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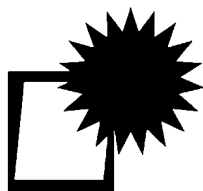
Interpretation and Application of
GENERALLY ACCEPTED
ACCOUNTING PRINCIPLES
for Not-For-Profit Organizations

Richard F. Larkin
Marie DiTommaso

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for Not-For-Profit Organizations

Richard F. Larkin
Marie DiTommaso

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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 book incorporates the codification of accounting standards into the FASB Accounting Standards Codification (the “Codification” or “FASB ASC”). The FASB essentially eliminated the statements on standards and other accounting literature and replaced them with the FASB ASC, which is 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 over the past decade 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 non-public entities, including not-for-profit organizations. However, the FASB’s agenda has focused 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. This is likely to change a bit as the FASB has established a Not-for-Profit Advisory Committee which has begun a reexamination of the reporting model used by not-for-profit organizations and has made suggestions to the FASB to improve the financial reporting of these organizations. The FASB has proposed some important changes to the financial reporting model now being used by not-for-profit organizations. These changes are contained in a proposed Accounting Standards Update, which is currently going through the FASB’s due process procedures, and is discussed in this book as well. In addition, 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. It has also finalized a significant revision of its accounting and audit guide for 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 Pam Reh contributed greatly to the production efforts over many years. The authors are greatly appreciative of their efforts as well as those of the current editorial and production teams.

Richard F. Larkin, CPA
Marie DiTommaso

October 2015

ABOUT THE AUTHORS

Richard F. Larkin is technical director of not-for-profit accounting and auditing for BDO USA, LLP, in McLean, Virginia. 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 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. References in these charts to the AICPA Audit & Accounting Guide are to the 2012 edition of the Guide. Some chapters have been rearranged in the 2013 edition.

An additional table in this section provides the reader with a list of the relatively recently issued (2013 through September 2015) Accounting Standards Updates (“ASUs” which amend the ASC) issued by the FASB. 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. Note that several ASUs beginning in 2014 are the result of consensus of the FASB’s Private Company Council, which provides a simplified method of accounting and reporting for certain transactions of private business entities. These ASUs are not applicable to not-for-profit organizations.

Where a specific ASU is addressed in a chapter of this book, that chapter is indicated in the table.

ASC—from previous:

<u>ASC</u>	<u>Subject Matter</u>	<u>Previous Guidance (primarily)</u>
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
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:

<u>Previous Guidance</u>	<u>Subject Matter</u>	<u>ASC (primarily)</u>
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:		
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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
Rest of Ch. 15	Tax	(not in ASC)
16	Fund accounting	(not in ASC)

Accounting Standards Updates Issued During 2013 through 2015 (September)

<u>ASU Number</u>	<u>Topic</u>	<u>Chapter</u>
2013-01	Balance Sheet (Topic 210): Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities	3
2013-02	Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income	
2013-03	Financial Instruments (Topic 825): Clarifying the Scope and Applicability of a Particular Disclosure to Nonpublic Entities	29
2013-04	Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation is Fixed at the Reporting Date	23
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2013-08	Investment Companies (Topic 946): Amendments to the Scope, Measurement, and Disclosure Requirements	
2013-09	Fair Value Measurement (Topic 820): Deferral of the Effective Date of Certain Disclosures for Nonpublic Employee Benefit Plans in Update No. 2011-04	
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2013-12	Definition of a Public Business Entity	1
2014-01	Investments—Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects	
2014-02	Intangibles—Goodwill and Other (Topic 350): Accounting for Goodwill—a consensus of the Private Company Council	
2014-03	Derivatives and Hedging (Topic 815): Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps—Simplified Hedge Accounting Approach—a consensus of the Private Company Council	
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2014-11	Transfers and Service (Topic 860): Repurchase-to-Maturity Transaction, Repurchase Financings, and Disclosures	
2014-12	Compensation—Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period	
2014-13	Consolidation (Topic 810) Measuring the Financial Assets and the Financial Liabilities of a Consolidated Collateralized Financing Entity	
2014-14	Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40) Clarification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure	
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<u>ASU Number</u>	<u>Topic</u>	<u>Chapter</u>
2015-13	Derivatives and Hedging (Topic 815) Application of the Normal Purchases and Normal Sales Scope Exception to Certain Electricity Contracts within Nodal Energy Markets	
2015-14	Revenue from Contracts with Customers (Topic 606) Deferral of the Effective Date	9
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PART 1

OVERVIEW OF NOT-FOR-PROFIT ORGANIZATIONS

1 OVERVIEW OF NOT-FOR-PROFIT ORGANIZATIONS

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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.

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 are 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. The governing board's involvement with setting appropriate levels of executive compensation is an area that has come under closer public and regulatory scrutiny in recent years, and is an important area for consideration in fulfilling these fiduciary responsibilities.

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 been under close scrutiny. 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 application 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. Further, some states have enacted legislation which defines certain responsibilities for boards of directors, including audit committees, covering areas such as the relationship with independent auditors, conflicts of interest policies, and other governance matters.

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. States are becoming increasingly active in requiring not-for-profit organizations to comply with prescribed governance requirements. These requirements can impact board and audit committee functions and composition.

Audit committees generally concern themselves with ensuring the integrity of the financial reporting process of the not-for-profit organization by understanding and overseeing the organization’s internal control, internal audit function (if any), financial reporting process, engaging the independent certified public accountant that will audit the financial statements, as well as reviewing the annual Form 990 filed with the Internal Revenue Service. Audit committees should have a direct relationship with the independent certified public accountant in terms of planning the audit, reviewing the results of the audit and addressing how the not-for-profit organization responds to any recommendations that the independent auditor makes as a by-product of the audit.

Key Differences between Not-for-Profit and Profit Organizations

One of the principal differences between not-for-profit and profit organizations is that they have different reasons for their existence. In oversimplified terms, it might be said that the ultimate objective of a commercial organization is to realize net profits for its owners through the provision of some product or performance of some service wanted by other people, whereas the ultimate objective of a not-for-profit organization is to meet some socially desirable need of the community or its members.

Like any organization, a not-for-profit organization should have sufficient resources to carry out its objectives. However, there is no real need or justification for “making a profit” (having an excess of revenue over expenses for a year) or having an excess of assets over liabilities at the end of a year beyond that which is needed to provide a reasonable cushion or reserve against a rainy day or to be able to take advantage of an unexpected opportunity. While a prudent board of a not-for-profit organization should plan to provide for the future, the principal objective of the board is to ensure fulfillment of the programmatic functions for which the organization was founded. A surplus or profit, per se, is only incidental. That said, larger not-for-profit organizations sometimes borrow funds, and often the lender imposes certain financial criteria as a condition for the loan (usually called debt covenants) which can make attention to reported results important.

Instead of profit, many not-for-profit organizations are concerned with the size of their cash and investment balances. They can continue to exist only so long as they have sufficient cash resources to provide for their programs. Thus the financial statements of not-for-profit organizations often emphasize the liquid financial resources of the organization. Commercial organizations are also very much concerned with cash, but if they are profitable they will probably be

able to finance their cash needs through loans or from investors. Their principal concern is profitability and this means that commercial accounting emphasizes the matching of revenues and costs.

The nature of most not-for-profit organizations' operations is that they receive most of their revenues from contributions (rather than receiving fees for services). This means of receiving revenues gives a not-for-profit organization an important fiduciary responsibility for the funds that it receives. This responsibility is why donors to a not-for-profit organization are significant users of the financial statements of not-for-profit organizations.

For example, if a customer goes into a hardware store and buys a gallon of paint for \$20, the customer really isn't concerned with what the hardware store does with the \$20 or how it controls and accounts for the money. On the other hand, when a donor puts a \$5 bill in a cash collection canister for the local children's soccer league, the donor is very interested in knowing that the \$5 actually gets to the soccer league, that most of the \$5 is spent on soccer programs instead of administrative costs, and that the \$5 is spent conservatively and appropriately (i.e., not on extravagant meals for the league's board meetings or travel to World Cup games). Many of the financial reporting principles and practices that are described throughout this book are aimed at meeting some of these very basic, but very important, needs of donors to not-for-profit organizations.

Somewhat conceptually in between a simple donation and selling a can of paint in the above example, are fees for service activities that not-for-profit organizations sometimes perform for governmental entities, often in the social services area. These services may include providing care for the developmentally disabled, educational services, or perhaps temporary housing. While the not-for-profit organization may be receiving a payment based on the number of clients served (a fee for service activity) it is almost always the case that the governmental grant or contract provider will have specific requirements that must be adhered to with respect to the use of funds, how those funds are "earned" and to the potential disallowances of costs upon audit by the government grantor or contractor.

Not-for-profit organizations also usually have a responsibility to account for specific funds that they have received. This responsibility includes accounting for certain specific funds that have been given for use in a particular project, for a particular constituency, or for a specified period of time. In some cases, donors provide not-for-profit organizations with resources in the form of an endowment, in which the not-for-profit organization must maintain the principal or corpus of the gift in perpetuity and only use the investment earnings in support of its programs. Emphasis must also be placed on accountability and stewardship of these specific types of resources in addition to the general fiduciary aspects discussed above.

Many times, not-for-profit organizations receive from donors gifts that are restricted for a specific purpose. This would sometimes require segregation of these funds in separate accounts and special financial reporting procedures.

In commercial or business enterprises, there is no such thing as a "pledge" or a contribution for something other than obtaining an ownership interest. If the business is legally owed money, that amount is recorded as an account receivable. A pledge to a not-for-profit organization may or may not be legally enforceable, or even if technically enforceable, the organization may (for public relations reasons) have a policy of not taking legal action to attempt to enforce unpaid pledges because they know from experience that they will not collect them. This represents another accounting and financial reporting challenge for not-for-profit organizations.

Resource Use Consideration

The fundamental purposes for the existence of not-for-profit organizations have a significant impact on how these organizations use their available resources and compete for new resources in the marketplace. Not-for-profit organizations often struggle to find resources to support their administrative functions because there is always a preference to spend their resources on program activities. For example, in a competitive labor market, not-for-profit organizations may find it difficult to allocate resources to attract and retain the necessary talent needed to effectively manage their operations. There are no stock option plans or performance share programs that are available to commercial enterprises to compensate a not-for-profit organization's staff. In addition, application of new technology is costly to implement and yet, in many cases, essential for existence. These factors may create a resource gap between not-for-profit organizations and commercial enterprises, particularly with smaller not-for-profit organizations.

Generally Accepted Accounting Principles

The purpose of this book is to provide the reader with information about how generally accepted accounting principles apply to not-for-profit organizations. In addition, other information related to financial activities of not-for-profit organizations is included for the reader's use, including discussions of budgeting, fund accounting, and federal tax compliance.

In June 2009 the FASB made the *FASB Accounting Standards Codification* (the *Codification*) the source of authoritative United States generally accepted accounting principles recognized by the FASB to be applied to nongovernmental entities, including not-for-profit organizations. All existing accounting and financial reporting standards (other than those promulgated by the United States Securities and Exchange Commission for public entities) were superseded. Any nongrandfathered (discussed below) non-SEC accounting literature not included in the FASB ASC is not considered authoritative. The *Codification* does contain in its SEC Sections authoritative content of the SEC related to the basic financial statements. Not-for-profit organizations which are non-public will continue to have to follow this guidance for public companies. Note that the issuance of the *Codification* has not changed any of the requirements of previously existing GAAP. It does rearrange and organize the standards to make them more available and to give the indicated standards the same level of authority in the GAAP hierarchy. Since its issuance, the *Codification* has been updated by Accounting Standards Updates (ASUs) which are issued periodically each year.

The *Codification* provides that if the guidance for a transaction or event is not specified within a source of authoritative GAAP for an entity, that entity should first consider accounting principles for similar transactions or events within a source of authoritative GAAP for that entity and then consider nonauthoritative guidance from other sources. Examples of the sources of nonauthoritative accounting guidance are provided as follows:

- Practices that are widely recognized and prevalent either generally or in the industry;
- FASB Concepts Statements;
- AICPA Issues Papers;
- International Financial Reporting Standards of the International Accounting Standards Board;
- Pronouncements of professional associations or regulatory agencies;
- Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids;
- Accounting textbooks, handbooks, and articles.

Of course, the appropriateness of the other sources of accounting guidance depends on its relevance to particular circumstances, the specificity of the guidance, the general recognition of the issuer or author as an authority, and the extent of its use in practice.

In December 2013, the FASB issued ASU 2013-12, *Definition of a Public Business Entity – an Addition to the Master Glossary*. The FASB's primary purpose in issuing ASU 2013-12 was to determine which entities would be within the scope of its *Private Company Decision-Making Framework: A Guide for Evaluating Financial Accounting and Reporting for Private Companies* (the Guide). The Guide provides a context in which the FASB began issuing certain ASUs in 2014 meant to simplify certain accounting and financial reporting requirements for private companies. In addition, the FASB has increasingly been distinguishing between public and non-public entities when establishing accounting and financial reporting standards, as well as when those standards become effective. However, no single definition of a public business entity was contained in the Codification's Master Glossary.

ASU 2013-12 d specifies that:

1. An entity that is required by the SEC to file or furnish financial statements with the SEC, or does file or furnish financial statements with the SEC, is considered a public business entity.
2. A consolidated subsidiary of a public company is not considered a public business entity for purposes of its standalone financial statements other than those included in an SEC filing by its parent or by other registrants or those that are issuers and are required to file or furnish financial statements with the SEC.
3. A business entity that has securities that are not subject to contractual restrictions on transfer and that is by law, contract, or regulation required to prepare US GAAP financial statements (including footnotes) and make them publicly available on a periodic basis is considered a public business entity.

ASU 2013-12 notes that generally, most not-for-profit organizations have received the same financial accounting and reporting alternatives within US GAAP that have been available to nonpublic business entities. Distinctions about which not-for-profit organizations would receive financial accounting and reporting alternatives within US GAAP typically have been made on the basis of whether the not-for-profit organization has public debt securities, including conduit debt.

ASU 2013-12 specifically excludes all not-for-profit organizations from the definition of public business entity so that a public versus nonpublic distinction will no longer be made between not-for-profit organizations in future standard setting. Instead, the FASB will consider factors such as user needs and not-for-profit organizations, resources, on a standard-by-standard basis, when determining whether all, none, or only some not-for-profit organizations will be eligible to apply financial accounting and reporting alternatives within GAAP for private companies. All employee benefit plans are also excluded from the definition of public business entity in a manner similar to not-for-profit organizations as described above.

This can be summarized as follows: Not-for-profit organizations are not included in the new definition of public business entities, however, they cannot use the private company framework accounting standards unless the FASB specifically says they can in each ASU that is issued.

Also of note is that prior definitions of public entities in existing standards are still applicable to those standards. Hence, not-for-profit organizations previously subject to a requirement because they were considered public entities (usually because they were conduit debt obligors) are still subject to those requirements. The new definition is not retroactive.

OBSERVATION: In April 2015 the FASB issued an Exposure Draft of a Proposed Accounting Standards Update entitled *Not-for-Profit Entities* (Topic 958) and *Health Care Entities* (Topic 954) *Presentation of Financial Statements of Not-for-Profit Entities*. This proposed ASU is the result of a complete re-examination of the financial reporting model currently used by not-for-profit organizations. The amendments in this proposed Update would change several of the requirements for financial statements and notes in Topic 958, *Not-for-Profit Entities*, as well as certain requirements in Topic 954, *Health Care Entities*.

The main provisions are as follows:

1. The statement of financial position would report amounts for two classes of net assets at the end of the period—*net assets with donor restrictions* and *net assets without donor restrictions*, rather than for the currently required three classes. The statement of activities would report the amount of the change in each of the two classes of net assets rather than that of the currently required three classes.
2. The statement of activities would report two additional amounts (subtotals) of the operating activities that are associated with changes in *net assets without donor restrictions*. Those subtotals would reflect *operating activities for the period*, which would be distinguished from *other activities* on the basis of whether the resource inflows and outflows are from or directed at carrying out a not-for-profit organization's purpose for existence and available for current-period operating activities.
3. The statement of cash flows would be prepared using the direct method of reporting and would classify certain cash flows differently than how they are classified under current guidance, as follows:
 - a. Classify as operating cash flows (rather than as investing cash flows)—those cash flows resulting from (1) purchases of long-lived assets, (2) contributions restricted to acquire long-lived assets, and (3) sales of long-lived assets.
 - b. Classify as financing cash flows (rather than as operating cash flows)—those cash flows resulting from payments of interest on borrowings, including cash management activities.
 - c. Classify as investing cash flows (rather than as operating cash flows)—those cash flows resulting from receipts of interest and dividends on loans and investments other than those made for programmatic purposes.
4. Provide enhanced disclosures about the following:
 - a. Governing board designations, appropriations, and similar transfers that result in the addition or removal of self-imposed limits on the use of resources without donor-imposed restrictions.
 - b. Composition of net assets with donor restrictions at the end of the period and how the restrictions affect the use of resources.
 - c. Management of liquidity and quantitative information as of the reporting date about financial assets available to meet near-term demands for cash, including demands resulting from near-term financial liabilities.
 - d. Expenses, including amounts for operating expenses by both their nature and function. That information could be provided on the face of the statement of activities, as a separate statement, or in notes to financial statements.
 - e. Method(s) used to allocate costs among program and support functions.

- f. Underwater endowment funds, which are donor-restricted endowment funds for which the fair value of the fund is less than either the original gift amount or the amount required to be maintained by the donor or law. In addition to disclosing the currently required aggregate amount by which funds are underwater, a not-for-profit organization would be required to disclose the aggregate of the original gift amounts (or level required by donor or law) for such funds and any governing board policies or decisions to spend or not spend from such funds. In addition, a not-for-profit organization would classify the amount by which the endowment is underwater in net assets with donor restrictions rather than in the current unrestricted net asset category.
5. Use the placed-in-service approach for reporting expirations of restrictions on gifts of cash or other assets to be used to acquire or construct a long-lived asset, thus eliminating the option to release the donor-imposed restriction over the estimated useful life of the acquired asset.
6. Report investment income net of external and direct internal investment expenses.

The FASB has received many comment letters on the proposed ASU and has indicated that it may need to re-examine certain areas of the proposed changes based upon this feedback. For example, some commentators noted that while preparing a cash flow statement on the direct method may be superior to the indirect method, there is nothing particular to not-for-profit organizations that should make them have a different requirement than private companies. Accordingly, readers should be aware that the proposed changes summarized above may well change by the time a final ASU is issued.

2 CASH VERSUS ACCRUAL BASIS ACCOUNTING

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PERSPECTIVE AND ISSUES

Although most of the medium-sized and larger not-for-profit organizations keep their records on an accrual basis of accounting, many smaller organizations still keep their records on the cash basis of accounting. The purpose of this chapter is to illustrate both bases of accounting and to discuss the advantages and disadvantages of each. For financial reporting in accordance with generally accepted accounting principles, the accrual basis of accounting must be used. However, the cash basis of accounting is a recognized “special purpose framework” of financial reporting and an independent auditor may opine on cash-basis statements as long as the statements (and the auditor’s opinion letter) clearly indicate that the cash-basis financial statements are not presented in accordance with generally accepted accounting principles. The cash-basis financial statements should also provide a description of the cash basis of accounting, including a summary of significant accounting policies, and how those policies differ from GAAP, include disclosures similar to those required by GAAP and any additional disclosures that may be necessary to achieve a fair presentation. Recently revised auditing standards refer to “other comprehensive bases of accounting”, such as the cash basis, as special purpose financial reporting frameworks.

CONCEPTS, RULES, AND EXAMPLES

Perhaps the easiest way to fully appreciate the differences between cash and accrual statements is to look at the financial statements of a not-for-profit organization prepared both ways. The Johanna M. Stanneck Foundation is a “private” foundation with assets of about \$200,000. The income from these assets plus any current contributions to the foundation are used for medical scholarships to needy students. Exhibit 1 shows the two basic financial statements that, in one form or another, are used by nearly every profit and not-for-profit organization; namely, a balance sheet as of the end of a given period and a statement of income and expenses for the period. Exhibit 1 shows these statements on both the cash basis and the accrual basis, side-by-side for

ease of comparison. In actual practice, an organization would report on one or the other basis, and not both bases, as here.

Exhibit 1: Cash-basis and accrual-basis statements side-by-side to highlight the differences in these two bases of accounting

The Johanna M. Stanneck Foundation
Statement of Financial Position*
December 31, 20X1

	<u>Cash basis</u>	<u>Accrual basis</u>
Assets		
Cash	\$ 13,616	\$ 13,616
Investments	186,519	186,519
Dividends and interest receivable	--	3,550
Contribution receivable	--	2,000
Total assets	<u>\$200,135</u>	<u>\$205,685</u>
Liabilities		
Accrued expenses payable	--	\$ 1,354
Federal excise tax payable	--	394
Scholarships payable—20X2	--	12,150
Scholarships payable—20X3	--	2,000
Total liabilities	--	15,898
Net assets	<u>\$200,135</u>	<u>189,787</u>
Total liabilities and net assets	<u>\$200,135</u>	<u>\$205,685</u>

* On a cash basis, the title should be "Statement of Assets and Liabilities Resulting from Cash Transactions."

The Johanna M. Stanneck Foundation
Statement of Activities*
For the Year Ended December 31, 20X1

	<u>Cash basis</u>	<u>Accrual basis</u>
Income:		
Contributions	\$ 5,500	\$ 7,500
Dividends and interest income	8,953	9,650
Gain on sale of investments	12,759	12,759
Total	<u>27,212</u>	<u>29,909</u>
Administrative expenses:		
Investment advisory service fees	2,000	2,200
Bookkeeping and accounting expenses	2,350	2,500
Federal excise tax	350	394
Other expenses	1,654	2,509
Total	<u>6,354</u>	<u>7,603</u>
Income available for scholarships	20,858	22,306
Less: Scholarship grants	<u>(17,600)</u>	<u>(21,800)</u>
Excess of income over expenses and scholarship grants	<u>\$ 3,258</u>	<u>\$ 506</u>

* On a cash basis, the title should be "Statement of Receipts, Expenditures, and Scholarships Paid" to emphasize the "cash" aspect of the statement. There would also have to be a note to the financial statement disclosing the amount of scholarships granted but not paid at the end of the year.