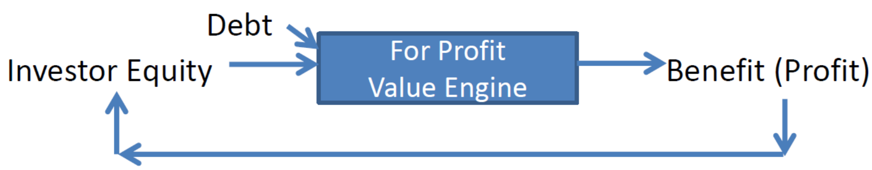
CHAPTER 1

INTRODUCTION TO FINANCIAL ACCOUNTING FOR N0T-FOR-PROFIT ENTITIES

INTRODUCTION

Not-for-profit organizations and commercial, for-profit organizations differ on several important dimensions which are reflected in the way we account for and govern each. These differences are grounded in the nature of the missions of the two types of organization.

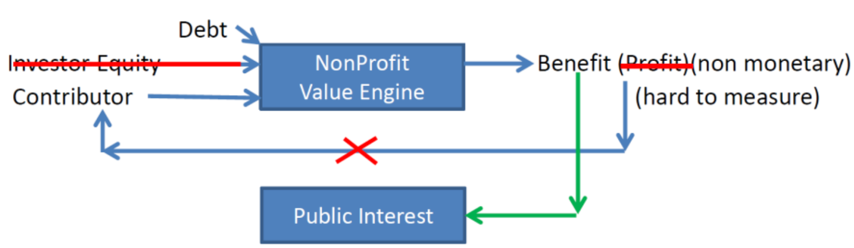
The mission of a commercial, for-profit organization is to engage in activities that maximize income, thereby insuring the greatest possible return to shareholders, the owners of the company. There are two primary sources of capital for profit making firms, debt holders and shareholders, both of whom expect a cash return. Debtholders provide dollars to the firm with an expectation of an interest payment and ultimate return of the principle amount of the loan. Shareholders buy shares of stock with the expectation of receiving dividends from the company and ultimately selling their shares of stock for more than what they paid for them. The bottom line is that the providers of capital to for profit firms put cash into the firm with an expectation of a cash return for their investment.



The only major "strings" or conditions are financial, cash based ones. Some strings might be slightly different (e.g. some preferred shareholders might want a guaranteed dividend and to be paid before anything is given to common shareholders), but all are seeking a cash return.

Even if an investor has other concerns than just a financial return (e.g. investing in a coffee company that only uses fair trade coffee) the decision to invest in a fair trade only company comes in weighing the differences between a fair trade and non-fair trade company and balancing the expected returns of each investment. Once the investment is made in the company (the stock is bought) it is all about getting the maximum return on their investment.

The mission of a not-for-profit is to engage in a set of activities that contributes most to achieving its stated mission, be that education, health, art or some social or community service. Now let us consider a typical nonprofit entity. The two major external sources of capital tend to be contributors and debt. We shall see later that there tends to be less debt in nonprofits than in for profits, but even nonprofits need to build buildings and invest in equipment (a nonprofit hospital for example). So when a bank loans money to a university, the bank is not making a contribution. It expects to be compensated in the form of being repaid the principal of the loan



plus interest. The bank only cares about the use to which the loaned funds are put only to the extent that it affects the likelihood that the bank will be repaid the principal and the interest it has earned. In that sense the bank's expectations of the nonprofit are similar to its expectations when making a loan to a for profit company, it wants its money back with interest. But what does a contributor to a nonprofit organization expect? The contributor of funds to a university used to endow a scholarship fund receives no direct repayment, but obtains satisfaction when the funds are used for the intended purpose – to help finance the education of the targeted recipients. Thus the suppliers of contributed capital do not usually receive direct compensation (other than psychic utility in that a worthy student who might not otherwise have been able to attend the university now has the chance to do so). The real benefit accrues to an external party or group, the benefit accrues to the public interest. As you can imagine, the benefit is often difficult to measure in any monetary sense.

THE PRIMARY DIFFERENCES

Let us consider some of the differences between profit and nonprofit entities which impact the way they have to be accounted for. These differences also impact the utility of the financial statements in assessing operating and financial performance of the entities.

Difference 1: Measuring Efficiency and Effectiveness

Efficiency has to do with minimizing the cost of inputs to achieve a stated output. In the short run management of an organization will decide the activities that need to be done and the organization will be most efficient if it uses the least value of resources to accomplish the desired set of activities. Effectiveness is a "loftier" measure that relates to the achievement of the stated organizational mission. The true power of the standard accrual accounting model applied to for-profit entities lies in its ability to simultaneously measure both the efficiency of the entity in conducting its operations as well as the effectiveness in meeting its mission. If efficiency is bad its reported net income is lower because revenues are lower or expenses are higher or both. If it is ineffective in meeting its mission (profit maximization) then almost by definition, reported net income will be low.

While we will use the same basic accrual accounting model to construct financial reports for private not-for-profit entities[1], these statements do not simultaneously provide a joint measure of efficiency and effectiveness. Inefficiencies may show up in the statement of activities or in the statement of functional expenses (defined in Chapter 3)[2]. The statements are of minimal help in measuring effectiveness, accomplishing its mission. In fact, there is usually no way of knowing from the financial statements if any of the activities the nonprofit engages in are appropriate to accomplish its stated mission.

This basic measurement deficiency is recognized in the titles of reports. For commercial, for-profit companies the Annual Report refers to its annual published financial statements. For a

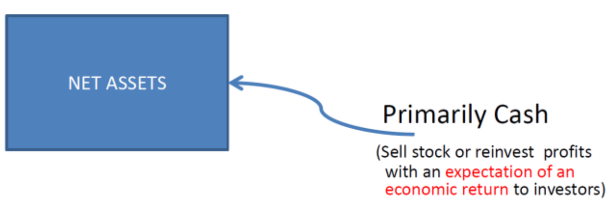
[1] Public nonprofit entities (public universities for example) must follow accounting rules promulgated by the Government Accounting Standards Board (GASB) as they are parts of municipal entities (states, cities, etc.). GASB rules are largely non-accrual. This makes financial comparisons between private and public entities difficult.

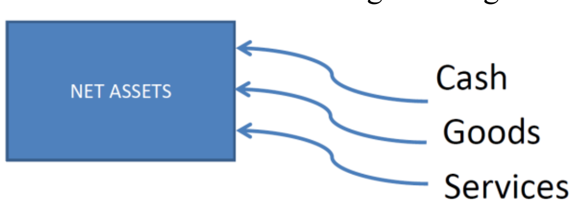
[2] But oftentimes we will not know the most efficient way to perform some task the nonprofit is engaged in and therefore will not know whether the expenditures we are looking at are higher or lower than they should be.

not-for-profit entity the basic financial statements are usually referred to as its Annual Financial Report or the Audited Financial Statements. The Annual Report of a not-for-profit entity, a separate document from its audited financial statements, usually contains extensive information about programs and activities for the period (with many pictures of the recipients of the goods or services they provide) and may list donors and government grants, etc. which more closely reflect on the achievement of mission, and which cannot normally be quantified or easily measured. The nonprofit Annual Report is "light" on numbers. The for-profit Annual Report is all about numbers with just a few explanations about people and products.

Thus the accrual accounting based financial reports for private nonprofits can be very useful in assessing the financial health of the nonprofit, but less useful in assessing the attainment of its mission or the efficiency of its utilization of resources (it only indicates whether or not it had enough money to do what they actually did). To convey information about mission the annual reports of nonprofits often provide nonfinancial, surrogate measures to convey the accomplishment of its mission. For example, the number of meals served by a soup kitchen, the student placement record for a university or the number of awards won by its faculty, the response times to 911 calls by a police department, etc.

Difference 2: The Number of non-Cash Transactions





You will recall from our earlier discussion that, in the case of for profit entities, shareholders' equity (net assets) largely relates to cash infusion from the sale of common or preferred stocks, or from profits reinvested in the activities of the firm (retained earnings). And all of this investment is done with the intention of a cash return. In the case of a nonprofit net assets enter the firm in cash, but also in forms other than cash, namely in the form of donated goods and services. Oftentimes these 'infusions" or "contributions" come with restrictions as to use and we will discuss these restrictions in a moment. The other accounting challenges for these "in-kind", non-cash infusions is to decide if indeed they should be included in the financial statements and, if so, how should they be valued. For example, a typical Habitat for Humanity operation will value the donated labor to help construct houses and include it as a charitable contribution. A typical hospital will not include the value of donated labor of the many volunteers who support patients in various ways.[3] What if a nonprofit receives an interest free or lower than market interest rate loan? How should it record this? How does the local

[3] It is estimated that in recent years approximately 25% of the adult population (about 64 million people) volunteer time to nonprofit organizations. At an hourly rate of just under $20 this amounts to about $260 billion. How do the accounting rules deal with this number? A large fraction of this amount never enters into the nonprofit financial statements making it difficult in some instances to understand what the true "cost" is of conducting the business of the nonprofit. See "The Nonprofit Sector in Brief: Public Charities, Giving, and Volunteering,, 2013", The Urban Institute. (see http://nccs.urban.org/)

Goodwill value contributions of clothing or household goods? How should a nonprofit receiving donated pills from a pharmaceutical company value the contribution? What if an art museum is given a unique, valuable painting to include in its collection? GAAP will provide rules and frameworks, often quite complex, to help answer these questions. In general nonprofits have many more in-kind transactions which must be analyzed than do for profit entities.
And we will see that, as expected, the valuation of non-monetary contributions is much less precise (much more subjective) than cash contributions.

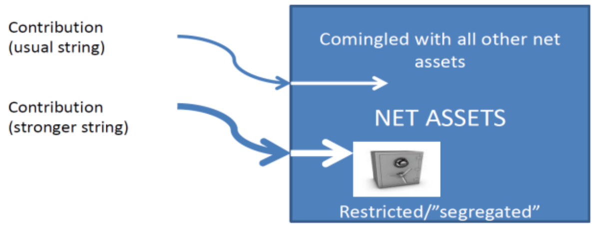
Difference 3: The Need to Keep Track of Donation "Strings" in Nonprofits

As we have mentioned, people and organizations make cash and in-kind donations to nonprofits without an expectation of any direct compensation. We will define contributions rigorously and differentiate them from normal exchange (business type) transactions in the next chapter. For the moment let's intuitively talk about the "strings" or restrictions that come with contributions to nonprofits.

Because donors often place restrictions on contributions to not-for-profits, accounting for nonprofits is driven by the nature of the restrictions (strings) that accompany the receipt of donations. Contributions can be classified as unrestricted, temporarily restricted or permanently restricted. An unrestricted contribution can be used for whatever purpose the management of the nonprofit deems to be in the best interests of the organization. Donors often restrict the use of monies as to purpose or time (temporary restrictions)—the organization can only use the donated funds to support Program A in Period X. And donors sometimes place permanent restrictions on the contribution. Examples of permanently restricted funds might be those given to create an endowment for some purpose and only earnings from the endowment may be spent for the purpose and the corpus of the gift must be maintained in perpetuity.

Nonprofits are required to maintain internal records in order to demonstrate the restrictions placed upon assets and liabilities by donors are being met. Since it is important for readers of the financial statements of nonprofits to understand the nature and type of restrictions that accompany contributions to nonprofits, it is not surprising that GAAP are also very string or restriction driven as will be demonstrated in chapters that follow.

As an example of how restrictions affect accounting and disclosures in a nonprofit consider the following. Suppose a university mounts a campaign to raise money for scholarships. The campaign raises $2 million. As the pledges are collected in cash the nonprofit deposits it in a bank account with all of its other cash. The net asset section of the university's balance sheet will show $2 million in restricted net assets. The university also receives a $1 million cash gift with a restriction that it can only be spent on developing programs for learning disabled students. This $1 million will be deposited in the same bank as the $2 million received which is to be spent on scholarships. If these are the only two contributions received with temporary restrictions the net asset section of the balance sheet will indicate temporarily restricted net assets in the amount of $3 million. The $3 million might be further explained as to purpose in a footnote to the financial statements. While the cash balance may contain a total of $10 million it is often difficult to see how much of the cash balance actually has restrictions on how it can be spent.

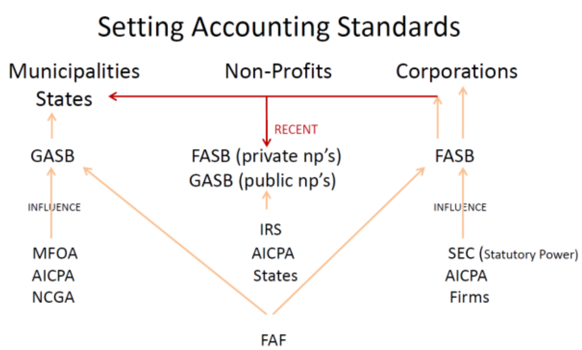


Suppose however that the donor in support of the learning disabled student programs wants to be 100% sure that the $1 million will be there when an opportunity arises for development of a new program. The donor insists that the $1 million be deposited in a separate bank account which can only be accessed to make payments directly for learning disabled program development, No other withdrawals are allowed for any other purpose. In that case there would be a Restricted Cash balance listed on the balance sheet. The $1 million would also still be part of the temporarily restricted net asset balance on the right hand side of the balance sheet. The accounting rules to account for all of the nuanced conditions that accompany contributions have to be flexible and comprehensive enough to convey this important information to readers of audited financial statements.

SETTING STANDARDS

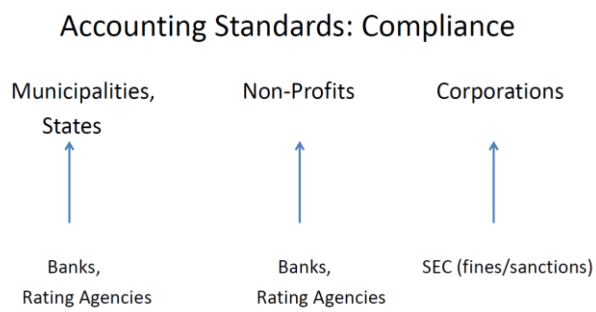
The U. S. Securities and Exchange Commission (SEC) has the statutory power to determine accounting rules and regulations for firms in the for profit sector who have stocks listed on stock exchanges. It has delegated this authority to an independent entity, the Financial Accounting Standards Board (FASB) and mandated that all exchange listed firms provide investors with statements conforming to Generally Accepted Accounting Procedures (GAAP) as promulgated by the FASB, or face sanctions and fines. The American Institute of Certified Public Accountants (AICPA) as well as corporations listed on the exchanges influence accounting rules through participation in hearings on accounting issues held by the FASB. Compliance to FASB statements and rules is very high because of the stiff sanctions and penalties which accompany noncompliance.

On the other end of the spectrum are states and municipalities which follow rules written by the Government Accounting Standards Board (GASB) which, like the FASB, is an independent entity. The GASB is not backed by statutory power as is the FASB. However, the AICPA, the Municipal Finance Officers Association (MFOA), and the National Council on Governmental Accounting (NCGA) influence rules and pronouncements of the GASB. As mentioned earlier, public nonprofits are parts of states and municipalities and are subject to GASB rules.



Until about 25 years ago even private nonprofits were required to follow GASB rules. All interested parties at that time decided that accrual based, FASB statements would better serve the constituencies that read and rely on audited financial statements as inputs into their decision making. However, the SEC has no authority to sanction or fine private nonprofits who do not comply with FASB rules. Recently, several accrual based rules written by the GASB have shown up in municipal accounting.

As with all systems one should ask "Why does it work?". In the case of for profit firms, the sanctions and fines levied by the statutorily empowered SEC for noncompliance can be draconian and therefore most firms follow FASB rules. In the cases of all nonprofits and municipalities the system works because private rating agencies (Moody's, Standard & Poor's, etc.) will downgrade credit ratings for an entity not in conformity with GAAP. This will cause municipalities and nonprofits to pay higher interest rates on borrowed monies. Furthermore, banks and foundations often require an audited set of financial statements prepared in conformity with GAAP before they will make a loan.



Many private nonprofit organizations, which are tax exempt, are required by the Internal Revenue Service (IRS) to fill out form 990. This form contains financial information, governance structures, and an overview of activities. These forms are usually filed with the state that the nonprofit resides in and are available, on request. These statements are not audited and are not as rigorously prepared as audited financial statements. We will introduce and discuss form 990 in a later chapter.

Knowing how the reporting process works is important in assessing the credibility of numbers that you are looking at. Larger entities have more dollars to spend on reporting, auditing and financial controls. This has implications not only for accuracy but for the probability that some of the numbers are fraudulent. Unfortunately, the nonprofit sector is not without fraudulent activity. Given that financial oversight and scrutiny is less than in the for profit sector this is to be expected.

THE TYPES AND SIZES OF NONPROFIT FIRMS

Many nonprofits are narrowly focused on one basic "business" (e.g. delivering medical care to a third world country, running an art gallery or a small museum, constructing affordable housing units, helping the untrained and unemployed to develop skills to obtain employment, etc.). Of course, they do have many accounts in common (cash, contributions receivable, fixed assets, etc.) but usually they have several accounts that are unique to their particular endeavor, the accounting for which is often not similar to much that we have seen in for profit accounting. Oftentimes these "unique" accounts define the bulk of their activities relating to their main endeavor and it is extremely important, as a reader of financial statements, to be able to understand the information they convey. Several examples of what we mean by this follow:

a. An economic development agency that constructs housing usually under an agreement with a state or municipality. Once the housing is constructed and occupied for the municipal purpose (e.g. house low income, returning veterans, recovering addicts, etc.) it is turned over to the municipality and funds that the nonprofit borrowed to complete the project are forgiven. Prior to meeting all of the conditions specified by the municipality the loans and construction is carried on the books of the nonprofit. The nonprofit may pay zero interest or the interest on the loans may be subsidized. The debt on the nonprofit's balance sheet may be entirely forgiven. How is all of this borrowing and construction accounted for?

b. Consider a museum with extensive collections of art, much of which is donated. How does it account for contributions of new art for the collection? What if it sells a work or art in the collection and, by policy these proceeds must be used to buy other items for the collection? Should the museum even show the works of art as assets on their balance sheet? We will look at the accounting rules that provide answers to these questions.

c. Relief agencies often receive much of the food, pharmaceuticals, and other items they distribute to needy populations as gifts in kind from for profit companies. Do all of these show up as charitable contributions? How does the agency attach values to the gifts in kind? Oftentimes these non-cash contributions may constitute 90% or more of the total revenue stream.

d. Universities and other large nonprofits are often the beneficiaries of very complex split-interest agreements. Agreements with donors under which the nonprofit and the donor (or a designee) share legal and economic interests in something of value. For example, a donor establishes a trust which is to make periodic payments to an individual as long as they live. When the beneficiary dies any assets remaining in the trust belong to the nonprofit. Such agreements vary as to the nature of the payments made to the beneficiary and the fiduciary responsibility for managing the funds. Accounting for these agreements requires actuarial estimates and investment return estimates which usually must be revised on an annual basis. Readers with a knowledge of the accounting for pensions will appreciate the complexity and detail of accounting for split-interest agreements.

e. Many nonprofits have permanent endowments which must be kept in perpetuity and only the earnings may be spent. Investments in the endowment are often comingled with other investments on the balance sheet. Many endowment investments are not very liquid. We must learn how to read disclosures in the footnotes and decide how to assess the spending rule the nonprofit uses to spend funds from the endowment.

There are over 1.4 million nonprofits registered with the Internal Revenue Service (IRS) accounting for more than 5% of the U.S. Gross Domestic Profit. Registered nonprofits include advocacy groups, business and professional organizations, labor unions and others. More than ¾ of registered nonprofits are 501(C)(3) public charities that collectively have more than $1½ trillion in annual expenses and own more than $3 trillion of assets. It is these public charities which are the focus of this book.

The size distribution of the nonprofit sector, as measured by total expenses, is much skewed. For reporting public charities the largest 4.4% (as measured by reported expenses) of public charities reports 86% of all reported expenses. Nonprofit charities with less than a half of a million dollars of expenses comprise 70% of all public charities yet only report approximately 2% of all charity entity expenses.[4]

All nonprofits registered with the IRS are required to file Form 990 which provides financial information about the nonprofit along with some information about personnel and programs. One chapter later in this book is devoted to IRS Form 990. Because Form 990 is not subject to audit, foundations, bond rating agencies, banks, and large contributors often insist that the nonprofit file an annual audited set of financial statements prepared according to Generally Accepted Accounting Principles as promulgated by the Financial Accounting Standards Board (FASB). These principles insure consistency and comparability across nonprofits in the way they present themselves to their constituencies. These rules and principles are the focus of this book.

The size discrepancies across the sector and the diversity and idiosyncrasies of mission make it imperative that anyone seriously interested in the charitable sector become proficient in reading audited financial statements. This financial information in the audited statements then must be melded with the information contained in the annual report of the nonprofit, as well as information from other external sources, to come to conclusions about efficiency and effectiveness of the nonprofit being analyzed.

[4] . See "The Nonprofit Sector in Brief: Public Charities, Giving, and Volunteering,, 2013", The Urban Institute. (see http://nccs.urban.org/) for detailed statistics about the nonprofit charitable sector.