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Interpretation and Application of GENERALLY ACCEPTED ACCOUNTING PRINCIPLES for Not-for-Profit Organizations

Richard F. Larkin
Marie DiTommaso

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Published by John Wiley & Sons, Inc., Hoboken, New Jersey.

Published simultaneously in Canada.

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ISBN: 978-0-470-92402-0 (paperback); 978-1-118-22135-8 (ebk); 978-1-118-23517-1 (ebk); 978-1-118-25981-8 (ebk)

PREFACE

Not-for-profit accounting is a specialized field of accounting that is receiving a growing level of attention. Over one million not-for-profit organizations currently operating in the United States have unique accounting and financial reporting issues that must be understood by a growing number of not-for-profit organization financial statement preparers and users.

The Financial Accounting Standards Board (FASB) has issued a series of statements and accounting standards updates that have significantly affected how not-for-profit organizations account for and report their activities and financial position. The overall financial statement format reports "net assets" instead of fund balance or other description of "equity," and the accounting principles for two key areas for these organizations—contributions and investments—were the topics of separate FASB pronouncements. The American Institute of Certified Public Accountants (AICPA) issued a pronouncement specifying how not-for-profit organizations should account for the joint costs of activities that include fund-raising. The FASB has also issued a statement detailing the accounting for resources which a not-for-profit organization passes through to another organization. The FASB has also finalized the accounting requirements that will apply when two not-for-profit organizations combine, and has also provided guidance for reporting endowments. The FASB has also been active in many areas that affect a broad range of business and other organizations, including not-for-profit organizations. For example, financial instruments, asset impairments, intangible assets, pension obligations, and fair value measurements have all been areas that have been impacted by recent FASB pronouncements. All of these topics are examined in detail in this book.

This year’s edition incorporates the codification of accounting standards into the FASB Accounting Standards Codification (the “Codification”). The FASB essentially eliminated the statements on standards and other accounting literature and replaced them with the FASB ASC, which will be frequently updated as the means of promulgating changes in generally accepted accounting principles.

Despite the steady stream of accounting pronouncements that affect not-for-profit organizations, it’s important to understand that accounting standards setting has been influenced by a great deal of recent change. The Sarbanes-Oxley Act of 2002 created the Public Company Accounting Oversight Board (PCAOB) which has responsibility for setting auditing and other standards for public companies. Even with all of the new requirements and changes, the FASB continues to set generally accepted accounting principles for both public and nonpublic entities, including not-for-profit organizations. However, the FASB’s agenda has continued to focus more on issues affecting public companies, which has likely been influenced by the changes in the regulatory environment and issues highlighted by the numerous accounting shortcomings, and more recently by the turmoil being experienced in the financial markets. The AICPA, through technical practice aids, industry risk alerts, and accounting and auditing guides, continues to be an important contributor to the body of accounting principles used by not-for-profit organizations.

This book is designed as a complete and easy-to-use reference guide for financial statement preparers and users, as well as for auditors of not-for-profit organizations. It focuses on three key areas.

- Distinguishing characteristics of not-for-profit organizations and their financial accounting and reporting

- Accounting areas that are unique to not-for-profit organizations
- General areas of accounting that are applicable to the accounting and financial reporting of not-for-profit organizations

This book would not have been possible without the hard work and efforts of several individuals. John DeRemigis and Judy Howarth of John Wiley & Sons, Inc. provided overall direction in developing the concept for the book and seeing it through to completion. Pam Reh contributed greatly to the production efforts. The authors are greatly appreciative of their efforts.

Richard F. Larkin, CPA

Marie DiTommaso

December 2011

ABOUT THE AUTHORS

Richard F. Larkin is technical director of not-for-profit accounting and auditing for BDO USA, LLP, in Bethesda, Maryland. Previously he was the technical director of the Not-for-Profit Industry Services Group in the national office of PricewaterhouseCoopers. He is a certified public accountant with over forty years of experience serving not-for-profit organizations as independent accountant, board member, treasurer, and consultant. He teaches, speaks, and writes extensively on not-for-profit industry matters and is active in many professional and industry organizations. He has been a member of the Financial Accounting Standards Board Not-for-Profit Advisory Task Force and the AICPA Not-for-Profit Organizations Committee, and chaired the AICPA Not-for-Profit Audit Guide Task Force. He participated in writing both the third and fourth editions of *Standards of Accounting and Financial Reporting for Voluntary Health and Welfare Organizations*, and the AICPA Practice Aid, *Financial Statement Presentation and Disclosure Practices for Not-for-Profit Organizations*. He graduated from Harvard College and has an MBA from Harvard Business School. He is a coauthor of the fourth, fifth, and sixth editions of *Financial and Accounting Guide for Not-for-Profit Organizations*, which were published by John Wiley & Sons, Inc.

Marie DiTommaso has thirty years of experience in accounting and financial reporting in both the not-for-profit and commercial accounting environments. She began her career with KPMG after graduating from Queens College of the City University of New York. Later in her career, she joined the American Express Company and then Dun & Bradstreet Corporation, both to develop, write, and implement accounting policies and procedures. After leaving these corporate organizations, Ms. DiTommaso served as the chief financial officer of a not-for-profit organization.

Ms. DiTommaso is a member of the American Institute of Certified Public Accountants. She has served as President of the Bergen County chapter of the New Jersey Women Business Owners Association, and as an advisor to its Board of Directors.

NOT-FOR-PROFIT ACCOUNTING LITERATURE

Cross-references between the FASB Accounting Standards Codification (ASC) and Previous Guidance

As more fully described in Chapter 1, the source of all authoritative generally accepted accounting principles for not-for-profit organizations is now contained in the FASB Accounting Standards Codification (ASC). The following tables cross-reference several of the more common ASC sections with the prior FASB pronouncements to assist readers in navigating the ASC.

An additional table in this section lists all of the Accounting Standards Updates ("ASUs" which amend the ASC) issued by the FASB during 2010 and 2011 (through September). Most of the ASUs will not affect the accounting and financial reporting for many, if not all, not-for-profit organizations and are not discussed in this book. However, it is important for the reader to be aware of the changes being made to the ASC so that any potential impacts of these changes can be evaluated. Where a specific ASU is addressed in a chapter of this book, that chapter is indicated in the table.

ASC–from previous:

ASC	***Subject matter***	***Previous Guidance (primarily)***
958-		
10	Overall	AAG (AICPA audit guide) Ch. 1 Para 15.04
20	Financially-interrelated entities	FAS 136
30	Split-interest agreements	AAG Ch. 6 DIG B-35
205	Presentation of financial statements	FAS 117, FSP 117-1, FAS 124
210	Balance sheet	FAS 117
225	Income statement	FAS 117, others
230	Statement of cash flows	FAS 117, AAG Ch. 3
310	Receivables	FAS 116, AAG Ch. 5 & others

ASC	***Subject matter***	***Previous Guidance (primarily)***
320	Investments–debt and equity securities	FAS 124, AAG Ch. 8
325	Investments–other	FAS 124, FSP 124-1, AAG Ch. 8
360	Property, plant, and equipment	FAS 116, FAS 93, AAG Ch. 7, 9
405	Liabilities	AAG Ch. 10, 11, 13, EITF D-089
450	Contingencies	FAS 116, AAG Ch. 10, 3
470	Debt	AAG Ch. 10
605	Revenue recognition	FAS 116, FAS 136, AAG Ch. 5
715	Compensation-retirement benefits	FAS 87, 88, 106, 132 (R) 158
720	Other expenses	FAS 117, SOP 98-2, AAG Ch. 13
805	Combinations	FAS 164
810	Consolidation	SOP 94-3, FSP 94-3-1, EITF 90-15, 96-21, ARB 51
815	Derivatives and hedging	DIG B-35
840	Leases	SOP 94-3, EITF 90-15, 96-21, 97-01

Previous–to ASC:

Previous Guidance	***Subject matter***	***ASC (primarily)***
FAS 87, 88, 106, 132(R), 158	Retirement benefits	958-715
FAS 93	Depreciation	958-360
FAS 116	Contributions	958-605
FAS 117	Financial statement presentation	958-205, 210, 225, 230, 720
FSP 117-1	Endowments	958-205
FAS 124	Investments	958-320, 325, 205
FSP 124-1	Investments	958-325
FAS 136	Pass-through gifts	958-605, 20
FAS 157	Fair value	820
FAS 164	Combinations	958-805
FIN 48	Uncertain tax positions	740-10
DIG B-35	Derivative in a split-interest	958-30, 815
SOP 94-3	Consolidation	958-810
FSP 94-3-1	Consolidation	958-810
SOP 98-2	Joint costs	958-720
AAG-NPO Chapter:		
1	Introduction	958-10
2	Auditing	(not in ASC)
3	Financial reporting	958-205, 210, 230
4	Cash	958-210
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6, DIG B-35	Split-interest	958-30, 815
7	Other assets	958-605, 360
8	Investments	958-320, 325
9	Property, plant, and equipment	958-360
10	Liabilities	958-405, 450, 720
11	Net assets	958-225
12	Exchange transactions	958-605, 310
13	Expenses	958-720, 225
14	Auditors' reports	(not in ASC)
Para. 15.04	Tax	958-10

Previous Guidance	Subject matter	ASC (primarily)
Rest of Ch. 15	Tax	(not in ASC)
16	Fund accounting	(not in ASC)

Accounting Standards Updates Issued During 2010 and 2011

ASU Number	Topic	Chapter
2010-01	Equity (Topic 505): Accounting for Distributions to Shareholders with Components of Stock and Cash—a consensus of the FASB Emerging Issues Task Force	
2010-02	Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of Subsidiary—a Scope Clarification	
2010-03	Extractive Activities—Oil and Gas (Topic 932): Oil and Gas Reserve Estimation and Disclosures	
2010-04	Accounting for Various Topic—Technical Corrections to SEC Paragraphs	
2010-05	Compensation—Stock Compensation (Topic 718): Escrowed Share Arrangements and the Presumption of Compensation	
2010-06	Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements	9, 10
2010-07	Not-for-Profit Entities (Topic 958): Not-for-Profit Entities: Mergers and Acquisitions	24
2010-08	Technical Corrections to Various Topics	
2010-09	Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements	6
2010-10	Consolidation (Topic 810): Amendments for Certain Investment Funds	
2010-11	Derivatives and Hedging (Topic 815): Scope Exception Related to Embedded Credit Derivatives	29
2010-12	Income Taxes (Topic 740): Accounting for Certain Tax Effects of the 2010 Health Care Reform Acts	
2010-13	Compensation—Stock Compensation (Topic 718): Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades—a consensus of the FASB Emerging Issues Task Force	
2010-14	Accounting for Extractive Activities—Oil & Gas—Amendments to Paragraph 932-10-S99-1	
2010-15	Financial Services—Insurance (Topic 944): How Investments Held through Separate Accounts Affect an Insurer's Consolidation Analysis of Those Investments—a consensus of the FASB Emerging Issues Task Force	
2010-16	Entertainment—Casinos (Topic 924): Accruals for Casino Jackpot Liabilities—a consensus of the FASB Emerging Issues Task Force	
2010-17	Revenue Recognition—Milestone Method (Topic 605): a consensus of the FASB Emerging Issues Task Force	9
2010-18	Receivables (Topic 310): Effect of a Loan Modification When the Loan Is Part of a Pool That Is Accounted for as a Single Asset	
2010-19	Foreign Currency (Topic 830): Foreign Currency Issues: Multiple Foreign Currency Exchange Rates	
2010-20	Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses	

ASU Number	***Topic***	***Chapter***
2010-21	Accounting for Technical Amendments to Various SEC Rules and Schedules	
2010-22	Accounting for Various Topics—Technical Corrections to SEC Paragraphs	
2010-23	Health Care Entities (Topic 954): Measuring Charity Care for Disclosure	
2010-24	Health Care Entities (Topic 954): Presentation of Insurance Claims and Related Insurance Recoveries	
2010-25	Plan Accounting—Defined Pension Plans (Topic 962): Reporting Loans to Participants by Defined Contribution Plans	
2010-26	Financial Services—Insurance (Topic 944); Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts	
2010-27	Other Expenses (Topic 720): Fees Paid to the Federal Government by Pharmaceutical Manufacturers	
2010-28	Intangibles—Goodwill and Other (Topic 350): When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts	22
2010-29	Business Combination (Topic 805): Disclosure of Supplementary Pro Forma Information for Business Combinations	24
2011-01	Receivables (Topic 310): Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20	
2011-02	Receivables (Topic 310): A Creditor’s Determination of Whether a Restructuring Is a Troubled Debt Restructuring	9
2011-03	Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements	
2011-04	Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement an Disclosure Requirements in US GAAP and IFRS	10
2011-05	Comprehensive Income (Topic 220): Presentation of Comprehensive Income	
2011-06	Other Expenses (Topic 720): Fees Paid to the Federal Government by Health Insurers	
2011-07	Health Care Entities (Topic 954): Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowances for Doubtful Accounts for Certain Health Care Entities	4
2011-08	Intangibles—Goodwill and Other (Topic 350): Testing Goodwill for Impairment	22
2011-09	Compensation—Retirement Benefits—Multiemployer Plans (Subtopic 715-80): Disclosures about an Employer’s Participation in a Multiemployer Plan	25

PART 1

OVERVIEW OF NOT-FOR-PROFIT ORGANIZATIONS

Chapter 1

OVERVIEW OF NOT-FOR-PROFIT ORGANIZATIONS

- **Perspective and Issues**
    - Key Differences between Not-for-Profit and Profit Organizations
    - Resource Use Consideration
    - Generally Accepted Accounting Principles

PERSPECTIVE AND ISSUES

Not-for-profit organizations represent a significant portion of the economy of the United States. Over one million of these organizations provide almost every conceivable type of service from education to politics, from social services to country clubs, and from religious to research organizations. The number and importance of these organizations to the overall US economy continues to grow. The Financial Accounting Standards Board (FASB) defines not-for-profit organizations by distinguishing them from profit organizations. It defines not-for-profit organizations as entities that possess the following characteristics not usually found in other organizations:

1. They receive contributions from significant resource providers who do not expect a commensurate or proportionate monetary return.
2. They operate for purposes other than to make a profit.
3. There is an absence of ownership interests like those of business enterprises.

> *NOTE: Item 1. above describes transactions that are sometimes called "nonexchange" transactions. In a typical contribution to a not-for-profit organization, the giver (donor) and the receiver (the not-for-profit organization) do not exchange items of equivalent value—the not-for-profit organization receives the majority of the value in the actual transaction. The donor compensates for this difference by obtaining value separate from the transaction, such as through a tax deduction that it is likely to receive, recognition, goodwill, or simply a good feeling about supporting a cause that the donor believes is worthwhile*.

While not-for-profit organizations share many of the same accounting principles as commercial enterprises, their accounting and financial reporting is quite unique because the focus of financial reporting for not-for-profit organizations is not on the measurement of net income. Reflecting this, and other differences, the FASB has issued some pronouncements specifically affecting the accounting and financial reporting of not-for-profits. In addition, the application of the FASB's other accounting standards to not-for-profit organizations typically requires some modification for applying those standards to not-for-profit organizations because the primary focus of financial reporting for not-for-profit organizations is not on the measurement of net income or comprehensive income.

Typically, not-for-profit organizations are controlled by boards of directors composed of individuals who generally volunteer their time. The size of not-for-profit organizations varies greatly. A small not-for-profit organization may have no paid staff; all functions may be performed by a governing board and volunteers. On the other hand, some not-for-profit organizations are quite large with hundreds or even thousands of employees, such as a university, a health-related research association, or a large cultural organization such as a museum. When a small, newly formed organization becomes large enough or complex enough in operation to require it, the board may delegate either limited or broad operating responsibility to a part-time or full-time paid executive. This executive may be given any one of many alternative titles—president, executive director, administrator, manager, etc. Regardless of the size of the not-for-profit organization, the board will usually appoint one of its own part-time volunteer members as treasurer. In most cases, the treasurer is second in importance only to the chairperson of the board because the ability of the organization to carry out its programs is based upon strong oversight and administration of its finances.

Every board member has a fiduciary responsibility for all of the affairs of the organization, including finances. While the treasurer may be charged with paying special attention to this area, this does not excuse any board member from exercising diligent oversight in the finance, as well as all other areas of operation.

> *NOTE: In many instances, the board member designated as treasurer is a businessperson who is active in both professional and community affairs and has only a limited amount of time to devote to the organization. Therefore, financial awareness from the rest of the board is necessary as is the appropriate development of a financial function within the organization that has the appropriate skill set given the size of the organization.*

The treasurer has significant responsibilities, including the following:

1. Keeping financial records
2. Preparing accurate and meaningful financial statements
3. Budgeting and anticipating financial problems
4. Safeguarding and managing the organization's financial assets
5. Complying with federal and state reporting requirements

While this list certainly is not all-inclusive, most of the financial problems the treasurer will face are associated with these five major areas.

In the public company commercial accounting environment, the role of the Board of Directors (including Board members who are part of an organization’s Audit Committee) has come under close scrutiny recently. This scrutiny has a number of different causes, but certainly the inappropriate (or perceived inappropriate) application of accounting principles by a number of these public companies can be described as one of the more important factors leading to this scrutiny.

While the circumstances receiving public attention relate primarily to public companies, not-for-profit organizations are not immune to the misapplication of accounting principles. Boards of directors, management, and independent auditors of not-for-profit organizations must be vigilant to ensure that accounting principles used are appropriate and are appropriately applied. In addition to meeting the “letter of the law” as found in various accounting standards, not-for-profit organizations must ensure that the applications of generally accepted accounting principles to their financial statements results in statements that truly do present fairly the activities and financial position of the organization.

Not-for-profit organizations that are large enough to be required by the laws and regulations of the state in which they are located to have their financial statements audited each year (or in some cases compiled or reviewed) are increasingly establishing audit committees to oversee this obligation. Generally the audit committee members represent a subgroup of the members of the board of directors, although sometimes nonboard members are invited to join audit committees.

Audit committees generally concern themselves with ensuring the integrity of the financial reporting process of the not-for-profit organization by understanding and