deferred revenue, representing the obligation to hold the performances. That revenue is earned as the theater performances are held.

REFUNDS DUE TO AND ADVANCES FROM THIRD PARTIES

10.05 Some not-for-profit organizations (a) receive advances from third parties, such as government agencies and private foundations, based on the estimated cost of providing services to constituents and (b) receive resources from third parties to be used to make loans to the organization's constituents. Advances from third parties for services not yet performed, as well

[1] Chapter 15, "Tax Considerations," of this Guide discusses tax issues concerning not-for-profit organizations.

as refunds due to third parties for amounts previously received under such agreements, should be included as liabilities on a statement of financial position.

PROMISES TO GIVE

10.06 A promise carries rights and obligations - the recipient of a promise to give has a right to expect that the promised assets will be transferred in the future, and the maker has a social and moral obligation, and generally a legal obligation, to make the promised transfer. Paragraph 18 of FASB Statement No. 116 requires donors to recognize a liability for unconditional promises made to give cash or other assets to recipients or to settle or cancel the recipients' liabilities. **Unconditional promises to give should be recognized at the time the recipient has a right to expect that the promised assets will be transferred in the future, which generally occurs when the donor approves a specific grant or when the recipient is notified. If a donor explicitly reserves the right to rescind an intention to contribute, or if a solicitation explicitly allows a donor to rescind the intention, a promise to give should not be recognized by the donor. If payments of the unconditional promise to give are to be made to a recipient over several fiscal periods and the recipient is subject only to routine performance requirements, a liability and an expense for the entire amount payable should be recognized and measured at the present value of the amounts to be paid. Conditional promises to give should not be recognized until the conditions are substantially met.**[2]

ANNUITY OBLIGATIONS

10.07 Some contributions received by not-for-profit organizations, such as interests in charitable gift annuity contracts and charitable remainder and lead trusts, impose obligations on the organization to make future payments to others. Guidance for reporting such contributions, often referred to as "split-interest agreements," is included in chapter 6, "Split-Interest Agreements," of this Guide. **Annuity obligations arising from split-interest gifts should be recognized as liabilities and measured at the present value of the actuarially determined obligation. Periodic revaluations of these liabilities result in changes in the value of split-interest agreements, which should be included as changes in net assets in a statement of activities.**

AMOUNTS HELD FOR OTHERS UNDER AGENCY TRANSACTIONS

10.08 Some not-for-profit organizations receive assets in agency or pass-through transactions in which they serve as agents or intermediaries between donors and donees. **Amounts that must be remitted to other entities pursuant to such transactions should be included as liabilities in statements of financial position.** Paragraphs 5.05 to 5.13 of this Guide discuss agency transactions in more detail.

[2] Paragraphs 5.38 to 5.42 provide additional guidance for recognizing conditional promises to give.

CONTINGENCIES

10.09 To conform with FASB Statement No. 5, notes to the financial statements may have to include information about, or a liability may have to be accrued for, the following:

- Noncompliance with donor-imposed restrictions on contributed assets

- Problems with the organization's tax-exempt status, or that a determination letter regarding that status has not been received

AUDITING

10.10 Many audit objectives, control procedures, and auditing procedures for debt and other liabilities of not-for-profit organizations are similar to those of other organizations. In addition, the auditor may need to consider the following specific audit objectives, selected control procedures, and auditing procedures that are unique to not-for-profit organizations.

AUDIT CONSIDERATIONS

Financial Statement Assertions	**Specific Audit Objectives**	**Examples of Selected Control Procedures**	**Examples of Auditing Procedures**
Tax-Exempt Financing			
Completeness; presentation and disclosure	Amounts related to tax-exempt debt are recognized in the financial statements and related disclosures are adequate.	Confirm outstanding balances and other relevant matters with trustee.	Review financing agreements to ascertain that information about tax-exempt financing is properly reported and disclosed. Review minutes of board and board committee meetings for information about tax-exempt financing.

Promises to Give			
Existence/ occurrence	Amounts recognized as contributions made and related liabilities represent valid unconditional promises to give.	Procedures ensure that only unconditional contributions made and promises to give are recognized in the financial statements.	Examine documentation supporting recognition of contributions made and related liabilities, including information such as the absence of conditions and the periods over which the promises to give become due.
Completeness	All unconditional contributions made and promises to give are recognized.	Procedures ensure that all unconditional contributions made and promises to give are recognized in the financial statements.	Review minutes of board and board committee meetings for information about contributions made and promises to give. Review cash disbursements subsequent to year-end to ascertain that contributions made were recorded in the proper period.
Valuation	Contributions made and related liabilities expected to be paid beyond one year are measured at the present value of the amounts expected to be paid.		Review and test the method used for valuing promises to give collectible more than one year from the date of the financial statements.

Chapter 11

NET ASSETS

INTRODUCTION

11.01 Paragraph 49 of FASB Concepts Statement No. 6 defines *net assets* as "the residual interest in an entity's assets remaining after liabilities are deducted."[1] As a residual interest, net assets cannot be measured independently of an organization's assets and liabilities. Changes in net assets result from transactions and other events and circumstances in which total assets and total liabilities change by different amounts. In many not-for-profit organizations, such changes include nonreciprocal transfers of assets received from donors who do not expect to receive either repayment or proportionate economic benefit in return. Display of and disclosures about net assets and changes in them are intended to assist donors and other users in assessing an organization's efforts to provide goods and services to its constituencies, its efficiency and effectiveness in providing such services, and its continuing ability to do so.

11.02 Changes in net assets result from revenues, expenses, gains, and losses; those changes are discussed in chapters 5 to 10, and 12 and 13 of this Guide. This chapter describes principles for reporting total net assets in statements of financial position and changes in total net assets in statements of activities, as well as related disclosures.

NET ASSET CLASSES

11.03 The following three classes of net assets should, if applicable, be reported in statements of financial position: permanently restricted, temporarily restricted, and unrestricted.[2] Net assets should be included in one of the three classes depending on the presence and type of donor-imposed restrictions limiting an organization's ability to use or dispose of specific contributed assets or the economic benefits embodied in those assets. Donor stipulations should not be considered restrictions unless they include limitations on the use of contributed assets that are more specific than the broad limits imposed by the organization's purpose and nature.

11.04 **Donor-imposed restrictions generally apply to net assets. Donors may also restrict specific assets as to their use (for example, land contributed for a park) or over time (for example, contributed securities that must be held in perpetuity).** Paragraphs 3.03 and 11.12 of this Guide discuss reporting requirements for assets that have been received with donor-imposed restrictions.

PERMANENTLY RESTRICTED NET ASSETS

11.05 Permanently restricted net assets must be maintained by the organization in perpetuity. Permanently restricted net assets increase when organizations receive contributions for which

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[1] Though not-for-profit organizations may use other terms, such as *equity*, this Guide uses the term *net assets* to describe the residual interest.

[2] Though FASB Statement No. 117 encourages the use of the terms *unrestricted*, *temporarily restricted*, and *permanently restricted* net assets, other titles for these classes may also be used, and further disaggregation of total net assets may also be reported. For example, *equity* may be used for net assets and unrestricted net assets may be labeled *other* and subdivided into *board-designated* net assets and *undesignated* net assets.

donor-imposed restrictions limiting the organization's use of an asset or its economic benefits neither expire with the passage of time nor can be removed by the organization's meeting certain requirements. For example, contributions of cash or securities restricted by the donor with the stipulation that they be invested in perpetuity and contributions of collection items (if they are capitalized[3]) required by the donor to be maintained permanently in the organization's collections should be recognized as increases in permanently restricted net assets.

11.06 Permanently restricted net assets may also change as a result of increases and decreases in existing assets that are subject to permanent restrictions. For example, increases in the carrying amounts of assets that are invested in perpetuity because of donor-imposed restrictions should be recognized as increases in permanently restricted net assets to the extent that donor stipulations or applicable law requires those increases to be retained permanently.

TEMPORARILY RESTRICTED NET ASSETS

11.07 Temporarily restricted net assets are those net assets whose use by the organization has been limited by donors (a) to later periods of time or after specified dates[4] or (b) to specified purposes. For example, contributions restricted by the donor to use by the organization over the next five years or to support a specific future program should be recognized as increases in temporarily restricted net assets. Contributions of assets (such as equipment or buildings) that by their nature are used up over time and that the donor stipulates must be used by the organization should also be recognized as increases in temporarily restricted net assets.[5]

11.08 Temporarily restricted net assets may also change as a result of increases and decreases in existing assets that are subject to donor-imposed temporary restrictions. For example, if the donor has stipulated that income earned on temporarily restricted net assets must be added to principal until the principal is spent for a restricted purpose, the income should be reported as increases in temporarily restricted net assets.

UNRESTRICTED NET ASSETS

11.09 Unrestricted net assets include those net assets whose use is not restricted by donors, even though their use may be limited in other respects, such as by contract or by board designation. Changes in net assets arising from exchange transactions (except income and gains on assets that are restricted by donors or by law) should be included in the unrestricted class.

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[3] Chapter 7, "Other Assets," of this Guide discusses accounting policies concerning the capitalization of collection items.

[4] Contributions received with restrictions that are met in the same reporting period may be reported as unrestricted if the organization discloses such a policy and reports consistently from period to period. Paragraph 5.33 provides further discussion of this.

[5] Some organizations may adopt an accounting policy of implying time restrictions on contributed long-lived assets in the absence of explicit donor-imposed restrictions. Paragraphs 5.36 and 5.37 provide additional guidance on alternative policies.

RECLASSIFICATIONS

11.10 Reclassifications of net assets — that is, simultaneous increases in one net asset class and decreases in another — should be made if (a) the organization fulfills the purposes for which the net assets were restricted, (b) donor-imposed restrictions expire with the passage of time or with the death of an annuity beneficiary (if the net assets are not otherwise restricted), or (c) a donor withdraws, or court action removes, previously imposed restrictions. For example, the amount of a donor's contribution that must be used by the organization for a specified program would be reclassified from temporarily restricted to unrestricted net assets in the period in which the organization conducts the program.[6] Paragraph 9.08 of this Guide discusses reclassifications concerning the use of contributed depreciable assets.

DISCLOSURE

11.11 A statement of financial position should include, at a minimum, the amounts of total permanently restricted, temporarily restricted, and unrestricted net assets and the amount of total net assets. A statement of activities should include the amount of total changes in net assets and of changes in each net asset class. These amounts should articulate with the net asset amounts in the statement of financial position. Reclassifications of amounts between net asset classes should be reported separately from other transactions in the statement of activities. Specific changes in each net asset class should be aggregated into reasonably homogeneous groups.

11.12 Information about the following should be shown on the face of the financial statements or in the notes:

- Different kinds of permanent restrictions, such as those related to collection items and other specific assets to be held in perpetuity and to assets that have been contributed by donors with stipulations that they be invested in perpetuity

- Different kinds of temporary restrictions, such as those concerning the support of specific operating activities, use in specific future periods, or the acquisition of long-term assets

Separate disclosures of significant limitations other than those imposed by donors, such as those imposed by governing boards, are permitted to be made on the face of the financial statements or in the notes to the financial statements.

AUDITING

11.13 Since net assets cannot be measured independently of an organization's assets and liabilities, the auditor's consideration of net asset balances generally focuses on the assertions about rights and obligations and presentation and disclosure. In addition, the auditor may need to consider the following specific audit objectives, selected control procedures, and auditing procedures that are unique to not-for-profit organizations.

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[6] A purpose restriction is often fulfilled when the organization incurs an expense or recognizes a liability to a vendor to acquire goods or services that satisfies the restriction. Paragraph 5.35 of this Guide discusses appropriate accounting when expenses are incurred for a purpose for which (a) more than one source of temporarily restricted net assets is available and (b) both unrestricted and temporarily restricted net assets are available.

AUDIT CONSIDERATIONS

Financial Statement Assertions	Specific Audit Objectives	Examples of Selected Control Procedures	Examples of Auditing Procedures
Rights and obligations	Net assets are used and accounted for in accordance with donor restrictions.	Management monitors compliance with donor restrictions.	Review minutes of board and board committee meetings for evidence of donor restrictions. Determine compliance with donor restrictions; test expenditures to determine that restricted net assets are used for their restricted purposes.
Presentation and disclosure	Temporarily restricted net assets are reclassified as unrestricted net assets in the statement of activities when donor-imposed restrictions have been fulfilled	Procedures ensure that reclassification of temporarily restricted net assets occurs when donor restrictions have been met.	Determine that appropriate reclassifications are made on the statement of activities when donor-imposed restrictions have been fulfilled.

Chapter 12

REVENUES AND RECEIVABLES FROM EXCHANGE TRANSACTIONS

INTRODUCTION

12.01 This chapter discusses recognition, measurement, and display issues for revenues and related receivables arising from exchange transactions.[1] Because of the specialized nature of investment activities, they are discussed separately in chapter 8, "Investments." Chapter 5, "Contributions Received and Agency Transactions," includes guidance on distinguishing exchange transactions from contributions and agency transactions.

REVENUES

12.02 Paragraph 78 of FASB Concepts Statement No. 6 defines *revenues* as "inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations." Exchange transactions that give rise to revenues for not-for-profit organizations typically involve their efforts to provide goods or services to members, clients, students, customers, and other beneficiaries for a fee.

12.03 Revenues are distinguished from gains, which are increases in an organization's net assets from peripheral or incidental transactions. In some situations, judgment is required to determine whether an increase in net assets should be reported as a revenue or as a gain. That determination should be based on the relationship of the transaction to the organization's activities. Transactions and other events that would properly be considered part of one organization's ongoing major or central activities (and hence give rise to revenues) may be considered peripheral for other organizations (and hence give rise to gains). For example, sales of computer equipment by a college store should be reported as revenues if such sales are considered part of the college's ongoing major or central activities. Sales of old computer equipment used in a museum's administrative offices would, however, be reported as gains if such sales are peripheral and if the equipment were sold above book value. Chapter 13, "Expenses, Gains, and Losses," discusses reporting gains from exchange transactions.

RECOGNITION, MEASUREMENT, AND DISPLAY

12.04 The recognition, measurement, and display of revenues and related receivables arising from exchange transactions are similar for both not-for-profit and for-profit entities. Revenues from exchange transactions should be recognized based on accrual accounting principles and should be measured by the increase in cash, receivables, or other assets or by the decrease in liabilities resulting from the transaction.[2] Revenues from exchange transactions should be reported as increases in unrestricted net assets in a statement of activities. As discussed in chapter 3, "Basic Financial Statements," further classifications (for example, between operating and nonoperating) may be incorporated within a statement of activities beyond the net asset classes stipulated by FASB Statement No. 117.

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[1] Paragraph 48 of FASB Statement No. 116 defines *exchange transactions* as "reciprocal transfers in which each party receives and sacrifices approximately equal value."

[2] Consistent with GAAP, interest on loans made to students and to other individuals or organizations should be recognized as revenue when earned.

12.05 Revenues from exchange transactions should generally be reported gross of any related expenses.[3] **If the organization regularly provides discounts (such as some types of financial aid for students, reduced fees for services, or free services) to certain recipients of its goods or services, revenues should be reported net of those discounts.**[4]

12.06 Receivables arising from exchange transactions should be reported at net realizable value if the amounts are due within one year. Long-term receivables should be reported in conformity with APB Opinion No. 21. All receivables should be reported net of allowances for uncollectible amounts, if applicable.

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[3] Expenses that are directly related to specific gross revenues may, however, be displayed sequentially with those revenues. For example, gross revenues from special events less the direct expenses related to those events, followed by a subtotal, may be reported in a statement of activities. Chapter 13, "Expenses, Gains, and Losses," discusses reporting of special events.

[4] Net revenue may be reported as a single line item in a statement of activities, or the gross revenue is permitted to be reported less the related discount, provided that the discount is displayed immediately beneath the revenue.

Chapter 13

EXPENSES, GAINS, AND LOSSES

INTRODUCTION

13.01 Generally, expenses, gains, and losses of not-for-profit organizations are similar to those of for-profit organizations and are recognized, measured, and displayed similarly. This chapter discusses certain expense, gain, and loss recognition, measurement, and display issues that are unique to not-for-profit organizations and that are not covered elsewhere in this Guide.

EXPENSES

13.02 Paragraph 80 of FASB Concepts Statement No. 6 defines *expenses* as "outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations." Expenses are distinguished from losses, which are decreases in an organization's net assets from peripheral or incidental transactions.

13.03 Expenses should be reported in a statement of activities as decreases in unrestricted net assets. As discussed in chapter 3, "Basic Financial Statements," further classifications (such as between operating and nonoperating) may be incorporated within a statement of activities beyond the net asset classes required by FASB Statement No. 117.

13.04 Paragraph 26 of FASB Statement No. 117 specifies that a statement of activities or notes to the financial statements should provide information about expenses reported by their functional classification, such as major classes of program services and supporting activities.[1] No similar requirement exists with respect to losses.[2] Voluntary health and welfare organizations[3] are required to report information about functional classifications, together with information about expenses by their natural classifications (such as salaries, rent, electricity, interest expense, depreciation, awards and grants to others, and professional fees), in a matrix format in a separate financial statement. FASB Statement No. 117 encourages but does not require other not-for-profit organizations to provide information about expenses by their natural expense classification.

13.05 For organizations that do not meet the FASB Statement No. 117 definition of a not-for-profit organization but are nevertheless covered by this Guide, paragraph 3.15 includes guidance

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[1] Reporting information about the functional classification of expenses may require the allocation of costs that benefit two or more functions. All references in this Guide to the allocation of costs among functions are subject to the constraints imposed by applicable AICPA SOPs on that subject. At the time of this writing, the applicable Statement is SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal.* On September 10, 1993, the Not-for-Profit Organizations Committee of the AICPA issued an exposure draft of an SOP, *Accounting for Costs of Materials and Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include a Fund-Raising Appeal*, which would revise SOP 87-2. The final version of this Guide will include the guidance in either SOP 87-2 or the guidance in the SOP that is expected to revise SOP 87-2, depending on which SOP is applicable at the time this Guide is issued. Accordingly, this Guide will supersede that SOP.

[2] Paragraphs 13.12 to 13.14 of this Guide discuss the differences between expenses and losses.

[3] Voluntary health and welfare organizations are defined in appendix D of FASB Statement No. 117.

concerning reporting information about expenses by their functional classification as well as information about expenses by their natural classification in a matrix format in a separate financial statement.

EXPENSE RECOGNITION ISSUES

13.06 Expenses are recognized when an organization's economic benefits are used up in delivering or producing goods, rendering services, or other activities or when previously recognized assets are expected to provide reduced or no future benefits. Some expenses, such as cost of goods sold, are recognized simultaneously with revenues that result directly and jointly from the same transactions or other events as the expenses. Some expenses, such as salaries, are recognized when cash is spent or liabilities are incurred for goods and services that are used up either simultaneously with acquisition or soon after. Some expenses, such as depreciation, are allocated by systematic and rational procedures to the periods during which the related assets are expected to provide services. An expense or loss is also recognized if it becomes evident that the previously recognized future economic benefits of an asset have been reduced or eliminated, or that a liability has been incurred or increased, without associated economic benefits.

Fund-Raising Costs

13.07 Fund-raising costs, including the cost of special fund-raising events, are incurred to induce potential donors to make contributions to an organization and should be expensed when incurred. Fund-raising costs incurred in one year, such as those made to obtain bequests, compile a mailing list of prospective contributors, or solicit contributions in a direct-response activity[4] may result in contributions that will be received in future years. **These costs should be expensed as incurred, however, because of the difficulty of assessing their ultimate recoverability.**

Advertising Costs

13.08 SOP 93-7 provides recognition, measurement, and disclosure guidance for the advertising activities of all entities, including not-for-profit organizations. (SOP 93-7 specifically notes, however, that fund-raising by not-for-profit organizations is not considered advertising and is not within the scope of the SOP.) SOP 93-7 requires certain disclosures about advertising activities, including disclosure of total advertising costs for a period.

13.09 SOP 93-7 defines *advertising* as "the promotion of an industry, an entity, a brand, a product name, or specific products or services so as to create or stimulate a positive entity image or to create or stimulate a desire to buy the entity's products or services." **Advertising by a not-for-profit organization also includes activities to create or stimulate a desire to use the organization's products or services that are provided without charge.**

13.10 Advertising costs should be expensed either as incurred or the first time the advertising takes place, except for direct-response advertising that results in probable future benefits. Direct-

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[4] The costs of direct-response fund-raising activities, which according to this Guide should not be capitalized, are similar to the costs of direct-response advertising activities, which according to SOP 93-7 should be capitalized in certain circumstances. (Paragraphs 13.08 to 13.10 discuss advertising costs.) Costs of direct-response fund-raising activities should not be capitalized because practice with respect to these costs is uniform, and expensing such costs is not a practice problem.

response advertising should be capitalized if it is expected to result in future benefits, as in sales resulting from direct response advertising of merchandise or performance admissions in excess of future costs to be incurred in realizing those revenues. If no future revenues are anticipated, however, because the products or services advertised are being provided by the organization without charge, there is no basis for capitalizing the costs of direct-response advertising beyond the first time the advertising takes place.

Contributions Made

13.11 FASB Statement No. 116 provides guidance on contributions made as well as contributions received. The recognition rules for contributions made are discussed in paragraph 10.06 of this Guide.

GAINS AND LOSSES

13.12 Revenues are inflows of assets that result from an organization's ongoing major or central operations and activities. Gains are increases in net assets resulting from an organization's peripheral or incidental transactions and other events and circumstances affecting the organization other than those that result from revenues. Expenses are outflows of assets or incurrences of liabilities that result from an organization's ongoing major or central operations and activities. Losses are decreases in net assets from an organization's peripheral or incidental transactions and other events and circumstances affecting the organization other then those that result from expenses.

13.13 Gains and losses result both from an organization's peripheral or incidental activities and from events and circumstances that stem from the environment and that are largely beyond the control of a particular organization and its management. Some gains and losses result from holding assets or liabilities while their values change, such as from changes in the fair value of securities or changes in foreign exchange rates. Other gains and losses result from natural catastrophes, such as fires, floods, and earthquakes. Still others result from transactions (such as an organization's sale of buildings and equipment that are no longer needed for its ongoing operations, or from its winning or losing a lawsuit) that are only peripheral or incidental to the organization.

13.14 **Transactions resulting in revenues for one not-for-profit organization may result in gains for another, which, in turn, determines how the related costs should be classified and displayed. Revenues and expenses are reported gross (except for investment revenues and related expenses), while gains and losses may be reported net.** Gains and losses should be reported as increases or decreases in unrestricted net assets unless their use is restricted by a donor or by law, in which case they should be reported as increases or decreases in temporarily restricted or permanently restricted net assets, as appropriate. Expenses should be reported as decreases in unrestricted net assets and by their functional classification. Losses need not be reported by their functional classification or in the matrix that presents information about expenses according to both their functional and natural classifications.

Reporting Costs Related to Sales of Goods and Services

13.15 The way that costs related to sales of goods and services are displayed depends on whether the sales constitute a major or central activity of the organization or a peripheral or incidental activity. For example, a museum that has a store that is a major or central activity should report and display separately the revenues from its sales and the related cost of sales. Cost of sales is permitted to be reported immediately after revenues from sale of merchandise, and may be followed by a descriptive subtotal, or it may be reported with other expenses. If the store sells merchandise that is related to the museum's program, the store would be a program service and the cost of the store's sales would be reported as an expense of providing that service in the presentation of expenses by their functional classification, which is discussed in paragraph 13.24. In other circumstances, cost of sales could be reported as a separate supporting service. For example, if operating a cafeteria is a major or central activity but is not related to the organization's programs, the cafeteria's cost of sales should be reported in a separate functional classification.

13.16 In contrast, a church that occasionally produces and sells a cookbook (considered to be a peripheral or incidental activity) has gains (or losses) from those sales, and the receipts and related costs are permitted to be offset and only the net receipts (or costs) are reported. Since the costs related to the receipts are netted against the receipts, the costs are not classified as an expense that should be reported by its functional classification.

Reporting the Cost of Special Events and Other Fund-Raising Activities

13.17 Some organizations conduct fund-raising activities, including special social and educational events (such as symposia, dinners, dances, and theater parties) in which the attendee receives a direct benefit (for example, a meal or theater ticket). FASB Statement No. 117 requires the reporting of the gross amounts of revenues and expenses from special events and other fund-raising activities, but permits (but does not require) reporting net amounts if the receipts and related costs result from special events that are peripheral or incidental activities, that is, that result in gains or losses.

13.18 Organizations may report the gross revenues of special events and other fund-raising activities with the cost of directly related goods and services (for example, meals and room rental) displayed either (1) as a line item deducted from the special event revenues or (2) in the same section of the statement of activities as are other programs or supporting services and allocated, if necessary, among those various functions. Alternatively, the organization could consider revenue from special events and other fund-raising activities as part exchange (for the fair value the participant received) and part contribution (for the excess of the payment over that fair value) and report the two parts separately.

13.19 For example, a special event that is an ongoing and major activity with a ticket price of $100 may include a dinner that costs the organization $25 and that has a fair value of $30. (Chapter 5, "Contributions Received and Agency Transactions," discusses the appropriate reporting if the meal or other items of value are donated to the organization for resale.) The organization could report special-event revenue of $100, costs of direct benefits of special events of $25, and other direct costs of the event. Alternatively, it could report contributions of $70, dinner sales of $30, costs of direct benefits of special events of $25, and other direct costs of the event. Direct costs should include only the incremental direct costs incurred in transactions with independent third parties and the payroll and payroll-related costs for the activities of employees who are directly associated with, and devote time to, special events or other fund-raising activities.

13.20 Paragraphs 25 and 138 of FASB Statement No. 117 permit, but do not require, organizations to report receipts from special events that are peripheral or incidental activities net of related costs, without reporting those costs on the face of a statement of activities. **Costs netted against receipts from peripheral or incidental special events should be limited to direct costs.**

13.21 **The frequency of the events and the significance of the gross revenues and expenses distinguish major or central events from peripheral or incidental events. Events are ongoing major and central activities if (a) they are normally part of an organization's strategy and it normally carries on such activities or (b) the event's gross revenues or expenses are significant in relation to the organization's annual budget. Events are peripheral or incidental if they are not an integral part of an organization's usual activities or if their gross revenues or expenses are not significant in relation to the organization's annual budget. Accordingly, similar events may be reported differently by different organizations based on the organization's overall activities.**

Investment Revenues, Expenses, Gains, and Losses

13.22 Investment revenues may be reported net of related expenses, such as custodial costs and internal and external investment advisory costs, provided that the amount of such expenses is disclosed either on the face of a statement of activities or in notes to the financial statements. **Expenses that are netted against investment revenues should, however, be reported by their functional classification on the separate statement that reports information about expenses by their natural classification as well as by their functional classification in a matrix format (if the organization presents that statement). Realized and unrealized losses on investments may be netted against realized and unrealized gains on a statement of activities.** Chapter 8, "Investments," includes a more detailed discussion of investment gains and losses.

FUNCTIONAL REPORTING OF EXPENSES

13.23 As has been previously noted, FASB Statement No. 117 requires the presentation, in either a statement of activities or the notes to the financial statements, of information about expenses (but not losses) reported by their functional classification, such as major classes of program services and supporting activities. Program services are defined in paragraph 27 of FASB Statement No. 117 as "the activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the organization exists. Those services are the major purpose for and the major output of the organization and often relate to several major programs." Program services may include cost of sales and costs of other revenue-generating activities that are program related. Supporting services are defined in paragraph 28 as "all activities of a not-for-profit organization other than program services. Generally, they include management and general, fund-raising, and membership-development activities." **Supporting services may include, as one or more separate categories, cost of sales and costs of other revenue-generating activities that are not program related.** FASB Statement No. 117 provides examples of kinds of activities that fall into each of those categories, and further elaboration is provided in the following sections.

Presentation of Expenses by Function

13.24 **This Guide amplifies the requirements of FASB Statement No. 117 by specifying that information about all expenses should be provided by their functional classification, regardless of where they are reported on a statement of activities. One way to meet this requirement is to report all expenses by function in one section of the statement of activities, followed by a total.**

If, however, certain expenses (such as cost of sales or the direct costs of special events) are subtracted from certain revenues (such as sales of goods or special-event revenues) and followed by a subtotal and the functional classification of those expenses is not evident from the details provided on the face of the statement of activities, the requirement to provide information about all expenses by function can be met only by presenting the information in a note to the financial statements. To facilitate articulating that note to the statement of activities, organizations may use a format that reconciles total expenses reported in all sections of the statement of activities with total expenses reported in the "expenses and losses" section of that statement.

13.25 An illustrative format for such a note follows. (It is assumed in the illustration that the organization is providing information about expenses by both their natural and functional classifications.) The purpose of the illustration is to suggest a way of presenting information about expenses that are not included in the "expenses and losses" section of the statement of activities, such as expenses that are subtracted from specific revenues or netted against investment revenues. Accordingly, numerous expenses that should be separately reported have been aggregated and called "various other expenses," and other simplifying assumptions have been made.

13.26 Assume that a one-program organization has the following revenues and expenses:

Revenues:	
Contributions	$ 8,460
Bookstore sales	2,150
Investment revenue	1,110
	$11,720
Expenses:	
Salaries	$ 6,000
Merchandise cost of sales	1,450
Investment fees	60
Various other expenses	4,000
	$11,510

A statement of activities might report that information as follows:

Changes in unrestricted net assets:		
Contribution revenue		$ 8,460
Bookstore sales	$2,150	
less: Cost of bookstore sales	1,450	
Gross profit on bookstore sales		700
Investment revenue (net of expenses of $60)		1,050
		10,210
Expenses:		
Program A	$7,120	
Management and general	2,100	
Fund raising	780	
Total expenses		10,000
Increases in unrestricted net assets		$ 210

A note to the financial statements might appear as follows:

Expenses were incurred for the following:

	Total	Program A	Management and General	Fund Raising
Salaries	**$ 6,000**	**$5,000**	**$ 400**	**$ 600**
Cost of sales	**1,450**	**1,450**		
Investment fees	**60**		**60**	
Various other expenses	**4,000**	**2,120**	**1,700**	**180**
Total expenses	**11,510**	**8,570**	**2,160**	**780**
Less:				
Expenses deducted directly from revenues on the statement of activities:				
Cost of sales	**(1,450)**	**(1,450)**		
Investment fees	**(60)**		**(60)**	
Total expenses reported by function on the statement of activities	**$10,000**	**$7,120**	**$2,100**	**$780**

Functional Classifications

Program Services

13.27 The number of functional reporting classifications for program services varies according to the nature of the services rendered. For some organizations, a single functional reporting classification may be adequate to portray what may, in effect, be a single, integrated program service that the organization provides. In most cases, however, several separate and identifiable services are provided, and in such cases the expenses for program services should be reported by the kind of service function or group of functions. For example, a large university may have programs for student instruction, research, and public service, among others. A health and welfare organization may have programs for health and family services, research, disaster relief, and public education, among others. **A federated fund-raising organization's programs may include making contributions to agencies supported by the organization.**

13.28 Paragraph 26 of FASB Statement No. 117 specifies that the information about expenses reported by functional classification should be provided by *major* classes of program services and supporting activities. **For guidance on what constitutes "major" classes of programs and** supporting activities, not-for-profit organizations may consider, among other sources, FASB Statement No. 14, ***Financial Reporting for Segments of a Business Enterprise.***[5]

13.29 In the section of the financial statements that reports expenses by function (either a statement of activities or the notes), an organization should disclose its total program costs. It should also provide a description of the nature of the organization's activities, including a description of each of its major classes of programs, either on the statement of activities (for example, using column headings) or in the notes to the financial statements.

Supporting Services

13.30 A single functional reporting classification is ordinarily adequate to portray each kind of supporting service. Organizations may, however, present more detailed disaggregated information for each kind of supporting service. For example, fund-raising expenses and the corresponding support that is obtained may be reported separately for each kind of fund-raising activity undertaken, either on the face of a statement of activities or in the notes to the financial statements.

13.31 *Management and general* activities are those that are not identifiable with a single program, fund-raising activity, or membership-development activity but that are indispensable to the conduct of those activities and to an organization's existence. They include oversight, business management, general record keeping, budgeting, financing, **soliciting revenue from exchange transactions, such as federal contracts** and related administrative activities, and all management and administration except for direct conduct of program services or fund-raising activities. The costs of oversight and management usually include the salaries and expenses of the governing board, the chief officer of the organization, and the supporting staff. **(If such staff spend a portion of their time directly supervising program services or categories of other supporting services, however, their salaries and expenses should be allocated among those functions.) The costs of disseminating information to inform the public of the organization's "stewardship" of contributed funds, announcements concerning appointments, and the annual report, among other costs, should similarly be classified as management and general expenses. The costs of soliciting funds other than contributions, including exchange transactions (whether program-related or not) and funds other than contributions solicited from governments, should be classified as management and general expenses. The financial statements should disclose total management and general expenses.**

13.32 *Fund-raising activities* involve inducing potential donors to contribute money, securities, services, materials, facilities, other assets, or time. They include publicizing and conducting fund-raising campaigns; maintaining donor mailing lists; conducting special fund-raising events; preparing and distributing fund-raising manuals, instructions, and other materials; and conducting other activities involved with soliciting contributions from individuals, foundations, governments, and others. (Paragraph 13.41 discusses how fund-raising activities of federated fund-raising

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[5] FASB Statement No. 14 applies only to business enterprises; however, the Statement's guidelines may be helpful to not-for-profit organizations in determining the number of functional classifications that would be appropriate in their particular circumstances. Applying paragraph 11 of FASB Statement No. 14 to not-for-profit organizations, the major classes of program services and supporting activities should be determined by (a) identifying the major programs and activities that an organization undertakes, (b) grouping those programs and activities by function, and (c) selecting those functions that are significant with respect to the organization as a whole.

organizations should be reported.) **The financial statements should disclose the total fund-raising expenses.**

13.33 *Membership-development activities* include soliciting for prospective members and membership dues, membership relations, and similar activities. **If there are no significant benefits or duties connected with membership, however, the substance of membership-development activities may, in fact, be fund-raising, and the related costs should be reported as fund-raising costs. Depending on the particular facts and circumstances, allocation of the costs of membership-development activities to more than one function may be appropriate. For example, membership may entitle the members to group life and other insurance at reduced costs because of the organization's negotiated rates and to a subscription to the organization's magazine or newsletter; part of the membership dues may also represent a contribution.[6] Under these circumstances, an appropriate part of the costs of soliciting members should be allocated to the membership-development function, a part to program services, and a part to fund-raising activities.[7]**

Classification of Expenses Related to More Than One Function

13.34 **Some expenses are directly related to, and can be assigned to, a single major program or service or a single supporting activity. Other expenses relate to more than one program or supporting activity, or to a combination of programs and supporting services. These expenses should be allocated among the appropriate functions. Examples include salaries of persons who perform more than one kind of service and the rental of a building used for various programs and supporting activities.**

13.35 **Direct identification of specific expense (also referred to as *assigning* expenses) is the preferable method of charging expenses to various functions. If an expense can be specifically identified with a program or supporting service, it should be assigned to that function.** For example, travel costs incurred in connection with a program activity should be assigned to that program.

13.36 **If direct identification (that is, assignment) is impossible or impracticable, an allocation is appropriate. The techniques used to allocate are common to all entities, for-profit and not-for-profit alike. A reasonable allocation of expenses among an organization's functions may be made on a variety of bases. Objective methods of allocating expenses are preferable to subjective methods.[8]** The paragraphs that follow provide guidance (in addition to that presented throughout this chapter) on allocating or presenting certain costs that may be incurred by not-for-profit organizations.[9]

13.37 The allocation may be based on related financial or nonfinancial data. For example, the expenses associated with occupying and maintaining a building, such as depreciation, utilities,

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[6] Paragraph 5.18 and Table 5.3 of this Guide provide indicators to help make these distinctions.

[7] Footnote 1 to this chapter describes an existing SOP and a proposed SOP that provide guidance in accounting for the costs of materials and activities that include a fund-raising appeal.

[8] Footnote 1 to this chapter describes an existing SOP and a proposed SOP that provide guidance on accounting for the costs of materials and activities that include a fund-raising appeal.

[9] The guidance found in OMB Circular A-122, may also be helpful in allocating costs.

maintenance, and insurance, may be allocated based on the square footage of space occupied by each program and supporting service. If floor plans are not available and the precise measurement of the occupied space is impractical, an estimate of the relative portion of the building occupied by each function may be made. **Occupying and maintaining a building is not a separate supporting service. Interest costs,[10] including interest on a building's mortgage, should be allocated to specific programs or supporting services to the extent possible; those that cannot be allocated should be reported as part of the management and general function.**

13.38 **An organization should evaluate its expense allocation methods periodically. The evaluation may include, for example, a review of the time records or activity reports of key personnel, the use of space, and the consumption of supplies and postage. The expense allocation methods should be reviewed by management and revised when necessary to reflect significant changes in the nature or level of the organization's current activities.**

Support To Affiliated Organizations

13.39 Some organizations make payments or provide other support to local or national affiliates. The specific purposes and benefits of those payments may be determinable (for example, permission to raise funds in a specified geographical area, or the provision of joint purchasing arrangements and technical and fund-raising assistance, functions that the organization would otherwise have to carry out itself), or the purposes and benefits may be indeterminable. Payments in the form of grants and dues may also be made to affiliates.

13.40 **Payments to affiliated organizations should be reported by their functional classification to the extent that it is practicable and reasonable to do so and the necessary information is available, even if it is impossible to allocate the entire amount of such payments to functions. Payments to affiliates that cannot be allocated to functions should be treated as a separate supporting service, reported on a statement of activities as a separate line item, and labeled "unallocated payments to affiliated organizations."**

Expenses Of Federated Fund-Raising Organizations

13.41 Federated fund-raising organizations solicit and receive designated and undesignated contributions and make grants and awards to other organizations. **The fund-raising activities of these organizations, including activities related to fund-raising on behalf of others, should be reported as fund-raising expenses.**

INCOME TAXES

13.42 **If a not-for-profit organization incurs income tax expense, the notes to the financial statements should disclose the amount of the taxes and describe the nature of the activities that generated the taxes.**

[10] Paragraph 21 of FASB Statement No. 34 requires disclosure of total interest costs incurred.

AUDITING

13.43 Audit objectives, control procedures, and auditing procedures for expenses, gains, and losses of not-for-profit organizations are similar to those of other organizations. In addition, the auditor may need to consider the following specific audit objectives, selected control procedures, and auditing procedures that are unique to not-for-profit organizations.

AUDIT CONSIDERATIONS

Financial Statement Assertions	Specific Audit Objectives	Examples of Selected Control Procedures	Examples of Auditing Procedures
Expenses			
Presentation and disclosure	Expenses are properly classified and displayed.	Controls ensure that expenses are properly classified and displayed.	Compare current period expenses in total and by functional classification with expectations based on prior-period expenses and/or budget and obtain explanations for variances from expectations. Determine that expenses have been properly assigned and allocated to functional and, if applicable, natural classifications.

Chapter 14

REPORTS OF INDEPENDENT AUDITORS

REPORTS ON FINANCIAL STATEMENTS

14.01 The guidance in SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508), applies to auditors' reports on the financial statements of not-for-profit organizations. The facts and circumstances of each particular audit will govern the appropriate form of report. This chapter discusses the application of SAS No. 58 to reports on the financial statements of not-for-profit organizations in specific circumstances.

14.02 The auditor's standard report described in SAS No. 58 refers to "results of operations," which is usually understood to refer to an enterprise's net income for a period together with other changes in net worth. As described in chapter 3, "Basic Financial Statements," of this Guide, a not-for-profit organization's statement of activities reports the changes in net assets for the period but does not purport to present the results of operations, as would an income statement of a for-profit organization.[1] **Accordingly, the opinion paragraph of the auditor's report should refer to "changes in net assets," since that is more descriptive of the information in the statement of activities than "results of operations." Auditors should not report separately on operations if the statement of activities includes an intermediate measure of operations.**

REPORTS ON COMPARATIVE FINANCIAL STATEMENTS

14.03 As noted in chapter 3, not-for-profit organizations sometimes present comparative information for a prior year or years only in total rather than by net asset class. If reporting on comparative financial statements, the auditor should consider paragraph 74 of SAS No. 58, which states the following:

> The fourth standard of reporting requires that an auditor's report contain either an expression of opinion regarding the financial statements *taken as a whole* or an assertion to the effect that an opinion cannot be expressed. Reference in the fourth reporting standard to the financial statements *taken as a whole* applies not only to the financial statements of the current period but also to those of one or more prior periods that are presented on a comparative basis with those of the current period. Therefore, a continuing auditor should update his report on the individual financial statements of the one or more prior periods presented on a comparative basis with those of the current period.

[1] As discussed in chapter 3, a not-for-profit organization may present an intermediate measure of operations within the statement of activities. As noted in chapter 3, however, if an intermediate measure of operations is reported, it must be in a financial statement that, at a minimum, reports the change in unrestricted net assets for the period. Such a statement would, therefore, ordinarily present more than merely the "results of operations."

Footnote 27 to paragraph 74 of SAS No. 58 states the following:

> A continuing auditor need not report on the prior-period financial statements if only summarized comparative information of the prior period(s) is presented. For example, entities such as state and local governmental units and not-for-profit organizations frequently present total-all-funds information for the prior period(s) rather than information by individual funds because of space limitations or to avoid cumbersome or confusing formats. In some circumstances, the client may request the auditor to express an opinion on the prior period(s) as well as the current period. In those circumstances, the auditor should consider whether the information included for the prior period(s) contains sufficient detail to constitute a fair presentation in conformity with generally accepted accounting principles. In most cases, this will necessitate including additional columns or separate detail by fund, or the auditor would need to modify his report.

14.04 Though FASB Statement No. 117 does not require fund reporting, it does require, however, that certain basic information, such as reporting net assets and changes in net assets by net asset class, be provided. **If the prior year(s) financial statements include the minimum information required by FASB Statement No. 117 and this Guide, the financial statements are not summarized information. Accordingly, the auditor should report on them.**

14.05 As noted in paragraph 3.21, if the comparative financial information is summarized and does not include the minimum information required by FASB Statement No. 117 and this Guide — for example, if the statement of activities does not present revenues, expenses, gains, and losses by net asset class — certain disclosures about the nature of the information presented are required. If the required disclosures about the nature of that information are omitted or are incomplete, the auditor ordinarily should add a paragraph to his or her report calling the omitted or incomplete disclosure to the readers' attention. Such a paragraph might include the same wording that appears in the illustrative note presented as an example in paragraph 3.22 of this Guide. To reduce the likelihood that a reader might misinterpret such a paragraph to be a qualified opinion on the current period financial statements, the paragraph should follow the opinion paragraph and should not be referred to in either the scope or opinion paragraphs of the auditor's report.

UNQUALIFIED OPINIONS

14.06 The auditor's standard report contains an opinion that the financial statements are presented fairly, in all material respects, in conformity with GAAP. That conclusion may be expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with GAAS. The form of the auditor's standard report on financial statements covering a single year is as follows:

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

> We have audited the accompanying balance sheet of XYZ Not-for-Profit Organization as of September 30, 19XX, and the related statements of activities and cash flows for the year then ended.[2] These financial statements are the responsibility of XYZ Not-for-Profit Organization's

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[2] **Each of the statements presented, which may include a statement of functional expenses, should be identified in the introductory paragraph.**

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 Not-for-Profit Organization as of September 30, 19XX, and the changes in its net assets and its cash flows for the year then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

MODIFIED REPORTS AND DEPARTURES FROM UNQUALIFIED OPINIONS

14.07 SAS No. 58 indicates the circumstances in which an explanatory paragraph should be added following the standard opinion paragraph for (a) material uncertainties and (b) changes in accounting principles or in their method of application that have a material effect on the comparability of financial statements. The Statement also provides examples of auditors' reports in these circumstances. In addition, SAS No. 58 indicates circumstances in which departures from GAAP and limitations on the scope of the audit would require a qualified opinion, an adverse opinion, and a disclaimer of opinion, and provides examples of auditors' reports in those circumstances. Examples of possible departures from GAAP that an auditor of a not-for-profit organization's financial statements might encounter include the organization's failure to (a) recognize or appropriately measure promises to give, contributed services, or depreciation on plant and equipment in conformity with GAAP, and (b) provide information about expenses reported by their functional classification. **The auditor's inability to obtain sufficient competent evidential matter to audit (a) contributed services that the organization has recorded or (b) receivables and revenues from fund-raising activities is an example of possible restrictions on the scope of the audit that an auditor of a not-for-profit organization's financial statements might encounter.**

14.08 SAS No. 59 indicates circumstances in which an explanatory paragraph should be added following the standard opinion paragraph because the auditor has substantial doubt about the organization's ability to continue as a going concern for a reasonable period of time not to exceed one year beyond the date of the balance sheet. SAS No. 59 also provides guidance on reporting in that situation, including an example of an explanatory paragraph (following the opinion paragraph) in the auditor's report describing an uncertainty about the entity's ability to continue as a going concern. Paragraph 2.46 of this Guide contains examples of conditions or events that are particularly applicable to not-for-profit organizations and that might indicate that there could be substantial doubt about the organization's continued existence.

REPORTING ON SUPPLEMENTARY INFORMATION

14.09 Footnote 6 to paragraph 27 of FASB Statement No. 117 states the following:

> Information about an organization's major programs (or segments) can be enhanced by reporting the interrelationships of program expenses and program revenues. . . . Related nonmonetary information about program inputs, outputs, and results also is helpful. . . . Generally, reporting that type of information is feasible only in supplementary information or management explanations or by other methods of financial reporting.

14.10 Although nonmonetary information about an organization's activities and programs may be informative and helpful to users of the financial statements, this information is not necessary for fair presentation of financial position, changes in net assets, or cash flows on which the auditor is reporting. In addition, this information may not be obtained from accounting records that are subject to the internal control structure policies and procedures of the organization's accounting system or derived directly from such accounting records by analysis or computation. **Accordingly, this information should not be included in the financial statements (including the related notes). Paragraph 46 of SAS No. 58 suggests that if information that is not necessary for a fair presentation is included in the financial statements (including the related notes), such information may be identified as *unaudited* or *as not covered by the auditor's report*, in which case the auditor should not comment on it or otherwise be associated with it.**

BASES OF ACCOUNTING OTHER THAN GAAP

14.11 Some not-for-profit organizations may find that financial statements prepared on the cash basis or the modified cash basis of accounting are adequate for their governing boards and other users. SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623), describes the auditor's reporting requirements when the financial statements are prepared on a comprehensive basis of accounting other than generally accepted accounting principles (OCBOA), including the cash receipts and disbursements basis of accounting and modifications of the cash basis having substantial support.[3]

14.12 SAS No. 62 also permits an auditor to issue a special report on financial statements that have been prepared in conformity with the requirements or financial reporting provisions of a governmental regulatory agency but that do not conform with GAAP or constitute OCBOA. In that instance, the auditor's report should include a paragraph that restricts the distribution of the report solely to persons within the organization and for filing with the regulatory agency. Such a restrictive paragraph is appropriate, even though by law or regulation the auditor's report may be made a matter of public record. The auditor may use this form of report, however, only if the financial statements and report are intended solely for filing with the regulatory agency to whose jurisdiction the organization is subject.

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[3] The accrual basis of accounting is required by GAAP for a fair presentation of financial position, changes in net assets, and cash flows. Financial statements presented on the cash receipts and disbursements basis of accounting or using modifications of the cash basis having substantial support may be considered to present financial position, changes in net assets, and cash flows in conformity with GAAP only if they do not differ materially from financial statements prepared on an accrual basis.

REPORTING ON PRESCRIBED FORMS

14.13 Some not-for-profit organizations prepare financial reports using forms prescribed by an affiliated organization. The auditor should review these forms and any accompanying preprinted auditor's report for compliance with GAAP and GAAS. If the financial statements prepared using the prescribed form do not conform with GAAP, either the auditor can attach a separate set of financial statements and report on them, or he or she can issue a report on the prescribed form but include a restriction on its distribution, as discussed above. If the auditor considers the preprinted auditor's report inappropriate, he or she should prepare a separate report. When a separate report is used, the auditor should consider inserting language such as "See attached independent auditor's report" in the space provided for the auditor's signature on the preprinted form.

14.14 Internal Revenue Service (IRS) Form 990, *Return of Organizations Exempt from Income Tax*, may be used in some states as an annual report by not-for-profit organizations for reporting to both state and federal governments. Many states require an auditor's opinion on the financial statements included in an IRS Form 990. An auditing interpretation of SAS No. 62 (AICPA, *Professional Standards*, vol. 1, AU sec. 9623.47–.54) provides guidance on reporting on financial statements included in Form 990. (Paragraph 9623.54 of that Interpretation may no longer be relevant as a result of the issuance of FASB Statement Nos. 116 and 117.)

REPORTS REQUIRED BY GOVERNMENT AUDITING STANDARDS AND OMB CIRCULAR A-133

14.15 The Yellow Book and OMB Circular A-133 broaden the auditor's responsibility to include reporting on not only an organization's financial statements but also its internal control structure and its compliance with laws and regulations. SOP 92-9 describes and illustrates the required reports.

Chapter 15

TAX CONSIDERATIONS

INTRODUCTION

15.01 This chapter discusses certain tax considerations relevant to not-for-profit organizations. It does not contain a detailed discussion of the IRC and of rulings that have been issued by the IRS and that apply to not-for-profit organizations, nor is it intended as a substitute for appropriate research in resolving tax issues.

15.02 Not-for-profit organizations and their auditors should be aware of relevant federal and state tax laws and regulations and their potential impact on the organization and its financial statements. An organization's failure to maintain its tax-exempt status could have serious tax consequences and affect both its financial statements and related disclosures, and it could possibly require modification of the auditor's report. Failure to comply with tax laws and regulations could be an illegal act that may, as discussed in chapter 2, "General Auditing Considerations," of this Guide, have either a direct and material effect on the determination of financial statement amounts (for example, the result of an incorrect accrual for taxes on unrelated business income) or a material indirect effect on the financial statements that would require appropriate disclosures (for example, the result of a potential loss of tax-exempt status).

BASIS OF EXEMPTION

15.03 The IRS determines whether an organization qualifies for exemption from federal income tax. The following are some of the more common types of tax-exempt organizations:

- Corporations, united funds, other funds, and foundations organized and operated (a) exclusively for religious, charitable, scientific, testing-for-public-safety, literary, or educational purposes, (b) to foster national or international amateur sports competition, or (c) for the prevention of cruelty to children or animals

- Civic leagues, organizations operated exclusively for the promotion of social welfare, and certain local associations of employees

- Labor, agricultural, and horticultural organizations

- Business leagues, chambers of commerce, real estate boards, boards of trade, and professional football leagues, that are not organized for profit

- Clubs organized for pleasure, recreation, and other not-for-profit purposes

15.04 Exemptions from state and local sales, real estate, and other taxes vary from state to state. Organizations are generally subject to the laws of the state of incorporation as well as the laws of states in which they conduct significant activities. Each state's laws govern exemption from its taxes and should be consulted for the applicable definitions and requirements.

15.05 Tax exemption is a privilege and not a right. At the federal level, the IRS has the authority to revoke exemptions for any one of several reasons. Furthermore, individual states have regulatory bodies that oversee not-for-profit organizations and that can revoke their state tax-exempt status without regard to their federal tax-exempt status and even prevent them from operating. There are many potential threats to an organization's federal tax-exempt status, of which the following are particularly important:

- Material changes in the organization's character, purpose, or method of operation
- Private inurement
- Private benefit
- Commerciality
- Lobbying
- Political campaign activities
- Unrelated business income
- Failure of the organization to meet the commensurate test
- Violation of public policy by the organization

15.06 The IRS has held that an organization must reapply for tax-exempt status if there is a material change in its character, purpose, or method of operation. Examples include changes in legal structure (such as from a trust to a corporation), the state of incorporation, and the services performed (such as a change to performing services that are substantially unrelated to the purpose for which the organization was granted tax exemption).

15.07 Not-for-profit organizations are generally not permitted to make distributions to those who control or support them financially. IRS rules regulate transactions between a not-for-profit organization and *insiders*. Insiders are individuals with a personal or private interest in the organization, such as board members, officers, certain employees, and substantial contributors. Transactions between insiders and not-for-profit organizations are permitted, but the organization has the burden of proving that the transactions do not result in private inurement. The organization must be able to satisfy the IRS that the transaction was reasonable, was adequately documented, had independent approval, and did not violate any law or regulation. Employee compensation can create an inurement problem if it is judged to be "unreasonably high."

15.08 The concept of private benefit prohibits a not-for-profit organization from benefitting the private interests of any specific individual or group — both insiders and outsiders. The organization should have sound policies for transactions with both insiders and outsiders, and these policies should document that the transactions were appropriate and were approved by disinterested parties.

15.09 A not-for-profit organization cannot qualify for tax exemption, or can have its tax-exempt status revoked, if it is, in reality, a commercial enterprise. Engaging in commercial activity, however, does not *per se* disqualify the organization from tax-exempt status unless the commercial activity becomes the organization's primary purpose. A gray area exists between commercial and noncommercial activities. To avoid problems with commerciality, many not-for-profit organizations have found it advantageous to create separate for-profit subsidiaries.

15.10 The IRC allows public charities (but not private foundations) to lobby to influence federal, state, and local legislation (including initiatives and referenda), but it places limits on how much lobbying they can do. Membership organizations that are granted tax-exempt status under IRC Section 501(c)(3) and lobby are required to make complex disclosures to their members or pay a proxy tax.

15.11 Public charities are prohibited from engaging in partisan political campaign activities. Prohibited political activities include contributing to candidates or political organizations, including, for example, in-kind contributions of services, publicity, advertising, paid staff time, facilities, and office space. Also prohibited are evaluating candidates and their positions on specific issues and encouraging voter registration for a specific political group. Permitted political activities include nonpartisan get-out-the-vote campaigns.

15.12 Not-for-profit organizations can lose their tax-exempt status if the IRS determines that too large a percentage of their income is from business activities unrelated to their specific exempt purposes. There is, however, no specific percentage of unrelated business income that can be designated as too large a percentage and as, therefore, not permissible. The facts and circumstances of each unrelated business income situation should be considered. Unrelated business income and the unrelated business income tax are discussed in more detail in paragraphs 15.17 to 15.19.

15.13 A not-for-profit organization can lose its tax-exempt status if it fails the commensurate test, which provides that the scope of the organization's programs must be commensurate with its financial resources. The test requires that an organization have a charitable program that is both real and, taking the organization's circumstances and financial resources into account, substantial. This means that fund-raising expenses and administrative expenses should not be an excessive percentage of total expenses. Although no specific payout percentage has been established and individual facts and circumstances must be considered, low levels of program spending invite IRS scrutiny.

15.14 An organization can also lose its tax exemption because it violates public policy, for example, through racial discrimination.

FEDERAL AND STATE FILING REQUIREMENTS

15.15 Most tax-exempt organizations, except public charities with less than $25,000 in gross receipts or churches, must file annual information returns with the IRS. Most states also have their own registration and filing requirements, some of which include audited financial statements. The auditor should be aware of specific state laws and regulations that specify filing and reporting requirements, but except for the discussion of related auditors' reports in chapter 14, "Reports of Independent Auditors," these are beyond the scope of this Guide.

PUBLIC CHARITIES AND PRIVATE FOUNDATIONS

15.16 The IRS considers all charitable organizations (that is, those that are tax-exempt under IRC Section 501(c)(3)), to be private foundations unless they qualify as public charities (sometimes referred to as *nonprivate foundations*) under one of several IRC tests. Private foundations are subject to more restrictions under the tax law than are public charities. These restrictions include statutory prohibitions against self-dealing, excess business holdings, jeopardy investments, and taxable expenditures. In addition, private foundations are subject to an excise tax on their net investment income and are required to make annual distributions of five percent of the average market value of their noncharitable-use assets for charitable, educational, scientific, and similar purposes. (Noncharitable-use assets are assets that are not used or held for use directly in carrying on the organization's exempt purpose; they include assets held for investment and the production of investment income.) Private foundations are also required to publish annually a notice that their annual reports are available for inspection. Public charities are exempt from federal unemployment taxes. Both public charities and private foundations may be exempt from property and sales taxes in some states.

UNRELATED BUSINESS INCOME

15.17 Unrelated business income is gross income from an unrelated trade or business less expenses "directly connected" with the unrelated trade or business, certain net operating losses, and qualified charitable contributions. An unrelated trade or business of an exempt organization is any trade or business whose conduct is not substantially related to the exercise or performance of its exempt purpose. The IRS is primarily interested in how the unrelated business income was earned, not in how it is used, even if it is used to further the organization's tax-exempt purpose. Unrelated business income is subject to federal corporate taxes on income, including the alternative minimum tax (AMT). (The first $1,000 of net unrelated business income is excluded from taxation, and corporate net operating losses and various tax credits are allowed.)

15.18 The unrelated-business-income tax requirements apply to all not-for-profit organizations except (a) corporations that have been organized under Acts of Congress and that are instrumentalities of the United States and (b) certain charitable trusts not subject to the tax on private foundations.

15.19 Income from certain specified activities that might otherwise be considered unrelated business income is excluded from taxation. For example, unrelated business income does not include dividends, interest, royalties, and gains on the sale of property (unless that property was used in an unrelated trade or business). Unrelated business income also does not include income from activities in which *substantially all* of the work is done by volunteers, income from the sale of donated merchandise, and rents from real property. However, rents from debt-financed property and rents based on a percentage of net income rather than gross income are considered to be unrelated business income.

AUDITING

15.20 As previously discussed, noncompliance with federal and state tax laws and regulations may have direct and material effects on an organization's financial statements. Noncompliance may also, possibly through the loss of the organization's tax-exempt status, have indirect effects on the statements. Since many organizations depend on their tax-exempt status for funding purposes and could lose their funding if that status was revoked, such indirect effects may also indicate that there is substantial doubt about the organization's ability to continue as a going concern.

15.21 Many audit objectives, control procedures, and auditing procedures for the tax provisions and liabilities of not-for-profit organizations are similar to those of other organizations. In addition, the auditor may need to consider the following specific audit objectives, selected control procedures, and auditing procedures that are unique to not-for-profit organizations.

AUDIT CONSIDERATIONS

Financial Statement Assertions	Specific Audit Objectives	Examples of Selected Control Procedures	Examples of Auditing Procedures
Rights and obligations	The not-for-profit organization has obtained qualifying tax exemptions from the appropriate government authorities.	Management monitors compliance with applicable tax regulations.	Ascertain whether the organization has been granted tax-exempt status. Review minutes of board meetings for changes in the organization's governing instruments that could affect its tax-exempt status. Consider the effect of new, expanded, or unusual activities on the organization's tax-exempt status.

Completeness	All liabilities and contingencies for taxes due for the current and prior years are accrued or disclosed.	Tax returns are prepared and reviewed by knowledgeable personnel.	Inquire if tax returns have been filed on a timely basis. Review tax returns or filings and related correspondence for all "open" years. Review revenue agent's reports, if any, for evidence of additional liabilities or contingencies. Review minutes of board and board committee meetings and the accounting records for evidence of significant unrelated business income. Review the reasonableness of the computation of any unrelated business income tax liability.
Presentation and disclosure	The organization's tax-exempt status and any tax contingencies are disclosed in the notes to the financial statements.		Determine whether the organization's tax-exempt status and any tax contingencies are appropriately disclosed in the notes to the financial statements.

Chapter 16

FUND ACCOUNTING

INTRODUCTION

16.01 Many not-for-profit organizations have used fund accounting both for internal recordkeeping and for external financial reporting purposes. Fund accounting segregates assets, liabilities, and fund balances into separate accounting entities associated with specific activities, donor-imposed restrictions, or objectives. FASB Statement No. 117, however, establishes a financial reporting model based on net assets, classified solely on the basis of donor-imposed restrictions, and requires not-for-profit organizations' external financial reporting to focus on aggregate information about the entity as a whole, rather than on individual funds.[1] Though fund accounting is not required by GAAP, some entities will continue to use fund accounting for internal recordkeeping purposes. Also, FASB Statement No. 117 and this Guide permit the continued disclosure, for external financial reporting purposes, of disaggregated data classified by fund groups, provided that the information required by FASB Statement No. 117 and this Guide is presented. This chapter provides an overview of fund accounting and discusses the reporting of information derived from an internal fund accounting system in conformity with the reporting requirements of the net asset model.[2,3]

FUND ACCOUNTING AND EXTERNAL FINANCIAL REPORTING

16.02 Fund accounting is a system of recording resources whose use may be limited by donors, granting agencies, governing boards, or other individuals or entities or by law. To keep records of these limitations for internal purposes, some not-for-profit organizations maintain separate funds for specific purposes. Each fund consists of a self-balancing set of asset, liability, and fund balance accounts. Before the FASB issued FASB Statement No. 117, most not-for-profit organizations prepared fund-accounting-based external financial statements by combining funds with similar characteristics into fund groups. Authoritative guidance for external financial reporting was provided by the two AICPA industry audit guides, one audit and accounting guide, and two SOPs that are superseded by this Guide.[4]

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[1] Both fund balances and net assets represent residual interests in assets less liabilities. Fund balances, however, are not the same as net asset balances.

[2] For purposes of discussing the concepts in this chapter, the discussion assumes that the provisions of paragraph 17 of FASB Statement No. 116 concerning the recognition of expirations of restrictions are applied prospectively, in conformity with paragraph 30 of Statement No. 116.

[3] The timing of recognition of changes in net assets under fund accounting and the net asset model may differ. For example, restrictions may expire under the net asset model in different periods than when expenses are reported in a fund. Accordingly, not-for-profit organizations should keep records of all transactions and events that have been recognized under one model but not the other and adjust opening fund accounting balances to amounts representing opening net assets.

[4] As noted in the preface, this guide supersedes *Audits of Voluntary Health and Welfare Organizations, Audits of Colleges and Universities* (including Statement of Position (SOP) 74-8, *Financial Accounting and Reporting by Colleges and Universities*) and *Audits of Certain Nonprofit Organizations* (including SOP 78-10).

16.03 For external financial reporting purposes, the total of all assets and liabilities included in all funds and changes in net assets should be measured and reported on a not-for-profit organization's financial statements in conformity with FASB Statement Nos. 116 and 117 and with chapters 3 through 13 of this Guide. (As stated in footnote 8 of Statement No. 117, "because receivables and payables between fund groups are not organizational assets or liabilities, a statement of financial position must clearly label and arrange those interfund items to eliminate their amounts when displaying total assets or liabilities.") Fund balances should be classified on a statement of financial position as unrestricted, temporarily restricted, or permanently restricted net assets based on the existence and type of donor-imposed restrictions.[5] For external financial reporting purposes, a fund balance may have to be divided among more than one net asset class. The remainder of this chapter describes seven commonly-used kinds of funds and discusses how their fund balances should be reported based on the requirements of FASB Statement No. 117 and this Guide.

UNRESTRICTED CURRENT (OR UNRESTRICTED OPERATING OR GENERAL) FUNDS

16.04 Unrestricted current funds (also called *unrestricted operating* or *general* funds) are used to record an organization's activities that are supported by resources over which the governing board has discretionary control. Amounts designated by governing boards for specific purposes may be included in unrestricted current funds, or those amounts may be accounted for in other funds, such as plant funds, endowment funds, and loan funds. The principal sources of unrestricted current funds are unrestricted contributions from donors; exchange transactions with members, clients, students, customers, and others; and unrestricted investment income. Resources are used to help meet the costs of providing the organization's programs and supporting services.

16.05 Fund balances of unrestricted current funds should be classified on a statement of financial position as unrestricted net assets unless donors have stipulated restrictions on the use of contributed assets that expire by passage of time. In those situations, net assets should be classified as temporarily restricted. Unrestricted fund balances that have been designated by governing bodies for specific purposes (such as *quasi-endowment*, *funds functioning as endowment*, *funds for long-term investment*, *self-insurance reserve funds*, or *future development funds*) should be classified as unrestricted net assets. Board designations are permitted to be disclosed, as discussed in chapter 3, "Basic Financial Statements," of this Guide.

RESTRICTED CURRENT (OR RESTRICTED OPERATING OR SPECIFIC-PURPOSE) FUNDS

16.06 Restricted current funds (also called *restricted operating* or *specific-purpose* funds) are used to record an organization's activities that are supported by resources whose use is limited by external parties to specific operating purposes. The principal sources of restricted current funds are contributions from donors; contracts, grants and appropriations; endowment income; and other sources where resource providers have stipulated the specific operating purposes for which the resources are to be used.

16.07 Fund balances of restricted current funds represent net assets held for specified operating activities that have not yet been used. The portion of the fund balances, if any, that represents amounts contributed with donor-imposed restrictions should be classified as temporarily restricted net assets. Fund balances representing amounts received with limitations other than donor-

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[5] Accounting for contributions received with donor-imposed restrictions is discussed in paragraphs 5.29 to 5.37 of this Guide.

imposed restrictions, such as contractual limitations, should be classified as unrestricted net assets. Any portion of the fund balances that represents unearned revenue resulting from exchange transactions should be classified as a liability.

PLANT (OR LAND, BUILDING, AND EQUIPMENT) FUNDS

16.08 Some not-for-profit organizations record plant and equipment (and resources held to acquire them) in a plant (or land, building, and equipment) fund or funds. A plant fund may be a single group of accounts or may be subdivided into some or all of the following subfund account groups:

- Unexpended plant funds
- Funds for renewal and replacement
- Funds for retirement of indebtedness
- Investment (or net investment) in plant

16.09 Unexpended plant fund balances and renewals and replacement fund balances represent net assets that have not yet been used to acquire, renew, and replace plant and equipment. Retirement-of-indebtedness fund balances represent net assets held to service debt related to the acquisition or construction of plant and equipment. The portion of those fund balances that represents amounts received with donor-imposed restrictions should be classified in a statement of financial position as temporarily restricted or permanently restricted net assets, depending on the nature of the restrictions. Other fund balances, including those arising under agreements with trustees under bond indentures and those designated by the organization's governing board for the purchase, construction, renewal, or replacement of property and equipment, should be classified as unrestricted net assets.[6]

16.10 Investment-in-plant fund balances represent assets invested in property and equipment less any liabilities related to those assets. These fund balances should be classified as permanently restricted net assets to the extent that (1) donors have imposed restrictions on the assets' use that neither expire by passage of time nor can be fulfilled or removed by actions of the organization — for example, land that must be held in perpetuity — or (2) the proceeds from the ultimate sale or disposal of contributed assets must be reinvested in perpetuity. Amounts representing property and equipment donated or acquired with donor-imposed restrictions that expire by passage of time or that can be fulfilled or removed by actions of the organization should be classified as temporarily restricted net assets. Amounts representing gifts of property and equipment received without donor-imposed restrictions about how long the assets must be used should be classified as either unrestricted or temporarily restricted net assets, depending on the accounting policy adopted by the organization.[7] Amounts representing property and equipment acquired with unrestricted resources or with resources whose use is limited by parties other than donors should be classified as unrestricted net assets. Significant limitations on the use of property and equipment should be described in notes to the financial statements.[8]

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[6] Board designations and other limitations on the use of unrestricted net assets stipulated by entities other than donors can be described on the face of the financial statements or in the notes. Paragraph 3.07 of this Guide discusses such disclosures.

[7] Paragraph 9.05 of this Guide discusses alternative accounting policies concerning the contribution of long-lived assets received without donor-imposed restrictions.

[8] Examples of these disclosures are provided in paragraph 9.12 of this Guide.

LOAN FUNDS

16.11 Some not-for-profit organizations use loan funds to account for loans made to students, employees, and other constituents and resources available for those purposes. The assets initially made available for the loans may be provided by donors or various governmental and other granting agencies or designated by governing boards. These organizations or individuals may also stipulate qualifications for individual borrowers. Some loan funds are self-perpetuating — that is, the principal and interest repayments on outstanding loans are used to make additional loans. Other loan funds are created on a temporary basis, and the original resource providers must be repaid. In some situations, repayments may be forgiven by resource providers if certain conditions are met.

16.12 Fund balances of loan funds represent net assets available for lending. The portion of the fund balances representing net assets restricted by donors in perpetuity for use in making loans (for example, a revolving fund) should be classified as permanently restricted. The portion of the fund balances representing net assets temporarily restricted by donors (for example, if, each year, a portion of the fund may be used for the unrestricted purposes of the organization) should be classified as temporarily restricted. Amounts that have been designated by governing boards to be used as loan funds, such as amounts designated as matching funds for government loan programs (for example, government loans to students that require colleges and universities to match a portion of those loans) and other amounts used for loans that have not been restricted by donors, should be classified as unrestricted net assets. Any portion of loan fund balances that represents refundable advances, such as under a government loan program, should be reported as a liability.

ENDOWMENT FUNDS

16.13 Some not-for-profit organizations record cash, securities, or other assets held to provide income for the maintenance of the organization in an endowment fund or funds. Three kinds of endowment may be identified: permanent endowment; term endowment; and quasi endowment, or funds functioning as endowment. *Permanent endowment* refers to amounts that have been contributed with donor-specified restrictions that the principal be invested in perpetuity; income from those investments may also be restricted by donors. *Term endowment* is similar to permanent endowment, except that at some future time or upon the occurrence of a specified future event, the resources originally contributed become available for unrestricted or purpose-restricted use by the entity. *Quasi endowment* refers to resources designated by an entity's governing board to be retained and invested for specified purposes for a long but unspecified period.

16.14 Fund balances of endowment funds represent net assets for which various limitations exist on the use of the resources invested and, in some cases, on the income generated by those resources. Amounts that represent net assets restricted by donors in perpetuity should be classified as permanently restricted. If donor-imposed restrictions exist that preclude the use of gains and losses (net appreciation) on permanent endowment, either as a result of explicit or implicit donor stipulation or by the organization's interpretation of the relevant law, those gains and losses should also be classified as permanently restricted. In the absence of such restrictions, those gains and losses should be classified as unrestricted or temporarily restricted, depending on the existence or absence of temporary restrictions imposed by the donor.

16.15 Fund balances that represent term endowments for which the principal must be maintained for a specific period or must be used at the end of the term for a specified purpose should be classified as temporarily restricted net assets. Amounts representing resources that will be permanently restricted at the end of a specified term should be classified as permanently restricted net assets.

16.16 Fund balances that represent quasi endowments or other amounts designated by the organization's governing board should be classified as unrestricted net assets unless donor-imposed restrictions exist on their use. Paragraph 11.12 of this Guide permits separate disclosure, on the face of the financial statements or in the notes, of significant limitations on the use of net assets imposed by governing boards.

ANNUITY AND LIFE-INCOME (SPLIT-INTEREST) FUNDS

16.17 Annuity and life-income (or split-interest) funds may be used by not-for-profit organizations to account for resources provided by donors under various kinds of agreements in which the organization has a beneficial interest in the resources but is not the sole beneficiary. These agreements include charitable lead and remainder trusts, charitable gift annuities, and pooled (life) income funds. Split-interest agreements are discussed in chapter 6, "Split-Interest Agreements."

16.18 Fund balances of annuity and life-income funds represent a not-for-profit organization's beneficial interest in the resources contributed by donors under split-interest agreements. Any portion of the fund balances representing amounts that will become part of permanent endowment when the agreements terminate should be classified as permanently restricted net assets. Any portion of the fund balances representing amounts that will be available for restricted purposes, or available for unrestricted use, by the entity when agreements terminate should be classified as temporarily restricted net assets. Any portion of the fund balances representing amounts that are available for unrestricted purposes should be classified as unrestricted net assets.

AGENCY (OR CUSTODIAN) FUNDS

16.19 Agency (or custodian) funds are used by not-for-profit organizations to account for resources held by the entity as an intermediary or fiscal agent for resource providers before those resources are transferred to third-party recipients specified by the resource providers. The entity has little or no discretion over the use of those resources. Accounting for agency transactions and distinguishing agency transactions from contributions are discussed in chapter 5, "Contributions Received and Agency Transactions." Because the assets and liabilities are always equal in agency funds, no net assets are reported.

SUMMARY

16.20 The following exhibit summarizes the net asset classes into which various kinds of fund balances will typically be classified.

TYPICAL CLASSIFICATION OF FUND BALANCES

----------------------------------Net Asset Class-----------------------------------

Fund Type	Permanently Restricted	Temporarily Restricted	Unrestricted
Unrestricted Current (or Unrestricted Operating or General)	Not applicable	Contributions with donor-imposed restrictions that expire with the passage of time (not usually present in unrestricted current funds)	Unrestricted fund balances, including those designated by governing bodies for specific purposes
Restricted Current (or Restricted Operating or Specific Purpose)	Not applicable	Contributions with donor-imposed restrictions that expire with the passage of time or that can be fulfilled or removed by actions of the organization	Unrestricted fund balances, including those designated by governing bodies for specific purposes[9]
Plant (or Land, Building, and Equipment)	Contributions with donor-imposed restrictions that do not expire with the passage of time or cannot be fulfilled or removed by actions of the organization.[10]	Contributions with donor-imposed restrictions that expire with the passage of time or that can be fulfilled or removed by actions of the organization[11]	Unrestricted fund balances, including those designated by governing bodies for specific purposes[12]

[9] Any portion of the fund balances representing unearned revenue from exchange transactions should be classified as a liability.

[10] This would include contributed assets such as land and capitalized collection items that must be held in perpetuity and other contributed assets when donors have stipulated that the proceeds from their ultimate sale or disposal must be reinvested in perpetuity.

[11] Amounts representing assets contributed without donor-imposed restrictions about how long the land, building, or equipment must be used should be classified as unrestricted or temporarily restricted net assets, depending on the accounting policy adopted by the organization.

[12] Amounts representing assets contributed without donor-imposed restrictions about how long the land, building, or equipment must be used should be classified as unrestricted or temporarily restricted net assets, depending on the accounting policy adopted by the organization.

Loan	Contributions with donor-imposed restrictions that do not expire with the passage of time or can not be fulfilled or removed by actions of the organization	Contributions with donor-imposed restrictions that expire with the passage of time or that can be fulfilled or removed by actions of the organization.	Unrestricted fund balances, including those designated by governing bodies for specific purposes
Endowment	Permanent endowment[13]	Temporary (or term) endowment[14]	Quasi endowment[15]
Annuity and Life-Income (Split Interests)	Donor-restricted in perpetuity	Amounts available for unrestricted or time-or-purpose restricted use when agreement terminates	Unrestricted fund balances, including those designated by governing bodies for specific purposes
Agency (or Custodian)	Not applicable	Not applicable	Not applicable

[13] Includes gains and losses on permanent endowment when donor restrictions or law permanently preclude their use.

[14] Includes gains on permanent endowment when donor restrictions or law specify their use.

[15] Includes gains on permanent endowment when donors or laws do not restrict or specify their use.