PART 1

OVERVIEW OF NOT-FOR-PROFIT ORGANIZATIONS

COPYRIGHTED MATERIAL
http://www.pbookshop.com

http://www.pbookshop.com

1 OVERVIEW OF NOT-FOR-PROFIT ORGANIZATIONS

Perspective and Issues	**3**
Key Differences between Not-for-Profit and Profit Organizations	5
Resource Use Consideration	7
Generally Accepted Accounting Principles	7

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

http://www.pbookshop.com

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 ac-

http://www.pbookshop.com

counting 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 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.

http://www.pbookshop.com

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.

NOTE: 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.

---

http://www.pbookshop.com

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.

NOTE: 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.

http://www.pbookshop.com

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 issued Statement 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accounting Principles* (SFAS 168), which 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.

On the date that SFAS 168 became effective (financial statements for periods ending after September 15, 2009) essentially 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 nonpublic 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.

SFAS 168 (and ASU 2009-01) provide 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. SFAS 168 and ASU 2009-01 provide examples of the sources of nonauthoritative accounting guidance. This nonauthoritative guidance is stated to include

- 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.

http://www.pbookshop.com

OBSERVATION: For the practitioner, financial statement preparer, or auditor, the ***Codification*** *has two large impacts. First, researching of authoritative accounting literature must now be done using the* ***Codification*** *to ensure that actual authoritative GAAP is being considered. Frankly, this takes a bit to get used to, as it is a bit difficult to learn to navigate around the* ***Codification*** *to find the appropriate standards. However, since the Codification is available online, searches will be done by computer. Second, many financial statements, particularly in the notes, contain references to former FASB or AICPA standards or pronouncements. These references should be replaced with references to the* ***Codification's*** *various sections and topics. However, as a practical matter, there is seldom a need to actually reference an actual standard in the financial statements (usually only when a new standard is first implemented, or when one will be effective in the future.) Accordingly, financial statement preparers may wish to take this opportunity to delete the unneeded references to accounting standards.*