CHAPTER 1

Understanding the Basics of Not-for-Profit Accounting

This chapter provides some very basic information about not-for-profit accounting to provide a basis for understanding the principles and standards that are discussed in greater detail throughout the remainder of this book. A lack of understanding or misunderstanding of these fundamentals will cause the reader to be lost when trying to understand more complex principles. Specifically, this chapter will:

- Identify generally accepted accounting principles.
- Define and give examples of assets, liabilities, net assets, revenues, and expenses usually found in not-for-profit organizations' financial statements.
- Explain what is meant by the accrual basis of accounting. How does this differ from the cash basis of accounting, and which is better?
- Describe what happened to fund accounting.

WHAT ARE GENERALLY ACCEPTED ACCOUNTING PRINCIPLES?

Non-accountants sometimes ask the question, "Well, if these accounting principles are only generally accepted, that must mean that there are other perfectly good accounting principles that have less than general acceptance that are fine to use." Unfortunately for those desiring creativity and uniqueness in their accounting principles, this is not the case. Generally accepted accounting principles (GAAP) are the rules of road that need to be followed by not-for-profit organizations if they want to proclaim that their financial statements are prepared in accordance with GAAP.

WHY IS PREPARING GAAP FINANCIAL STATEMENTS IMPORTANT?

Sometimes not-for-profit organizations are required by law or regulation to prepare financial statements in accordance with GAAP. Most states require that not-for-profit organizations that are organized within a state (or raise funds within that state) file an annual report with the state charities bureau (or its equivalent) and, for all but the smallest not-for-profit organizations, the annual reports usually require that financial statements prepared in accordance with GAAP be included with the annual report.

Several other groups are also fond of financial statements prepared in accordance with GAAP. Large, sophisticated donors often request copies of an organization's financial statements, and having these financial statements prepared in accordance with GAAP lends a high degree of credibility to the financial statements. Creditors that loan money or provide credit lines to not-for-profit organizations also like to see GAAP financial statements. Sometimes a significant vendor or contractor will also request financial statements of the organization, particularly when a long-term lease or equipment-financing contract is being executed. Having financial statements prepared in accordance with GAAP makes them more understandable, comparable with other not-for-profit organizations, and provides a better representation of the financial affairs of the not-for-profit organization. Additionally, if the not-for-profit organization provides services to a governmental organization (federal, state, city, school district, county, etc.), the contract with the governmental entity often requires that financial statements prepared in accordance with GAAP be submitted to the government every year.

Who Sets the Laws of GAAP?

Generally accepted accounting principles for not-for-profit organizations are basically set by the Financial Accounting Standards Board (FASB). The FASB is a private organization that is financially controlled and supported by the Financial Accounting Foundation (FAF), itself a not-for-profit organization. The FAF also oversees the Governmental Accounting Standards Board (GASB), which sets GAAP for governmental entities.

The first level in the GAAP hierarchy, category A, consists of Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards and Interpretations (as an example, the reader may be familiar with FASB Statement No. 117, which has had a significant impact on financial reporting for not-for-profit organizations and will be discussed throughout this book). Also at the highest level of authority are statements issued by the FASB's predecessor standards-setting organizations, opinions issued by the now-defunct Accounting Principles Board (APB), and Accounting Research Bulletins, which were formerly issued by the American Institute of Certified Public Accountants (AICPA).

The next level in the GAAP hierarchy, category B, consists of FASB Technical Bulletins and, if cleared by the FASB, Industry Audit and Accounting Guides issued by the AICPA and Statements of Position issued by the AICPA.

The third category, category C, consists of AICPA Accounting Standards Executive Committee Practice Bulletins that have been cleared by the FASB and issues resolved by the FASB's Emerging Issues Task Force.

The lowest level in the GAAP hierarchy, category D, consists of AICPA Accounting Interpretations and Implementation Guides published by the FASB staff. Also included in this category are other practices that are widely recognized as prevalent, either generally or as pertain to a specific industry.

While these terms may not mean much to the non-accountant, it is important for the reader to at least be a little familiar with them in order to have an idea of their relative importance, which can come in handy in conversations with a not-for-profit organization's accountants or independent auditors.

Who Makes Sure the Not-for-Profit Organization's Financial Statements Conform with GAAP?

The answer may surprise the non-accountant, but the fair presentation of a not-for-profit organization's financial condition and results of operations in its financial statements prepared in accordance with GAAP is the responsibility of the not-for-profit organization's management. For those who would have guessed this responsibility was that of the not-for-profit organization's independent auditor, a serious change in paradigm needs to be made. Independent auditors are hired to perform an audit and issue an opinion as to whether the financial statements *prepared by management* are presented in accordance with GAAP. Not-for-profit organizations are notorious for passing the responsibility for preparing financial statements off to the independent auditor. The common reason for doing this, particularly in smaller organizations, is that the not-for-profit organization may not have individuals with the technical expertise on staff to take full responsibility for preparing the financial statements. While it is understandable how this happens, the management of the organization is, in fact, responsible for the financial statements. If assistance is needed of the independent auditor, management should at least understand how the financial statements are ultimately prepared and what types of adjustments to the organization's books and records are being made by the independent auditor to result in GAAP financial statements.

It is worth noting, however, that independent auditors take the fact that the financial statements are management's responsibility very seriously. The second sentence of a standard auditor's opinion letter states: "These financial statements are the responsibility of XYZ's management." While this is most assuredly an attempt by independent auditors to limit their legal exposure in case the financial statements actually are not prepared in accordance with GAAP, it does highlight the fact that, the way the system works, the financial statements are management's responsibility.

What Happens If the Financial Statements Are Not in Accordance with GAAP?

It depends. If a not-for-profit organization prepares financial statements that its management believes are in accordance with GAAP while its independent auditor does not believe they are in accordance with GAAP, one of two things can happen:

- *The not-for-profit organization accepts changes to the statements prepared by the auditor and corrects the financial statements.* In this case, both management and the independent auditor now believe the financial statements are prepared in accordance with GAAP. The problem is resolved and the independent auditor issues an unqualified opinion on the financial statements.
- *The not-for-profit organization may disagree with the changes proposed by the auditor.* On the other hand, the independent auditor may propose that an adjustment be made to the financial statements or that additional disclosures be included, but the management of the not-for-profit organization is unable to obtain the necessary information with which to adjust the financial statements. In this case, the auditor will issue a qualified opinion on the financial statements because of the departure from GAAP. This means that the financial statements are prepared in accordance with GAAP, with the exception of the problem item. In some rare cases, if the problem is so serious that it is pervasive and affects the financial statements as a whole, the auditor may issue an adverse opinion on the financial statements.

This means that the financial statements in their entirety are not prepared in accordance with GAAP.

The acceptance of financial statements that are not in accordance with GAAP will vary among the different users of those financial statements. A state charities office may accept financial statements that are qualified for a GAAP exception, but may not accept statements with an adverse opinion. A bank or other creditor may find that any departure from GAAP in a not-for-profit organization's financial statements would be a negative factor in determining whether credit should be granted to the not-for-profit organization.

Tip A not-for-profit organization may deliberately choose not to use GAAP for its financial statements, but rather an "other comprehensive basis of accounting" (OCBA), such as the cash basis, for the statements. More on this topic will be provided later in this chapter.

The bottom line of this discussion is that GAAP is widely recognized as providing the best information about a not-for-profit organization's financial position and activities. For all but the smallest not-for-profit organizations (which may not even issue financial statements), it is likely that the benefits of having financial statements prepared in accordance with GAAP will outweigh the costs.

Red Flag Not-for-profit organizations often prepare annual financial statements on a GAAP basis, while providing their board of directors or executive management with financial information on a quarterly basis. The total of all four quarters of these quarterly financial information reports often does not equal amounts reported in financial statements prepared in accordance with GAAP, because there are frequently adjustments made to conform to

GAAP that are only made when the annual financial statements are prepared. Common examples include depreciation expense, bad debt expense, and inventories (each of which will be discussed later in greater detail), which are only recorded annually and not reflected in quarterly financial information.

DEFINITIONS AND EXAMPLES OF ASSETS, LIABILITIES, REVENUES, AND EXPENSES USUALLY FOUND IN NOT-FOR-PROFIT ORGANIZATIONS' FINANCIAL STATEMENTS

In order to understand the basic financial statements of a not-for-profit organization and how various transactions are accounted for under GAAP, the reader needs to understand the various asset, liability, revenue, and expense accounts typically found in the financial statements of not-for-profit organizations. Some accounts are easier to describe (for example, cash) than others (for example, deferred charges). Even with the easier accounts, there are often underlying rules that need to be understood to really comprehend the financial statement item being reported. Using the example of cash, the financial statement reader might be interested in knowing the distinctions between unrestricted cash and restricted cash and how each is reported. The financial statement reader might also be interested in knowing what cash equivalents are, which are sometimes included in the financial statement line item Cash and cash equivalents. The point is that there are any number of nuances and requirements that have developed that determine how items are reported. The following pages describe some of the more common items encountered in not-for-profit financial accounting. (Again, note that this discussion provides only basic rules. Financial statement preparers need to refer to the comprehensive rules found in other sources, such as Wiley's *Not-for-Profit GAAP*, which is written for those requiring a more in-depth understanding of the GAAP requirements.)

Assets

Let us start by looking at the GAAP definition of an asset. FASB Concepts Statement No. 6, "Elements of Financial Statements" (FASBCS 6), defines assets in the following way: "Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." And all this time you thought that assets were stuff that you owned! The fact is, the FASB definition is meant to provide a broader context to assets, rather than a narrower definition that only implies ownership. For example, if a not-for-profit organization prepays its liability insurance premium for the following year, it really does not "own" anything as a result of that prepayment. However, the prepayment will provide a future economic benefit to the not-for-profit organization, which will be insured during the following year without having to pay an insurance premium in that year. Thinking of assets as including things that the organization owns as well as future economic benefits that it is entitled to will help the reader understand what types of items are considered assets.

Note also that assets are measured in financial statements as of a point in time, that is, as of the date of the statement of financial position, which is sometimes referred to as the balance sheet. For example, if the not-for-profit organization's fiscal year-end is June 30, its statement of financial position will report its assets as of that date. Assets are also presented in the statement of financial position in their order of liquidity, which means the assets that can be converted the most readily into cash are reported first. More information on this concept will be presented in Chapter 2.

Some of the types of assets often found on a not-for-profit organization's statement of financial position are:

- Cash
- Cash equivalents
- Investments
- Contributions receivable
- Accounts receivable
- Other receivables

- Inventories
- Property, plant, and equipment
- Prepaid expenses

Cash

Cash is a fairly obvious asset. It represents the balances in the not-for-profit organization's bank accounts. The presentation of cash represents the book balances of the bank accounts, not the amounts reported on the bank statements. The book balances are similar to what individuals keep as balances in their own checkbooks, that is, checks that have been written and deducted from the balance but that have not yet cleared the bank. Similarly, deposits that have been received but have not yet cleared the bank are also included in the balance.

The cash amount reported on the statement of financial position should include:

- *All demand bank accounts that the not-for-profit organization has, including those for general disbursements, payroll imprest accounts, separate accounts for wire transfers, and so forth.* (One cash balance is reported on the financial statements representing the aggregation of all of these accounts.)
- *All petty cash accounts that are maintained by the not-for-profit organization.*

Cash on the statement of financial position should *not* include:

- *Cash that is restricted by some legally enforceable instrument.* Generally, this would include cash maintained in debt service reserve accounts required to be maintained by the related debt instruments. Restricted cash is usually shown as a separate line item in the statement of financial position to make it clear to the reader that it is not available to pay the not-for-profit organization's current bills.
- *Cash that is received and held as a security deposit that will be returned to the provider at the end of some agreement.* For ex-

ample, if a not-for-profit organization rents a part of its office space to another organization and holds a $1,000 security deposit that it collects from the renter, that security deposit cash should not be included in the cash balance of the not-for-profit organization on the statement of financial position.

Cash Equivalents

The term cash equivalents refers to investments that are so close to being realized as cash that they are viewed essentially as the equivalent of cash. Because the definition of what is considered a cash equivalent is important for preparing an organization's statement of cash flows (which will be discussed in Chapter 3), the rules for determining what can be considered a cash equivalent are set by FASB Statement No. 95, "Statement of Cash Flows" (FAS 95). These requirements define cash equivalents as short-term, highly liquid investments that are both readily convertible to known amounts of cash and so near their maturity that they present an insignificant risk of changes in value because of changes in interest rates. This is interpreted by SFAS 95 to mean that for an investment to be considered a cash equivalent, it must mature within three months of being bought by the organization. This means that a one-year treasury note that is purchased by a not-for-profit organization two months before it matures can be considered a cash equivalent. However, if the not-for-profit purchased the one-year treasury note when it was first issued (so that it matured in one year), it would not be considered a cash equivalent. Also, this investment would not be considered a cash equivalent if it was held by the organization and then reached a point where it only had three months left to maturity. Classification as a cash equivalent occurs when the investment is acquired by the not-for-profit organization. Examples of cash equivalents include Treasury bills, money market funds, and commercial paper. Note again that the term original maturity refers to the length of time to maturity at the time that the security is purchased by the not-for-profit organization, *not* to the security's original duration before maturity.

Investments

An entire chapter of this book (Chapter 5) discusses the accounting for investments by not-for-profit organizations, so not much space will be spent here discussing investments. Suffice it to say that most investments (stocks, bonds, and other debt instruments) are reported in the statement of financial position at their fair value (fair market value is an older term for what is now referred to as fair value). Changes in the fair value of investments from year to year are reported in the not-for-profit organization's statement of activities as part of overall investment earnings (or losses).

Contributions Receivable

Receivables represent money that is owed to the not-for-profit organization. Money may be receivable from any number of sources, but for a not-for-profit organization, most receivables will be from donors or contributors. Donors and contributors may owe the not-for-profit organization contributions that they pledged or promised to give the organization. An entire chapter of this book (Chapter 3) discusses the accounting for these contributions receivable.

Accounts Receivable

The other significant category of receivables, accounts receivable, is often referred to as trade accounts receivable. These receivables represent funds that are owed to the not-for-profit organization from individuals or other organizations because of services provided or goods sold to these other entities. Some common scenarios where these types of receivables may be present on a not-for-profit organization's financial statements are:

- A not-for-profit day-care center may provide services to a local government for children whose day-care the government is paying for. Once the services are provided, the not-for-profit organization has a receivable from the local government until it is paid for those services.

- A not-for-profit college may be owed tuition and fees from students that are past their due date, but have not as yet been paid.
- A not-for-profit club may bill its members for meals and other services that have been provided to the members and are due but have not as yet been paid.

These types of receivables occur from exchange transactions—the not-for-profit organization is not just collecting a donation, it is providing specific services in exchange for money. These business-type activities are becoming an increasingly significant portion of the activities of not-for-profit organizations, because the profit from these activities provides funding for the not-for-profit organization's other activities.

There are two basic considerations that the non-accountant should understand about accounts receivable. First, a receivable (and the related revenue) should not be recorded until the organization actually "earns" the revenue and the right to receive the money from the entity to whom they are selling services. Second, not all receivables are ultimately collected.

Practical Example Using the day-care services as an example, let us say that a not-for-profit organization wins a contract with a local government to provide day-care services to children referred to it by the local government. The contract is for one year and is of an amount not to exceed $100,000. The local government pays the not-for-profit $50 per day per child that is placed in its care. Some might think that the not-for-profit organization should set up a receivable of $100,000 on its statement of financial position on the date the contract is signed. That is the amount expected to be received under the contract. This is not correct, however, under GAAP. A receivable is only recorded when it, and the related revenue, are earned, which, in this case, is when the day-care center actually cares for a child. In other words, at the end of a week or a month, when the day-care center bills the local government for the services actually provided (number of children for the period times the number of days times $50), that is the time that a receivable should be recorded on the day-care center's books. Obviously, when the local government pays the bill, the receivable is reduced and the increase in cash is recorded on the statement of financial position.

Revenue recognition in the above example is straightforward and thus easy to understand. When transactions are more complex, the determination as to when revenue should be recorded becomes more complicated.

Practical Example Let us say that a customer of a museum's gift shop purchases a piece of jewelry on June 30, the fiscal year-end of the museum and the gift shop. The customer has an account with the gift shop and will be billed for the purchase. The customer has 10 days to return the item for a complete refund. Will the gift shop record the sale on June 30 (in the current fiscal year) or wait until 10 days have passed and it is certain that the customer will keep the jewelry? *The museum gift shop will record the sale (and the receivable) on June 30.* However, if returns of merchandise are for more than negligible amounts, the museum will likely record an allowance for returns, which will reduce the overall sales and receivable balances for estimated returns.

This example leads into a discussion of the second key point to understand about the accounting for accounts receivable, which is that not all receivables are necessarily collected. GAAP require that an estimate of accounts receivable that will *not* be collected be made and an "allowance for uncollectible accounts receivable" be established. This account reduces the overall receivable balance (and charges bad debt expense), so that the net of the gross receivable balance and the allowance represents the best estimate of how much of the receivable balance actually will be collected. Receivables are therefore reported at their net realizable value, which is in accordance with GAAP. Note that the not-for-profit organization does not really know which receivables it will not collect, but uses historical trends and an aging of its receivable balance (which categorizes how long receivables have been outstanding) to estimate this amount. If the not-for-profit knows that a particular account receivable will not be collected, that particular receivable should be reduced from the gross receivable balance, which is another way of saying that the particular receivable should be written-off.

Other Receivables

Not-for-profit organizations sometimes have other receivables reported on their statement of financial position representing money owed to them for reasons other than the two main categories previously described. The same principles discussed earlier would also apply to these receivables, meaning that they should only be recorded if the organization has a valid claim to them and that they should be reported at a value that represents the amount the organization expects to collect. Some of the common types of these other receivables are:

- *Amounts owed under grants* (the type of grant where no specific action is required by the not-for-profit organization to earn the right to receive the money).
- *Reimbursements of expenses* (for example, a dinner chair agrees to underwrite the costs of a fund-raising dinner).
- *Reimbursement of expenses paid on behalf of other not-for-profit organizations.*

These are only examples—the “other” category can include a wide variety of receivables. If a particular receivable is significant, it should be included as a separate line on the statement of financial position. Alternatively, the details of the “other” category could be described in the notes to the financial statements if the financial statement preparer feels that aggregating too many receivables in the “other” category obscures their nature.

Inventories

Inventories are most often associated with manufacturing and retail operations, rather than not-for-profit organizations. Many not-for-profit organizations *do* maintain inventories, however. Sometimes not-for-profit organizations set up for-profit subsidiaries to handle merchandising activities. This distinction is done basically for tax purposes. A reader of the not-for-profit organization's financial statements will see inventories on the parent not-for-profit organization's statement of financial position when the for-profit subsidiary is consolidated, that is, combined with, the parent organization's financial statements.

Inventories are items that the organization expects to sell. In other words, supplies that are expected to be used by the not-for-profit organization in its operations should not be reported as inventories.

Practical Example Sometimes there is confusion over these non-inventory items since supplies may be "inventoried" at the end of the fiscal year. If the supplies balance is significant, it should be reported as an asset on the statement of financial position. It should not be included with inventory, which should only represent merchandise held for sale.

Not-for-profit organizations often have inventories of merchandise that they sell, which should be reported as an asset on the statement of financial position. Some common examples of organizations that have inventories are:

- Gift shops of museums, galleries, and other attractions
- Bookstores of not-for-profit colleges and universities
- Snack bars, refreshment stands, or restaurants operated by various types of organizations
- Professional associations, soccer clubs, and other sports clubs that have T-shirts, coffee mugs, and other promotional items held for sale.

The accounting for inventories can be fairly complicated and the details are beyond the scope of this book. In fact, most not-for-profit organizations' merchandising activities are incidental to their overall operations. Hence, a basic understanding of inventory accounting will go a long way in understanding inventories reported on the statement of financial position of a not-for-profit organization.

Inventories are reported on the statement of financial position either at cost or at market value, whichever is lowest. One important matter in accounting for inventories is referred to as the flow assumption. The flow assumption determines which items from inventory are considered to be sold first. The first-in, first-out (FIFO) flow assumption sounds complicated, but simply means that the oldest items from inventory (that is, the first items "in") are the first items to be sold. This is the most common flow assumption used by not-for-profit organizations. Assuming that there is consistent inflation at some level, these older inventory items will have a lower cost assigned to them, because they were theoretically purchased at a lower cost. This means that when these items are sold, the profit realized by the not-for-profit organization will be higher than when the last items brought into inventory are sold. The alternative flow assumption, last-in, first-out (LIFO), assumes that the last items brought into inventory (that is, assuming inflation, the ones with a higher cost) are the first ones sold. This means that when these items are sold, the net profit to the not-for-profit organization is lower than it would be using the FIFO flow assumption. While the LIFO method has clear tax advantages to commercial organizations because reported profits are lower, its use by not-for-profit organizations is less popular, because tax considerations are generally not of paramount importance.

The second important consideration for inventory valuation in the statement of financial position is that the amount reported as the cost of inventories on the statement should not be more than the amount that the inventory can be sold for. The commonly used phrase that inventory is reported at the "lower of cost or market" means just that, with the term market referring to how much the item could be sold for, rather than what it would cost the not-for-profit organization to replace the inventory item.

Red Flag There are many other inventory methods with intimidating names that are variations on these two basic concepts, such as the *dollar value retail LIFO method.* Particularly when inventory amounts are not significant, not-for-profit organizations sometimes use the average cost of items in inventory to represent the cost of items sold. This results in a sort of hybrid method, combining the features of the FIFO and LIFO methods. While the calculations may grow in complexity, the basic concepts remain as described above.

Property, Plant, and Equipment

Sometimes referred to as fixed assets, the property, plant, and equipment of a not-for-profit organization represent its long-lived assets used in the conduct of the organization's business. These would include land, buildings, equipment, office furnishings, computers, vehicles, and other similar assets. What gets recorded as a capital asset is generally determined by a not-for-profit organization's capitalization policy. This policy determines what purchases are recorded as assets and what purchases are recorded as expenses. If a purchase of one of these types of assets meets the capitalization policy's criteria, it is recorded as an asset. The capitalization policy is usually based on the useful life of the item. Normally, a minimum useful life of three to five years is required before an item is recorded as an asset. The capitalization policy usually also sets a minimum dollar threshold in order for an item to be recorded as an asset. The threshold amount varies based on the size the organization. A $500 threshold is reasonably popular among average-size organizations, although amounts as low as $100 and as high as $10,000 are not uncommon for very small and very large organizations, respectively.

Two other items should be included in fixed assets—leasehold improvements and capitalized leases. Leasehold improvements are purchases that meet the capitalization criteria of an organization, but are improvements to leased property rather than to property owned by the not-for-profit organization itself.

Practical Example A not-for-profit organization enters into a 20-year lease for office space. Prior to moving into the space, the not-for-profit organization "builds out" the space by moving walls to create the desired office space, installing a reception area, carpeting, and so forth. These leasehold improvements would be considered part of the organization's fixed assets although the not-for-profit organization does not own the building to which these improvements are permanently attached.

Capitalized leases (which will be discussed in greater detail in Chapter 10) are an accounting creation that recognizes the substance of some lease transactions over their form. In other words, when a not-for-profit organization enters into a lease for an item, which, in substance, is a purchase of the item, the item is recorded as a fixed asset of the not-for-profit organization, even though the organization does not have title to the asset.

Practical Example A not-for-profit organization leases a copier machine that has a useful life of 10 years. The term of the lease is 10 years. Since the not-for-profit organization is using the asset for virtually its entire useful life, GAAP would require the not-for-profit organization to record the copier as a fixed asset, along with the liability for future lease payments. (These items will also be discussed in Chapter 10 of this book.)

Property, plant, and equipment is recorded on the statement of financial position at its cost to the not-for-profit organization, reduced by accumulated depreciation. Accumulated depreciation represents the decline in value of fixed assets as they are used in the operation of the not-for-profit organization's business. Depreciation expense is the annual amount charged to expense in a not-for-profit organization's statement of activities, which represents an estimate of the amount of the asset that is "used up" in the organization's operations during the year. Accumulated depreciation sums up the annual amounts of depreciation expense for fixed assets and represents a reduction in the recorded cost amount of the asset on the organization's statement of financial position.

Practical Example A not-for-profit organization buys a PC for $2,200, which it estimates to have a five-year useful life. At the end of five years, the organization expects that it can sell the PC for salvage for $200. The amount to depreciate is $2,000 ($2,200 less the $200 salvage value). $2000 divided by five years results in a depreciation expense of $400 per year. This table illustrates the calculations for the life of this asset:

Year	Depreciation Expense	Accumulated Depreciation	Remaining Net Book Value
1	$400	$400	$1,800
2	$400	$800	$1,400
3	$400	$1,200	$1,000
4	$400	$1,600	$600
5	$400	$2,000	$200

At the end of Year 5, the remaining net book value of the asset ($2,200 original cost less $2,000 accumulated depreciation) equals the estimated salvage value of the asset, $200. No further depreciation would be taken and the asset would remain on the books until it was actually disposed of. If the organization managed to sell the asset for $300, it would remove $2,200 from the asset account and $2,000 from the accumulated depreciation account from the books and record a gain of $100 on the disposition of the asset. If the asset was sold for $100, the organization would remove $2,200 from the asset account and $2,000 from the accumulated depreciation account from the books and record a loss of $100 on the disposition of the asset.

Accumulated depreciation is a *contra account* to property, plant, and equipment, meaning that its balance (which is a credit) offsets the gross amount of property, plant, and equipment that is recorded on the statement of financial position as an asset (debit). The accumulated depreciation account, as its name suggests, is the cumulative amount of depreciation that has been recorded on the assets that are included in property, plant, and equipment. Each year when depreciation expense is recorded, the accumulated depreciation amount is increased for the amount of the annual depreciation expense. Conversely, when an asset is retired or sold, the amount of accumulated depreciation that is applicable to that particular asset is removed from accumulated depreciation, meaning that the accumulated depreciation account is reduced for this amount.

One other relatively new, fancy accounting term related to property, plant, and equipment may have some applicability to not-for-profit organizations. This term is *asset impairment.* The accounting rules for asset impairments are found in FASB Statement No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of" (FAS 121). Impairment of long-lived assets occurs when the future benefits (meaning cash flows) from those assets are less than the net book value of the asset recorded on an organization's statement of financial position, or balance sheet. This standard applies more to private-sector accounting and can be explained with a simple example. Let us say that a manufacturing company owns a plant that produces 5¼-inch floppy disks for personal computers. Sales are understandably down. In fact, sales are only expected to be $5 million in total for the next five years, at which time the plant can be sold for $10 million. The net book value of the plant on this company's books is $50 million; it currently has a fair market value of $25 million. The total expected cash flows from the plant are $15 million ($5 million in sales plus the estimated selling price at the end of the five years of $10 million). Since $15 million is less than the book value of $50 million, an impairment has occurred. This company measures the amount of the impairment at $25 million, which is the difference between the book value of $50 million and the current fair market value of $25 million. The asset would be reduced to $25 million and a loss would be recognized of $25 million in the period in which the impairment became known as a result of the cash flow test described earlier.

The rules for identifying and recording asset impairment will not directly apply to many not-for-profit organizations, since many of these organizations' assets are not acquired to generate future cash flows. However, not-for-profit organizations that have many business-type activities (for example, colleges and universities and health-care facilities) must be cognizant of the requirements of this accounting principle.

Prepaid Expenses

Prepaid expenses are assets that arise because an organization has paid for services that it will receive in the future, with the future being defined as a time past the fiscal year-end. The most common example of a prepaid expense is an insurance premium. Let us say that a not-for-profit organization has a June 30 fiscal year-end. It pays its general liability insurance premium (assume it is $1,000) on January 1 for the next full calendar year. By June 30, it has used up six months of insurance, but still has another six months of insurance to which it is entitled. This organization would allocate the $1,000 of insurance premium over the 12-month calendar year period. On June 30, it would record a reduction of its insurance expense and record a prepaid insurance expense asset of $500 ($1,000 times 6/12). Note that this organization uses up this prepaid asset during the period from July 1 through December 31. If the organization issued its 6-month financial statements on December 31, it would reduce the entire prepaid asset to zero and record the corresponding $500 as insurance expense, which makes sense because, since the insurance works on a calendar year basis, on December 31, the organization has not prepaid any of its insurance. Assuming in this example that the insurance premiums stay the same every year, the not-for-profit would have recorded \$1,000 of insurance expense in its fiscal year (\$500 recognized as a result of the premium payment and \$500 recognized when the prepaid expense asset is used up).

While prepaid insurance is the most common and easily understood example of a prepaid expense, there can be many others. Rental payments on facilities or equipment are another example. Some judgment should be used by not-for-profit organizations in determining what should be recorded as prepaid expenses. For example, a motor vehicle registration fee is usually paid annually in advance. If the not-for-profit organization only owns a few motor vehicles, it is probably not worth the administrative effort to calculate and record this type of prepaid expense, particularly when registrations expire throughout the year.

Liabilities

FASB Concepts Statement No. 6 provides this definition of liabilities: "Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events." While this definition is somewhat less confusing than FASB Concepts Statement No. 6's definition of assets, it still requires a good deal of explanation. Non-accountants generally think of liabilities as simply "money that you owe." While this is not too far off from a GAAP perspective, there are several ideas in Statement 6's definition that will make the simple definition more accurate.

First, liabilities are measured at a point in time, which means, for financial statement purposes, as of the end of the not-for-profit organization's fiscal year. To be a present obligation means that the obligation has actually been incurred as of the year-end to be reported on the statement of financial position as a liability, meaning it is the result of past transactions or events. Second, the obligations are not simply those that must be satisfied by the payment of cash. Liabilities also consist of obligations of the not-for-profit organization to perform services or transfer assets other than cash to the party to which the organization is obligated.

Some of the more common liabilities found recorded on the statement of financial position of not-for-profit organizations are:

- Accounts payable and accrued expenses
- Debt
- Deferred income

Sometimes not-for-profit organizations report both accounts payable and accrued expenses on one line on the statement of financial position. Other times, separate amounts are reported for each. For the purpose of explaining what these liabilities represent, it is helpful to discuss accounts payable and accrued expenses together.

Accounts payable essentially represent the unpaid bills of a not-for-profit organization. These are bills for goods or services that have been received by the organization prior to the end of its fiscal year.

Practical Example The not-for-profit organization receives an invoice in the amount of $1000 for stationery that it ordered for a fund-raising campaign. The stationery was received on June 15. The fiscal year-end of the organization is June 30, and a check for $1,000 was issued to the stationery supply store on July 7. As of June 30, the not-for-profit organization records a $1,000 accounts payable (representing the unpaid invoice) along with a $1,000 supplies expense. (Note that accounts payable also arise when a not-for-profit organization buys assets or incurs expenses.)

There are two other situations that might also give a not-for-profit organization cause to record amounts as accounts payable, and both of these situations involve issuance of checks. Let us say that a not-for-profit organization with a June 30 year-end writes checks for all of its outstanding bills on June 29, even though it realizes that it will not have available funds in its bank account to clear the checks until the second week of July. The not-for-profit organization holds all of the checks written on June 29 and first mails them on July 12. When the checks are written, most automated (and manual) accounting systems would record a decrease in cash and a decrease in accounts payable. However, in this example, the not-for-profit organization has neither expended cash nor reduced its accounts payable on June 30—all it really did was write checks. Accordingly, the total amount of the checks held by the not-for-profit organization until past year-end would be added back to cash and to accounts payable.

A second similar situation arises when the not-for-profit organization writes checks prior to its year-end and reduces the book balance of its cash below zero. It can do this because it knows that all of the written checks will take some time to clear the bank, at which time the not-for-profit organization expects that the actual balance in its bank account—its bank balance—will be sufficient to clear the checks. The difference between this case and the first situation is that, in this case, the not-for-profit organization does not physically hold onto the checks. It mails them. In this case, the not-for-profit organization would not report a negative balance for cash on its statement of financial position. Rather, it would bring the book balance of the account up to zero and would add the same amount to its accounts payable balance. Effectively, this reclassifies the negative book balance of cash to accounts payable.

Accrued expenses represent liabilities for goods and services received by a not-for-profit organization for which either an invoice has not been received or the entire invoice does not apply to the fiscal year-end being reported. A simple example should make this clear:

Practical Example Referring to the $1,000 stationery purchase example used above, let us say that the not-for-profit organization did *not* receive the invoice for the stationery until July 7. Assuming that the physical delivery of the stationery still occurred on or before June 30, the organization would record an accrued expense for this purchase. Basically, a liability is recorded for the accrued expenses and, at the same time, stationery expense is charged. Also keep in mind that amounts might have to be estimated for shipping or similar charges in establishing the accrued expense. Conversely, the not-for-profit organization may take into consideration discounts for prompt payment that it intends to take, if it is the organization's normal practice to take advantage of such discounts.

Accrued expenses also arise because invoice amounts or service periods span the end of the fiscal year of an organization. For example, if a monthly telephone bill covers a period that ends on the 15th of each month, the organization should accrue a telephone expense for that portion of the July 15 telephone bill that applies to the fiscal year ending on June 30, which would be for the period from June 16 (first day of the bill period) through June 30.

A similar accrued expense concept applies to salary expenses where the pay period does not coincide with the end of a fiscal year. Only the portion of the weekly or biweekly salary expense (including related fringe benefit expenses) that is earned by employees up to and including the date of the fiscal year-end should be accrued as salary (and fringe benefit) expense through the end of the organization's fiscal year-end.

Debt

In addition to the accounts payable and accrued expense liabilities described above, not-for-profit organizations generally have a liability for at least some form of debt which they have incurred. Debt is known by several different names, usually based on how long the debt has before it becomes due, or matures. For example, a short-term loan is generally evidenced by some type of legal instrument, commonly referred to as a note. These types of loans are usually recorded in the financial statements as notes payable, and generally mature in five years or less. There are a wide variety of transactions that may give rise to notes payable, some of which are very common. For example, a not-for-profit organization may purchase new office equipment and desire to pay off the purchase price over a three-year period. The equipment seller would usually have the organization sign a promissory note for the purchase price, providing a legal basis for their future right to collect the purchase price, including interest, from the not-for-profit organization.

Another common form of short-term debt incurred by not-for-profit organizations is that of short-term cash advances received from lines of credit. Often, not-for-profit organizations receive donations on a cyclical basis. December is a popular time for donations, as the holiday season puts many donors in the spirit to give and donors rush to make contributions before the end of the calendar year for tax purposes. However, since a not-for-profit organization's cash needs may be quite different from its pattern of cash receipts, many organizations obtain a credit line from a bank to help them through any cash-short times. It is important to note that a liability is *not* recorded at the time that the not-for-profit organization obtains the line of credit, but rather when it draws down on the credit line. For example, assume that the organization negotiates with a bank and obtains a credit line of $10,000. No money is borrowed, but similar to a consumer home equity credit line, the $10,000 is available at will by the not-for-profit organization. No liability is recorded at this time, although the existence of the credit line must be disclosed in the notes to the financial statements. Let us say that during the year the not-for-profit organization draws $8,000 against the line, and at the end of the fiscal year the $8,000 is still outstanding. The statement of financial position would show a liability of $8,000 (in addition to any amount of accrued interest expense that should be recorded), reflecting the actual amount owed under the credit line.

Longer-term debt incurred by a not-for-profit organization is usually associated with the construction of a facility or other major capital improvement. Long-term debt may take the form of bonds or a mortgage or other long-term financing from a financial institution.

Larger not-for-profit organizations sometimes issue bonds to finance construction or purchase of significant facilities. The specific mechanics of these types of transactions are beyond the scope of this book. Suffice it to say that the unpaid principal of the bonds will be recorded as a liability on the statement of financial position of the not-for-profit organization. Since bonds can be sold at either a discount (e.g., a $1,000 face value bond can only be initially sold for $980) or a premium (e.g., a $1,000 face value bond is initially sold for $1,020), the liability recorded on the financial statements would represent the face amount of the bonds (also called their par value), decreased by discounts and increased on premiums on the initial sales of the bonds. Note that the total of the discounts or premiums is amortized (reduced) over the life of the bond. This amortization results in either a decrease in interest expense (in the case of a discount) or an increase in interest expense (in the case of a premium).

Other long-term financing obtained by a not-for-profit organization often takes the form of bank loans secured by mortgages against the specific facilities constructed. The outstanding balances of these loans are reported as liabilities on the statement of financial position of the not-for-profit organization.

All types of debt incurred by not-for-profit organizations will give rise to interest expense. Interest expense follows similar concepts for accruing other types of expenses. Interest expense is recognized as an expense when it is earned by the holder of the not-for-profit organization's debt, regardless of when the interest is actually paid, as explained in this example:

Practical Example A not-for-profit organization with a September 30 year-end makes semiannual interest payments—on January 1 and July 1 each year—on bonds that is has sold. Interest is paid in arrears, which means that it is paid after it has been earned by the bond holder. In other words, the January 1 interest payment is for interest earned by the bond holder from July 1 to December 31. Accordingly, the January 1 interest payment includes interest relating to the period of July 1 through September 30. Interest related to this period must be accrued by the not-for-profit organization in its September 30 financial statements. Accruing interest results in the recording of an accrued interest liability (another type of accrued expense liability as previously discussed), with a corresponding amount recorded as interest expense. When the actual payment is made on January 1, the accrued interest liability is reduced to zero, with the balance of the interest payment recognized as interest expense in the year that the payment is made.

Deferred Income

The liabilities discussed in the preceding pages are relatively easy to understand. However, liability for deferred income requires a little more conceptual thinking to understand. The idea of recording deferred income is matching the recording of income with the period in which the revenue is earned, which in some cases also matches the revenue to the costs incurred to generate that revenue. When cash is received by a not-for-profit organization prior to its either having earned the income or the right to keep the income, it records the cash along with a liability-type account called deferred income. Two examples should make this clearer:

Practical Example A performing arts organization sells subscriptions of tickets to its events for the year. One event is held each month beginning in January. A season's subscription (12 events) must be paid for in advance, prior to January. This organization earns its subscription revenue as the monthly events are performed. In the December prior to the start of the season, it would record all cash it received for subscriptions to the upcoming season as deferred revenue. As each event is performed, it earns $^1/_{12}$ of its subscription revenue. Accordingly, each month following the event, deferred income would be reduced by $^1/_{12}$ of the original amount recorded and event income would be recorded for the corresponding amount. At the end of the season after all events have been performed, all subscription revenue would be earned, meaning that deferred income would have been reduced to zero and the entire proceeds of the subscriptions would have been recorded as revenue. This accounting technique matches the revenue recognized to the accounting period in which the event was performed that generated, or earned, that revenue. It also matches, at least partially, the recognition of revenue to the costs of production that are incurred by the performing arts organization relating to the performance.

Practical Example As will be discussed in much greater detail later in this book, donors may make contributions to not-for-profit organizations that are conditional. Stretching the above example a little, let us say that a patron makes a $5,000 contribution to the organization in December 2001 and stipulates in a letter accompanying the check that unless the performing arts organization stages the donor's favorite concert in July 2002, the organization must return the contribution. The organization's right to keep the $5,000 doesn't become unconditional until the donor's favorite concert is performed in July 2002. The organization would record the initial receipt of the check in December 2001 as deferred income. After the required concert is performed in July 2002, the contribution becomes unconditional. The organization would reduce the deferred income related to this contribution to zero and record a corresponding amount of contribution revenue.

Net Assets

The difference between the assets and liabilities of a not-for-profit organization is its net assets. Net assets are a not-for-profit organization's equivalent of stockholder's equity in the commercial world or fund balance in the governmental accounting world. While the total of net assets is simple to calculate (assets less liabilities), what makes net assets somewhat difficult to understand is that when preparing financial statements in accordance with GAAP, net assets must be split into three different classifications:

- Unrestricted net assets
- Temporarily restricted net assets
- Permanently restricted net assets

Important note: While only net assets need be displayed in these three categories, the not-for-profit organization must be able to identify the assets and liabilities that would fall within each of the three classifications, as well as the additions and deductions from each of the three classifications. Remember that net assets are the result of a calculation (assets less liabilities), so that to classify net assets, the financial statement preparer needs to know what assets and liabilities fall into each of these classifications. In practice, this is not as difficult to do as it may appear. Usually the organization knows its temporarily and permanently restricted assets fairly well, and then assumes everything else is unrestricted.

Unrestricted Net Assets

Unrestricted net assets represent the net assets of a not-for-profit organization that are not temporarily restricted or permanently restricted. As will be explained in the following sections, the *temporary* and *permanent* restrictions that result in those two classifications of net assets are the results of restrictions made by donors. In the absence of a donor restriction, assets and liabilities are unrestricted and the difference between the two is reported as unrestricted net assets.

Some not-for-profit organizations have assets that are designated by their boards of directors to be held for specific purposes. For example, to provide a financial cushion and to generate investment income, a board of directors may designate that the organization set aside some level of assets in a "board-designated investment fund." Similarly, boards of directors might designate certain amounts of net assets that are being held and accumulated over a period of years for a major construction project. These board of directors' designations are *not* donor restrictions, and net assets relating to them are reported as unrestricted net assets.

Similarly, some not-for-profit organizations may view all of their net assets as restricted because all of the assets of the organization must be used for purposes of fulfilling the organization's exempt purpose, as set out in its charter, bylaws, tax-exemption designation, and so on. While it is true that the net assets of a not-for-profit organization that runs a homeless shelter are restricted in that it cannot simply take its assets and build a casino, this is not a specific donor restriction that would result in assets being classified as anything but unrestricted. The same goes for the argument "Well, although our donors made general contributions to our organization, they clearly gave us money to run a homeless shelter, not to build a casino. Therefore, these net assets are restricted." This is not correct, because there are no specific restrictions from a donor related to specific contributions. These are general contributions that are not restricted by the donors in any way other than the nature of the organization, its articles of incorporation, bylaws, and so forth.

Temporarily Restricted Net Assets

Temporarily restricted net assets are those net assets whose use is limited by either a donor-imposed time restriction or a donor-imposed purpose restriction. A time restriction requires that the net assets be used during a certain period of time. Sometimes time restrictions specify that the net assets cannot be used until after a specific point in time. A purpose restriction, as its name suggests, requires that resources be used for a specific purpose, such as a specific program of the organization. Examples will help clarify these concepts:

Practical Example A donor makes a $5,000 contribution to a school in May 2002 and specifies that the money be used by the school for the next school year, which begins in September 2002. This is a time restriction, and the $5,000 in cash would be considered an addition to temporarily restricted net assets until the time restriction was met, which would be when the new school year begins. Note that the $5,000 is recorded as contribution revenue when it is received as an increase in temporarily restricted net assets. Once the school year begins, the school is free to spend the money as it sees fit, so the $5,000 of assets is reclassified, that is, moved, to unrestricted net assets.

The reader is strongly encouraged to refer back to the discussion of deferred income in the prior section in which a donor condition resulted in a contribution being recorded as deferred income, that is, *not* contribution revenue, because the organization had to do something in the future to earn the right to keep the money. When a contribution is recorded as deferred income, there is no effect on net assets because an asset is being recorded (cash) as well as a liability (deferred income). Since net assets equal assets less liabilities and both assets and liabilities were increased by the same amount, there is no impact on net assets. In the school example, the school does not have to do anything to keep the money, it simply has to wait until September to spend it. This is a donor *restriction* which is different from the donor *condition* of the performing arts organization. Additional discussions of contributions can be found in Chapter 3 of this book.

Practical Example A donor purpose restriction can arise when a not-for-profit organization has several programs that it administers and donors would like to restrict the use of their contributions to a specific program. Referring to the school example above, let us assume that the donor does not specify when the $5,000 contribution must be spent, but instead specifies that the $5,000 be used to create a new art studio for the school. The donor has restricted the purpose for which the funds can be spent. Until the $5,000 is spent on a new art studio, it would be reported as part of temporarily restricted net assets. When the expenses are incurred in setting up the new art studio and the $5,000 is spent, an accounting entry is recorded in which the $5,000 is reclassified to unrestricted net assets so that it offsets the expenses of setting up the art studio, which are first paid out of unrestricted net assets. Note that expenses are paid from the not-for-profit organization's unrestricted net assets. Unrestricted net assets are "reimbursed" by reclassifying assets from temporarily restricted net assets to unrestricted net assets. Temporarily restricted net assets, accordingly, are then reduced to zero, which makes sense, because the funds have been spent on their restricted purpose.

Permanently Restricted Net Assets

As the name implies, permanently restricted net assets represent those net assets that a donor has instructed the not-for-profit organization to maintain in perpetuity, that is, permanently. The most common type of permanently restricted net asset arises from an endowment received by a not-for-profit organization. In the most common form of this type of transaction, a donor contributes assets (cash or investments) to a not-for-profit organization with the instructions that the corpus of the endowment fund not be spent, but that the organization can use the income generated by the endowment fund in conjunction with its activities. The income may be considered temporarily restricted or unrestricted, depending on the terms of the endowment agreement. In addition, appreciation in the value of investments made under an endowment agreement may be permanently restricted either by the donor or as a result of applicable state law. More information on donor restrictions on contributed assets is provided in Chapter 3.

Revenues

FASBCS 6 defines revenues as "inflows or other enhancements of assets of an entity or settlement of its liabilities (or a combination of both) from delivering or producing goods, receiving services, or other activities that constitute the entity's ongoing major or central operations." Not-for-profit organizations usually refer to donations as "support" and include support amount with other revenues that the organizations earn. This terminology acknowledges that contributions do not fit nicely into the true definition of a revenue, but are usually not-for-profit organizations' principal source of resources and should be treated as revenues. In most cases, not-for-profit organizations receive revenues in the form of cash. Sometimes revenue may initially be recorded as a receivable if the revenue is not received in cash when the not-for-profit organization has earned the revenue and has a legal right to its collection. Keep in mind that under this definition, donated goods and services are also considered revenue (or "support and revenue," in not-for-profit terminology). Similarly, if a donor or other party satisfies an outstanding liability of the not-for-profit organization, the organization would also record revenue, or support and revenue.

Not-for-profit organizations generally have two primary sources of revenues: contributions (sometimes called "support and contributions") and fee-for-service activities. Contributions are addressed in much more detail in Chapter 3 of this book. For the purpose of understanding contributions in the context of all of the revenues of a not-for-profit organization, it is sufficient to say that contribution revenues are recognized and recorded in the financial statements of a not-for-profit organization when the organization has an unconditional right to receive those revenues.

Accounting for fee-for-service revenues of a not-for-profit organization closely resembles the accounting for revenues by commercial organizations under GAAP. As briefly described earlier in this chapter, fee-for-service activities of a not-for-profit organization represent those activities where there is a direct exchange of value between the not-for-profit organization and the individual or entity purchasing the goods or services. Here are some examples of fee-for-service activities commonly found at not-for-profit organizations:

- A college or university provides education for a tuition payment.
- A visitor to a zoo buys a toy stuffed animal at the zoo's gift shop.
- A professional organization provides services to its members in return for annual membership dues.

- A day-care center provides a certain number of days of day-care to an agreed-on number of children under a contract with a local government.
- Parents buy a hot dog and soda from an athletic association's snack bar at their child's soccer tournament.

Fee-for-service revenues are recognized (i.e., reported as revenues in their financial statements) when the service is provided. This is easy to identify in the simple transactions described above. The cash collected for the hot dog and soda is recognized at the time of the purchase. For the day-care contract with a local government, the fee is most likely earned by the day-care center when it provides the service to the children in its care. Accordingly, revenue is recognized as the day-care center performs its services and bills the local government. Revenue is not recognized at the time that this type of contract is signed, which is a frequent misconception among readers of not-for-profit organization financial statements. As described earlier in this chapter, if the day-care center received a cash advance from the government at the time that the contract was signed or at the beginning of the service period, the day-care center would record the cash advance as deferred income recognized. Revenue would be recognized (and the deferred revenue amount recorded on the statement of financial position reduced) as the services were performed by the day-care center.

Expenses

FASBCS-6 defines expenses as ". . . outflows or other using up of assets or incurrence of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations." This definition is similar in format to that of revenues, except that expenses refer to the using up of resources while revenues refer to obtaining resources. Expense recognition was discussed briefly earlier in this chapter with regard to accounts payable and accrued expenses. Worth noting in this discussion, however, is that the above definition refers to a using up of assets, which does not always mean a payment in cash. For example, some of the assets described earlier in this chapter (inventory and prepaid expenses, for example) are treated as an asset when the cash is expended (or an accounts payable or accrued expense is recorded). These assets are then charged to expense either when time passes (in the case of prepaid expenses) or as the assets are sold or used by the organization (in the case of inventory). Similarly, property, plant, and equipment is originally recorded as an asset and then depreciated (except for land, which is not depreciated) using some systematic method. The depreciation calculated for each year is recorded as an expense of that period.

As will be discussed in the next chapter on the key financial statements of a not-for-profit organization, there are two important classifications of expenses used by not-for-profit organizations: functional and natural.

Functional Classification

This classification provides an indication of what the expenses were used for by the not-for-profit organization. The three principal functional classifications are:

- *Program expenses.* These are expenses that the not-for-profit organization incurs in the operation of its various program activities.
- *Management and administrative expenses.* These are the expenses incurred by the not-for-profit organization in its overall management and administration that are not identifiable with any particular program. (These expenses are sometimes called general and administrative expenses.)
- *Fund-raising expenses.* These are the expenses incurred by the not-for-profit organization in its efforts to raise money from donors.

Not-for-profit organizations that are membership organizations would report a fourth classification of functional expenses, membership development expenses. These are expenses incurred by the membership organization in soliciting for new members and membership dues.

Natural Classification

This classification indicates the type of expense that was incurred by the not-for-profit organization. Examples of the natural classification of expenses would be salary expenses, rent, electricity, depreciation, and so on.

Whereas functional classification indicates on what activity (function) the not-for-profit organization incurred the expense, natural classification indicates the type (nature) of the expense that was incurred. Each of these classifications will be discussed more fully in Chapter 2 of this book, in the section covering the statement of activities.

Gains and Losses

Revenues of not-for-profit organizations *increase* their net assets; expenses *decrease* net assets. All other transactions that increase or decrease the net assets of a not-for-profit organization are referred to as gains or losses, respectively. (An exception to this broad statement are equity transactions with the "owners" of an organization, such as a capitalization investment or a dividend or other distributions to owners. These are infrequent transactions in not-for-profit organizations.)

What distinguishes gains and losses from revenues and expenses centers on the phrase in both the definition of revenues and of expenses that they are transactions that ". . . constitute the entity's ongoing major or central operations." Gains and losses are transactions that are auxiliary to the not-for-profit organization's revenues and expenses. Investment gains or losses are very common examples of this type of transaction for not-for-profit organizations. Another example would include the gain or loss recorded on the sale of an asset, such as gains or losses resulting from the sale of a building or other fixed asset. In evaluating what transactions would be considered revenues/expenses or gains/losses, the nature of the operations of the not-for-profit organization needs to be evaluated. A transaction that would be considered outside of one organization's central operations, might be considered part of another organization's central operations and, accordingly, be included in revenues and expenses.

WHAT IS MEANT BY THE ACCRUAL BASIS OF ACCOUNTING? HOW DOES THIS DIFFER FROM THE CASH BASIS OF ACCOUNTING, AND WHICH IS BETTER?

Non-accountants tend to think, understandably so, that there is only one way that organizations record transactions. In other words, they believe the basis of accounting used by any not-for-profit organization should be the same as that used by any other organization. The old joke that an accountant's answer to the question "How much is two plus two?" is *"How much do you want it to be?"* had to have started somewhere, and maybe having more than one accounting basis is the place where it started.

The most important item to keep in mind in distinguishing between the accrual basis of accounting and the cash basis of accounting is that *only* the accrual basis of accounting is acceptable under generally accepted accounting principles. Any auditor's report accompanying financial statements prepared using the cash basis of accounting must include a statement that the financial statements are not prepared in accordance with generally accepted accounting principles. In trying to understand what is really meant by a "basis of accounting," keep in mind that the accounting basis essentially determines when (that is, in which accounting period) a transaction is recorded. We will now describe the principle differences between the accrual and cash bases of accounting in more detail.

Accrual Basis

The discussion of the various assets, liabilities, revenues, and expenses provided earlier in this chapter included the basic principles underlying the accrual basis of accounting. Revenues are recognized when they are earned, regardless of when the cash is actually collected. Revenues must also be realizable, meaning that the organization must at some time in the future be able to convert any receivables resulting from revenue recognition. If the organization does not expect to ever collect the cash from a revenue transaction, it should not record a receivable for it. Under the accrual basis of accounting, not-for-profit organizations record a donor's unconditional promise to give as revenue (and receivable), provided that the contribution is realizable, that is, the not-for-profit organization ultimately expects to collect the contribution.

Expenses recorded on the accrual basis of accounting follow three basic principles:

- *First, some expenses are recognized when they are "matched" to the revenue which they generate.* For example, when an item of inventory is sold, the "expense" for the item sold (basically, the not-for-profit organization's cost) is recognized at the same time as the revenue from the sale is recorded. Accordingly, the revenue and the related cost, or expense, is matched and recognized in the same fiscal year, or other accounting period.
- *Second, some expenses are recognized in the fiscal year or accounting period in which they are used by the organization.* The majority of the management, general expenses, and fund-raising expenses are recorded when the cash is paid or when the liability is incurred by the not-for-profit organization. In other words, these types of expenses are recognized when the organization has an obligation to pay the expense, which will generally correspond with the period in which the organization receives the benefit of the expense. For

example, rent expense should be recognized in the period in which the organization occupies the rented premises. Salary expense is recognized in the period during which the employees perform services. Utility expense is recognized in the period in which the particular service (telephone, electricity, gas, water, etc.) is used or consumed by the not-for-profit organization.

- *Third, some expenses are the result of a systematic allocation of costs to accounting periods.* Depreciation expense related to the depreciation of fixed assets is the classic example of this type of expense.

In considering the accrual basis of accounting, keep in mind that the time of the actual cash receipt or cash disbursement does not determine in which accounting period a transaction is recorded. Rather, revenues and expenses are recorded using the above principles, regardless of when the actual cash is collected or disbursed.

Cash Basis

Under the cash basis of accounting, transactions are only recorded when cash is received or disbursed. The terms revenues and expenses should not be used in the cash basis of accounting. Rather, only the terms *cash receipts* and *cash disbursements* should be used. In a pure application of the cash basis of accounting, the only asset of the organization would be the balance in its cash accounts. There would be no liabilities, and the cash balance would equal the total net assets of the not-for-profit organization. In actual practice, not-for-profit organizations seldom use a pure cash basis of accounting. More often, a modified cash basis is used, in which recognition may be given in the financial statements to certain receivables that are expected to be collected shortly after year-end as well as to certain payables that usually represent the unpaid bills of the organization. In addition, property, plant, and equipment, and long-term debt are also sometimes recorded. Other variations to the pure cash basis of accounting are common and are usually based on the specific needs of the organization.

Accountants almost universally agree that the accrual basis of accounting presents a better picture of an organization's financial position and results of operations and is, therefore, the only acceptable method for financial reporting in accordance with generally accepted accounting principles. The obvious question, then, is: Why would some not-for-profit organizations elect to use the cash or modified cash basis of accounting for preparing financial statements? The answer is that, particularly for small organizations, the cash basis of accounting may meet the basic needs of the users of the financial statements of the not-for-profit organization. Managers and overseers of the activities of the not-for-profit organization may feel more comfortable with the cash basis of accounting because it is generally easier to understand than the accrual basis. (Readers of this book should not fall into this category!) In addition, the cash basis of accounting is much simpler to apply than the accrual basis, meaning that it is more likely that the accounting staff of the not-for-profit organization will be able (or willing) to undertake full responsibility for preparation of the financial statements. Many small organizations that *do* use the accrual basis of accounting rely on their independent auditors to develop the necessary journal entries needed to convert from cash basis accounting records to accrual basis financial statements. This extra work, on top of the additional procedures that an independent auditor generally needs to perform in auditing accrual basis financial statements versus cash basis financial statements, will very likely result in higher audit costs for accrual basis financial statements than cash basis financial statements. The added complexities and costs associated with the accrual basis may induce many smaller not-for-profit organizations to prepare financial statements using the cash basis of accounting.

In considering the use of the cash basis of accounting, several matters should be kept in mind:

- *An independent auditor may issue an opinion that cash basis financial statements are prepared in accordance with the cash basis,* *which would be described in a note to the financial statements.* The auditor's opinion would note, however, that the financial statements are not prepared in accordance with generally accepted accounting principles.

- *Virtually all states have filing requirements for not-for-profit organizations, which usually require submission of financial statements.* State and other laws or contracts or donor agreements may require the not-for-profit organization to submit financial statements prepared in accordance with generally accepted accounting principles. Again, the cash basis of accounting could not be used in these circumstances.
- *Current and future creditors may not actually demand financial statements prepared in accordance with generally accepted accounting principles, but may feel more secure from a lending perspective if they are able to obtain GAAP statements from the not-for-profit organization.* Again, the accrual basis of accounting would be used.

As a hybrid methodology, many not-for-profit organizations maintain their books during the fiscal year on the cash basis of accounting and then prepare (or have their independent auditors prepare) the necessary adjusting journal entries to convert the cash basis accounting records into accrual basis financial statements. A word of caution in using this approach involves how an organization prepares and adopts an annual budget for its activities. Comparing monthly cash basis statements with an annual accrual basis budget can result in some important inconsistencies, particularly in types of expenses that are never recorded on a cash basis, such as depreciation expense. Adding these additional expenses at year-end may have a dramatic impact in determining whether the organization stayed within its budget during the fiscal year. It can also negate the effectiveness of a monthly or quarterly budget as an effective management tool. Determining how these noncash types of year-end adjusting entries are to be handled should be accomplished at the time that the budget is prepared and adopted, so that there are no year-end surprises for the not-for-profit organization's management and board of directors.

WHAT HAPPENED TO FUND ACCOUNTING?

Some readers of a book on not-for-profit accounting principles might have expected to read a long discussion of the intricacies of fund accounting. If this book were being written ten years ago, this topic would have been one of the first in this chapter, rather than the last. The fact is that, for the purpose of preparing financial statements in accordance with GAAP subsequent to the adoption of SFAS 117, reporting information by funds is no longer required. Fund accounting has essentially been replaced by classifications of net assets into their unrestricted, temporarily restricted, and permanently restricted categories.

Some not-for-profit organizations continue to use fund accounting in their internal accounting systems and then convert this information into net asset classifications for purposes of financial reporting. Since SFAS 117 does not preclude presentation of fund information (as long as its required net asset information is presented), some not-for-profit organizations still present some fund financial information in their financial statements prepared in accordance with GAAP. These organizations might present information about their current funds, which include both restricted and unrestricted amounts, endowment funds, and plant funds (in which they record property, plant, and equipment). Frankly, presentation of fund information in financial statements prepared in accordance with SFAS 117 can make the financial statements confusing, at best, and contradictory, at worst. Unless there is an overriding reason as to why this information is important to particular readers of financial statements, it is probably best to leave it out.

One of the primary reasons for using fund accounting was to improve the accountability of certain not-for-profit organizations that often found themselves in the somewhat unique circumstance of only being able to use some of their assets for certain purposes or programs. Fund accounting assisted in assuring compliance with these requirements. On the other hand, the fairly sophisticated accounting software packages available today can provide a high degree of accountability, assuming that the organization's chart of accounts and cost allocations are set up with some thought and care. As more and more not-for-profit organizations convert to more sophisticated systems, it seems likely that true fund accounting will gradually disappear from use.

The management of each not-for-profit organization should assess whether the use of fund accounting still makes sense for its particular organization. Consultation with the organization's independent auditor prior to abandoning a fund accounting system is encouraged to make sure that any new system or approach to accumulating and reporting information for GAAP financial statements (as well as any donor or grantor requirements for financial information of individual programs or grants) will still accumulate the required information at the necessary level of detail.

SUMMARY

This chapter presented a foundation for a basic level of understanding of the application of generally accepted accounting principles to not-for-profit organizations. The common features of not-for-profit financial statements presented as an overview will serve as a foundation for understanding the finer points of not-for-profit accounting described in subsequent chapters.