FREQUENTLY ASKED QUESTIONS ABOUT ACCOUNTING

By NONPROFITS

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Keller & Owens, LLC

Certified Public Accountants

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Notes:

1. Other areas of accounting relevant to nonprofits such as reporting of related entities, including consolidation, mergers and acquisitions, use of fair value measures, investments, split interest agreements, debt and certain other liabilities and other topics are beyond the scope of this booklet. Questions in those areas should be addressed to your Keller & Owens representative.
2. Responses to the questions below are based on professional standards described in the AICPA's *Audit & Accounting Guide: Not-for-Profit Entities* but may not fit the circumstances of every nonprofit organization and should be reviewed with your Keller & Owens representative prior to actual application.
3. ASU 2014-09, *Revenue from Contracts with Customers* and ASU 2018-08, *Not-for-Profit Entities* [clarifies contributions and exchange transactions] are effective for calendar year 2019. ASU 2016-02, *Leases*, is effective for calendar year 2020. These ASUs have not been reflected in this document.

ANSWERS TO QUESTIONS FREQUENTLY

ASKED ABOUT –

We use a professional fund-raiser to solicit some of our contribution revenue. We also receive some of our funds through a federated fund-raising entity. In both cases, we record the net proceeds in our records. Is this the correct accounting?

The contribution revenue from both sources should be recorded "gross", i.e., not reduced by the fund-raising expenses incurred by the solicitor or by an administrative fee deducted from donor-restricted contributions that it raises through an intermediary. Both the fund-raising fees and the administrative fee should be reported as fund-raising expenses.

Our organization receives noncash items, including used vehicles, from donors which we pass on to qualified recipients, other nonprofits or convert to cash for use in our mission. Occasionally, there is substantial doubt about existence of the item's value. How should we account for the donated items under these circumstances?

If there is substantial uncertainty about whether a potential noncash donation has value, it probably should **not** be recorded as either contribution revenue or as a pass-through liability. However, the existence of value is not the same as difficulty in determining a value.

Our educational institution has two revolving loan funds. Fund A provides low-interest loans to students with demonstrated financial need. Fund B is administered by our global missions department and makes small loans called micro loans to struggling small businesses or impoverished individuals who lack access to banking services. Donors to Fund A only specified that the contributed resources were to be used for loans to qualified students. Donors to Fund B required that the resources were to create a fund for making micro loans and all repayments were to be used to make additional loans. We are not sure whether the donations should be considered as without donor restrictions or with donor restrictions.

In the case of Fund A, the donations should be classified as with donor restrictions until the loan is made when they are reclassified (released) as unrestricted revenues. The contributions to Fund B should also be classified as with donor restrictions (permanently) even though losses may eventually exhaust the Fund because the resources are capable of providing economic benefits indefinitely.

Our church received a boat with a fair value of $15,000 as a contribution without donor restrictions. We immediately sold the boat through a dealer for $13,500 less $500 in selling expenses. How should we record this transaction?

The church should report two transactions: the donation and the sale. It should record an asset (the boat) and contribution revenue for $15,000. When the boat is sold (and removed from the records), the church should report cash (or a receivable) for $13,000, a loss for $1,500 and selling expense of $500.

Several years ago, a member of our board of trustees donated several lots he owned in a new housing development on the outskirts of our town. We expected to sell the lots within that fiscal year. Currently, many of the lots in the housing development, including the ones we own, remain unsold due to an economic downturn and loss of jobs in our area. We recorded the donation at the value provided by the donor at the time of donation. Should we revisit the value we are carrying on our records?

The recipient of the donation has the responsibility to obtain an independent and objectivity determined fair value for the property at the time of donation. This value may be significantly different than the value provided by the donor. The lots should be recorded at fair value on the balance sheet as an asset titled real estate held for resale. The asset's carrying value should be assessed for impairment at least annually and written down to fair value less cost to sell if that is less than its previous carrying value. An impairment loss should be recognized if the carrying value is not recoverable as measured by the undiscounted cash flows expected to result from use and eventual disposition of the lots.

Our organization is planning to conduct a fund-raising campaign to support several of our program activities. We don't want the fund-raising materials to create implicit restrictions as to the use of the funds raised. What language should we consider in the materials to help avoid this issue?

You would want to make it clear that the gifts raised in response to the solicitation will be used exclusively for the exempt purposes of the organization and are not limited only to the program activities enumerated in the materials unless the donor explicitly indicates a particular use in writing.

Our organization has held its first fund-raising auction. We received some well-known original works of art from a local philanthropist. We had a local art dealer provide us with a fair value of $10,000 for the art works. We sold them at auction for $11,750. How should we record the donation and the sale?

The donation should be recorded as an asset and a contribution for the fair value of $10,000. The additional revenue of $1,750 from the sale should be recorded as a contribution. No cost for the art works should be reported in the statement of activities. If the works of art had sold for $8,500, a reduction of $1,500 in contributions should be reported.

Our nonprofit is conducting a capital campaign to remodel our headquarters. The renovation project is scheduled to take two years. We have received cash contributions of $250,000 and pledges of $750,000 to be paid in equal payments over three years. We understand that both the cash and pledges are considered to be with donor restrictions but we are unclear when they can be reclassified or released to net assets without donor restrictions.

These resources illustrate both purpose and time restrictions. Both the cash and pledges are restricted by the donor for the purpose of renovating the facility. The pledges receivable are also time restricted, i.e., until the receivable is paid by the donor. Both the $250,000 in cash contributions and $500,000 collected from pledges receivable would be reclassified or released to net assets without donor restrictions when the funds are disbursed during construction. The remaining pledges would be reclassified (released) to net assets without donor restrictions when the payment is due or when the renovation is fully placed in service, whichever is sooner.

A local foundation has pledged a contribution of $500,000 to a permanent endowment for our school's performing arts program with the stipulation that we raise $250,000 in matching funds as well as we make a contribution of $250,000 to the endowment from net assets without donor restrictions. What are the accounting considerations from the foundation's gift?

First, because the donor stipulation would prevent the school from redirecting the use of previously net assets without donor restrictions in perpetuity, the school should carefully consider whether it wants to accept the gift under these terms. Second, $250,000 of the foundation's pledge is contingent on the school raising an equivalent amount of matching funds. A conditional pledge can't be recorded until the condition is met, i.e., the matching funds are raised. However, both the reclassification of net assets without donor restrictions to net assets with donor restrictions and the conditional pledge should be disclosed.

We are a nonprofit retirement home which is partially funded from government grants made on behalf of most residents. The government agency requires that certain assets be restricted for use in maintaining the retirement facilities. Should these restricted funds be reported as restricted net assets in our financial statements?

Certain government grants that are exchange or contractual transactions may limit the use of the recipient's funds. Only donors can place restrictions on net assets. However, you can disclose the contractual limitations on net assets, in the footnotes or on the balance sheet, as long as it is clear that they are part of net assets without donor restrictions.

Near the end of last fiscal year, the University received a $1,000,000 cash gift from an alumnus without any stipulations. The Board of Trustees decided to reserve the funds for general operations. In the first quarter of the current fiscal year, the same alumnus made another $1,000,000 cash gift but reserved the right to specify the purpose of the gift at a future date. At the end of the year, the donor decided that both gifts should be used to establish a permanent faculty chair in the business school. Can the donor's request be honored and what is the related accounting?

The University is not required to restrict an earlier unrestricted gift, although it may do so. After making sure that the initial classification was not a misunderstanding and therefore a potential correction of an error, the University can reclassify net assets without donor restrictions to net assets with donor restrictions. The $1,000,000 cash gift in the current year would be recorded as with donor restrictions. Later when the donor indicated that the gift should be restricted in perpetuity it should be so disclosed.

We have a new development director who suggested that we start charging an administrative fee on gifts raised including on restricted gifts. The administrative fee is intended to cover the costs of soliciting and accounting for the gifts. Is this permissible? If so, what is the accounting?

The administrative fee would only be charged on gifts with donor restrictions since funds without donor restrictions could already be used for fundraising and other supporting services. If you decide to charge an administrative fee on gifts with donor restrictions, then you should clearly communicate that intent to the donor in the fundraising activities and materials **before** the solicitation is made. Then if the gift is made, the donor acknowledges that a portion of the gift will go to cover the indicated costs. In the case on an unconditional pledge, the administrative fee is restricted for the specified expenses until the pledge is paid.

We are a small private nonprofit college. We have experienced a serious down trend in enrollments and donations in the past several years. Additional bank loans were not available. As a result, we have had to borrow net assets with donor restrictions to meet operating needs. Is this permissible?

Nonprofits are legally required to use net assets with donor restrictions according to the stipulations of the donor. Borrowing from donor restricted funds is a serious matter. Such action may hinder much needed future donors from providing restricted funds. Accordingly, borrowing funds with donor restrictions would be done under limited circumstances. For example, the college should only take such action in dire circumstances, when it has informed its constituents, including requesting temporary or permanent lifting of the restrictions, developing a realistic repayment plan and seeking court approval for the action (although the court may look unfavorably on fiduciary irresponsibility).

Our organization has units in multiple locations throughout the region. One of the units began a $3,000,000 capital campaign to renovate and expand its facilities. At present, $2,500,000 in pledges and cash have been received. Now headquarters has decided only to renovate, not expand, the facilities at an estimated cost of $1,500,000. What do we do?

Consider contacting the actual or potential donors of the extra $1,000,000 and 1) requesting that the restriction be released permitting general use of the funds or 2) that the restriction be changed to specify other programs or 3) projects with which the unit will be able to comply or requesting a court to issue a *cy pres* ruling to change the restriction on the funds. If none of the preceding approaches accomplish the goal and unused cash donations and pledges received in the previous year are returned, a loss should be recorded. You should also inform the donor in writing to contact their tax advisor if a tax deduction had been claimed in their previous tax return. Restricted contributions and pledges received in the current year should be written off against contribution revenue rather than reporting a loss.

We recently we lost our executive director who had promoted and raised funds for three new projects. The new executive director wants to eliminate one of the projects and focus on two of the projects she believes better serve the organization's exempt purpose. In the future, how do we avoid situations like this where we might need to refund contributions with donor restrictions?

Plan ahead by stating in the solicitation 1) the organization will not accept restricted gifts unless the donor grants you written variance power, i.e. the unilateral right to substitute a different project or purpose at the Board's discretion or 2) that amounts received in excess of those needed for the original designated project will be used for similar projects.

We are a small private nonprofit college. We have experienced a serious down trend in enrollments and donations in the past several years. Additional bank loans were not available. As a result, we have had to borrow cash and marketable securities held for net assets with donor restrictions to meet operating needs. How do we report these circumstances in our financial statements?

An organization in these circumstances is required to disclose noncompliance with donor-imposed restrictions if there is a reasonable possibility that 1) it has incurred a material contingently liability (to return restricted donations), 2) it could lose a material amount of revenue or 3) cease to continue as a going concern. Disclosures may also be required re: the amounts of restricted cash and marketable securities used.

Our church received $100,000 in cash from a bequest without any stipulations. The governing board restricted the funds for a future church plant. How should this be reported in our financial statements?

Only donors can impose restrictions on net assets. Boards can designate or reserve net assets without donor designations for specific purposes and also reverse the self-imposed limitations. It may be useful to readers of the financial statements to know that a portion of net assets without donor designations has been segregated and not available for general operations. This information is to be disclosed on the face of the statement of financial position or in the footnotes to the financial statements.

The following is an example footnote:

Note D - Net Assets without Donor Restrictions: Board-Designated

> The governing board has designated, from net assets without restrictions of $1,700,000, net assets in the amount of $275,000 reserved for missions-related opportunities expected to develop in the future. In addition, the Board has set aside $500,000 in funds to be used in the event of seasonal or other immediate liquidity needs. These limitations can be revised or removed at any time by future Board action.

Our organization's balance sheet at year end tentatively reported the following for net assets:

Without donor restrictions:	
Net investment in property and equipment	**$1, 750,000**
Board designated for contingencies	**250,000**
Undesignated	**(300,000)**
Total unrestricted	**1,700,000**
With donor restrictions:	
Perpetual in nature	**50,000**
Purpose restricted	**75,000**
Time restricted for future periods	**50,000**
Total restricted	**175,000**
Total Net Assets	**$ 1,875,000**

I have been asked to review the draft financial statements with the Board. How should I explain this section of the balance sheet?

The net assets with donor restrictions represent funds with time or purpose restrictions from donors or by law. The components of net assets with donor restrictions at year-end are disclosed in the financial statements, often in the footnotes, and are useful in providing for improved resource analysis. The components of net assets without donor restrictions have been disclosed to provide the reader some idea of the availability of net assets without donor restrictions for operations. Net investment in property and equipment represents the book value of those assets less related debt. While this portion of net assets without donor restrictions is used in operation, it is not available to fund current operations unless liquidated. The portion of net assets without donor restrictions designated by the Board is intended to reserve funds for contingencies. However, since there is a deficit in the remaining undesignated net assets without donor restrictions, the organization has actually used the $250,000 designated for contingencies as well as $50,000 of funds with donor restrictions. Accordingly, the Board should reverse the designation for contingencies and consider the actions delineated in the "small private nonprofit college" questions above.

Our organization provides services to battered women and children. During the year we received a $50,000 cost-reimbursement grant from the State for services and $75,000 from individual donors, restricted for job skills and employment training for the women. The Board also budgeted $100,000 for such training from general contributions. We incurred $150,000 in expenses for the job skills and employment training during the year. Can we attribute the expenses to the grant and the budget ?

Generally accepted accounting principles requires organizations to use net assets with donor designations first and release them to net assets without donor designations unless the expenses are for a purpose that is directly attributable to some other specific source of revenue. Assuming that all expenses are allowable under the cost-reimbursement grant, the organization can allocate up to $50,000 of the expenses to the grant because it is a specific external source of revenue that would not otherwise be available to the organization. The next $75,000 in expenses would be attributed to the net assets restricted for job skills and employment training for the women with the remaining $25,000 charged to the net assets without donor designations in the budget allocation.

Our private school receives contributions restricted by donors for scholarships. This year, we received $25,000 for scholarships and awarded $20,000 in scholarships to qualified students. Must we report the $25,000 as contributions with donor restrictions with $20,000 released to unrestricted net assets?

Twenty thousand dollars of the funds received for scholarships may be reported as contributions without donor restrictions if they meet all of the following conditions: 1) the restrictions are met in the same fiscal year; 2) the school has a policy that all donor-restricted contributions whose restrictions are met in the same period are reported as without donor restrictions, the policy is disclosed and is followed consistently; and 3) the school has a similar policy for accounting for investment gains and losses. The remaining $5,000 of unused scholarship funds would be included in net assets with donor restrictions at the end of the period.

A local mission for the homeless received a building to be used to house homeless women and children. The donor did not specify the period over which the building was to be used. The mission's board has adopted a policy of implying a time restriction on the contributed asset. The mission's controller wants to know the accounting ramifications of this policy. What if the donor had explicitly stated how long the building must be used?

Since the donor specified <u>how</u> the building was to be used, the gift is reported as donor restricted revenue. Although the mission adopted the policy of implying a time restriction, under GAAP, the time restriction expires <u>when</u> the building is placed in service. If the donor had specified how long the building must be used by the mission before it could be disposed of or used for other purposes, the restriction expires ratably over the period specified by the donor. Absent explicit donor restrictions of time or purpose, net assets are reclassified from net assets with donor restrictions to net assets without donor restrictions when placed in service. This same rule applies whether acquiring or constructing any long-lived asset, such as the building in this example.

Our social service agency received both cash and in-kind donations as well as pledges during a recent fund-raising campaign. A large pledge was made by a donor from her donor advised fund held by a community foundation. Our outside accountant says that we can't record that pledge. Is the accountant right?

Maybe. Usually when a donor contributes funds to a community foundation, the donor explicitly gives the foundation variance power in order to make the donation tax deductible. Variance power is the unilateral power to redirect the funds to a beneficiary other than a beneficiary specified by the donor. The donor may be able to "advise" the foundation as to a beneficiary, but the foundation has the final say. Accordingly, the pledge may be only an intention to give which cannot recorded or disclosed until the funds are released by the foundation. If the foundation agrees in writing to release the funds at a specified date in the future, an unconditional pledge might be recorded.

A major donor gave $1,000,000 to our nonprofit organization with the suggestion that $250,000 be given to an overseas affiliated entity. We recorded the $1,000,000 as contribution revenue. When we transferred the $250,000 to the affiliate, we recorded a contribution expense. Is this correct?

First, you must determine whether the overseas entity is financially interrelated to your organization. The overseas entity is financially interrelated if 1) your organization can influence the other entity's financial and operating decisions and 2) your organization has an ongoing economic interest in the other entity's net assets. Both factors must be present to be financially interrelated and must be thoroughly understood. If both factors are met, your organization does not have a liability to deliver the $250,000 to the affiliated entity because of the relationship between the entities. In that case, the full $1,000,000 can be recorded as a contribution. In all likelihood, you would honor the donor's suggestion, transfer the $250,000 to the affiliated entity and record an expense which would be functionally reported.

On the other hand, if both factors are not met, i.e., the organizations are not financially interrelated, $250,000 is an agency transaction if the donor didn't grant variance power and should not record as contribution revenue but record as a liability to the affiliated organization.

Our private nonprofit college has some land that it would like to transfer to an affiliated church to enable the church to establish a campus location. We have heard that we need an independent appraisal to determine the value of the contributed asset. Is this correct?

Generally accepted accounting principles permit assets to be transferred between commonly controlled entities at the carrying value of the resource provider.

Our nonprofit organization teaches youth about the theatre, provides acting lessons and conducts performances to permit the young actors to display their talents. A private school provided us with a $25,000 grant to provide our services to some of their students. Our bookkeeper recorded the $25,000 as a donation. Is this correct?

Grants represent contributions if the grantor receives no or only incidental value in exchange for the funds provided. This appears to be an exchange transaction in which the school is purchasing services from your organization. Therefore, the $25,000 should not be reported as contribution revenue but rather as fee for services revenue.

The State Department of Family Services provided our organization with a grant to train men to be better fathers and thereby reduce the number of broken homes and neglected children in certain communities. The Department hopes that success in this program will reduce the number of social services cases the Department will need to handle thereby controlling staffing costs. Our controller wants to know how to classify these funds.

Grants represent exchange transactions rather than contributions if the potential public benefit derived is secondary to the potential benefit derived by the grantor. Each grant should be evaluated based on its specific elements and requirements. Even though the Department may benefit from the program, the primary benefits appear to come from services delivered to individuals other than services to the government agency making this contribution revenue.

Our organization provides basic living skills and pre-elementary education to handicapped children. We receive funding from various state and municipal agencies. Some of these grants reimburse us as we report actual expenses incurred, others pay on the basis of clients served (1 requires a minimum of 25 clients) and a few provide the funds at the start of the program and require only a periodic report of clients served and funds expended. How do we account for these revenues?

The primary accounting and reporting issue relates to the event that initiates the revenue recognition. In the first case, the grant agrees to reimburse allowable costs when incurred and reported, therefore revenue is recognized for every allowable dollar incurred and reported. In the second case, revenue is recognized on a pro rata basis for each client served except for one grant that requires at least 25 clients served before the end of the grant period. In the latter case the organization would recognize revenue only after the minimum had been reached. Then it would recognize revenue equal to the costs incurred until that time and on a dollar for dollar basis thereafter. In the final case, the prepaid funds would be recorded as a refundable advance which is reduced when the revenue is recognized. The requirement for the organization to submit a periodic report of clients served and funds expended may have administrative rather than economic value and does not make the grants exchange transactions.

Near its fiscal year-end, The Metropolitan Ballet received a letter from a local foundation that specializes in grants to nonprofit arts organizations that the Ballet had been awarded $50,000 as a program support (operating) grant. The funds were to be distributed the following month. When and how should the Ballet account for the grant?

The donor did not indicate that the grant was conditional or restricted so the grant should be recognized at the time of the award, i.e., in the month the formal notice of award was received – assuming the Ballet doesn't use the cash basis of accounting in which case it would record the funds when received. The grant without donor restrictions could be used at the Ballet's discretion to support any of its programs. However, it would be donor restricted if the foundation had limited the grant's use to a particular program or time period.

A well-known religious ministry has instituted a capital campaign to establish an international headquarters. Donor A has pledged to match every dollar given to the campaign up to $2,000,000. Donor B has pledged to match every dollar given to the campaign up to $1,000,000 but only after the ministry has raised its first $1,000,000 in cash. How should the ministry account for these promises to give to the capital campaign?

Due to the matching requirement, the ministry would consider the pledges as conditional. The ministry's financial statements would not reflect the promises to give as receivables or revenue but would include the required disclosures about conditional promises to give until the matching funds are raised. At that time, the pledges would become unconditional and recognized as contribution revenue.

We are the local chapter of a national nonprofit organization that fights a chronic disease. Part of our mission is to educate the public on the disease and how to mitigate the effects on those that have it. We conduct these programs throughout the year. We charge a small nonrefundable fee for the educational programs and materials and have received advance admission fees at year end. How should we account for these funds?

Resources received in exchange transactions from customers, attendees or other service beneficiaries for specific projects, programs or activities that have not yet taken place should be recognized as liabilities (deferred revenue) to the extent that the earnings process has not been completed. The revenue is earned when the educational program takes place.

We are a trade association representing attorneys in the greater metropolitan area. Members pay annual dues at various levels. The premium level membership is $250 per year. The members at that level receive one free pass to a half day CLE program, the quarterly newsletter and two invitations to the annual auction and ball. These benefits are valued at $150. How should we account for these funds?

Membership dues may be `partly contributions and partly exchange transactions. Several indicators are used for determining contribution and exchange portions of membership dues. For example, contributions provide only negligible benefits to members while exchange transactions make substantive benefits available to the members. In this case, the contribution portion is $100 and the benefits portion is $150 initially recorded as deferred revenue and recognized as revenue when the services are provided or made available, even if not used.

We are a nonprofit college that participates in federal grant programs. We determine the student's eligibility and compute the award using the government agency's guidelines. We then disburse the funds to the student and send the needed forms to the government for reimbursement. How should we account for these transactions?

The college is acting as an agent for the resource provider whose purpose is to provide financial assistance to qualified students. The college would reduce its cash or student tuition receivable account and set up a receivable from the government. On the other hand, if the college received grant funds directly to be disbursed to the students, it would record the asset and a liability which would be reduced as payment are made to students. In neither case would the college record revenue directly from the grant.

A local rescue mission has received a grant to provide meals to needy families. The mission gets $5 for each meal served. The maximum reimbursement under the grant is $25,000. For efficiency sake, the mission may prepare a large quantity of meals and freeze them for use later. What are the accounting considerations here?

First, it is necessary to determine whether this grant is a contribution or an exchange transaction. The terms of the agreement determine the appropriate classification. Generally, it is a contribution if the grantor receives no or only incidental value in return. If it is a contribution, receipt of funds is conditioned on meals served and would be recorded as contribution revenue and a receivable when that occurs. If it is an exchange transaction, the transaction would be reported using the percentage of completion method. Here the timing and amount of revenue recognition are essentially the same in either case. The cost of the pre-prepared meals would be considered inventory until used.

We are a shelter for battered women that uses volunteers to operate a telephone hotline. We also have doctors who volunteer to provide medical services to shelter residents and a licensed clinical social worker to provide counseling to the residents. We also have an attorney and a CPA on our board of directors. The attorney provides legal advice acting as a board member and occasionally provides legal services, but then at a discounted rate. The CPA serves as the organization's treasurer, reads the financial reports prepared by the accounting staff and then reports to the board on the financial results. However, this year he did prepare the organization's Form 990. How should we report these donated services?

Donated services that either create or enhance a nonfinancial asset need to be recognized. Donated services related to the shelter's ongoing activities that typically require specialized skills and would otherwise be purchased would include doctors, attorneys, licensed clinical social workers and CPAs. The services of the attorney and the CPA in their role as members of the board or treasurer would not be recorded. Other eligible services would be recorded at fair value regardless of whether the Shelter could afford to purchase the services at fair value.

We are an affiliate of ABC International (ABCI). ABCI performs both fundraising and accounting services for us. Our executive director was told by our treasurer that those services should be recorded as a contribution at fair market value. Our board chair insists that no recognition in the financial records is required since it is from a related party. Who is correct?

First, an affiliate is a party that directly (or indirectly through an intermediary) controls or is controlled by another organization. If ABCI does not charge you (requiring payment) for the services, your entity should measure the services provided at the cost recognized by ABCI in providing those services. Cost should at least include an approximation of the direct personnel costs incurred. Direct personnel costs could include compensation and payroll-related fringe benefits. If recording the services at cost does not materially represent the value of those services, you may elect to recognize those services at fair value. Though not mandated, you will probably want to record the services as an increase in net assets as contribution revenue and a decrease in net assets as personnel expense or fundraising costs.

I am the bookkeeper for a small nonprofit entity. Our new Board treasurer is a CFO of a local manufacturing company. He asked me why our Statement of Activities classifies expenses by program and supporting services rather than by natural classifications as does his for-profit employer. He also asked how we determine what goes into each classification. What do I tell him?

A nonprofit entity is required to report expenses by both natural and functional classifications either on the face of the Statement of Activities, in a Statement of Functional Expenses or in the footnotes to the financial statements (not in a supplemental schedule). Management is interested in controlling expenses so the natural classification (e.g., total payroll, telephone or travel expenses) can be helpful. Other financial statement users such as donors, governing boards, charity watchdogs and regulatory bodies are usually more interested in the cost of providing the entities' program services than they are in particular types of expenses incurred.

Program service expenses are the direct and indirect costs related to providing the nonprofit entity's programs or services for which it exists. Program services could include compensation, facilities cost, supplies and other program related costs.

Supporting services are expenses costs of activities not directly related to the organization's mission. In broad categories, supporting services are classified as management and general expenses, fund-raising expenses and membership development expenses. Other classifications that describe an organization's supporting services may be used, such as administrative or institutional support.

We are a nonprofit that relies heavily on contributions from donors. Our executive director believes that donors and potential donors want to see almost all funds spent on programs, but we do have administrative expenses. What expenses should be appropriately reported in this category?

Management and general or administrative expenses are those that are incurred in the overall direction of the entity. They typically include governing board expenses, organization management, finance and accounting, general record-keeping, budgeting, soliciting funds other than contributions and membership dues, communications other that fund-raising, and producing an annual report. Compensation of the executive director and related staff may relate to overall direction of the organization. Time they spend directly involved in or supervising program, fund-raising or membership development activities should be allocated to those activities.

A potential donor read our Form 990 and noted that we reported no fund-raising expenses though we had substantial contribution revenue. We have been uncertain about what should be included in that category so we allocated any related expenses to other classifications. Can you help us clarify this misunderstanding?

Fund-raising activities are those that make an appeal for support. The support can include money, securities, materials, facilities, vehicles or time. The cost of the fund-raising appeals include personnel costs, facilities costs, printing and postage, mailing list acquisition and maintenance, direct contact solicitations, special fund-raising events, preparation of fund-raising manuals and other material materials, cost of solicitation of contributed services (including those for program functions or management and general services) and the cost of professional fund-raisers. Personnel costs of the executive director and others may be allocated to this category to the extent of their involvement. There are special accounting considerations for determining the cost of fund-raising.

We are a religious organization that receives support solely from member tithes. We have a related nonprofit foreign missions entity that is supported primarily by a private foundation. Neither organization reports fund-raising expenses in their financial statements. Are we in compliance with generally accepted accounting principles (GAAP)?

Some organizations such as a church incur minimal or no fund-raising costs due to the nature of their activities. Others receive contributions such as certain contributed services that do not meet the criteria for recognition under GAAP. For example, a NFP has no paid staff and nearly all contributions come from solicitations by unpaid board members. The foreign missions organization should consider whether to make financial statement disclosures required by GAAP for related party transactions.

Our organization just hired a new development director. She wants to know the answers to the following questions: 1) how will the direct cost of benefits to donors be reported in our financial statements; and 2) must the cost of a professional fund-raiser or NFP fund-raising organization be offset against the contributions raised by that party?

Professional standards suggest that the direct costs of donor benefits that are provided in exchange transactions, such as a book, a meal, event tickets, golf outing, etc., unless insignificant, should be reported in categories other than fund-raising such as cost of sales or program services. If the costs are deemed to be insignificant, they can be included in fund-raising expenses. If the donor benefits are not exchange transactions, such as a dinner for which there is no charge to attend, the costs of donor benefits should be reported as fund-raising unless they are program related. You may report direct cost of benefits to donors displayed either (1) as a line item deducted from the special event or revenues other fund-raising activities with the direct cost of benefits to donors or (2) in the same section of the statement of activities as are other programs or supporting activities and allocated, if necessary, among those various functions.

Contribution revenue should be reported in the full amount contributed by donors; any fees charged by a professional fund-raiser or NFP fund-raising organization should be reported as fund-raising expense.

We are a NFP organization that conducts activities that may include program, management and general and fund-raising components. We understand that the costs of these joint activities may need to be allocated to various functions. What are joint costs and how should we account for them?

Some expenses are directly related and accounted for in a specific program or supporting activity. Other expenses may relate to more than one program or supporting activity or a combination of activities. The latter expenses are considered to be joint costs and should be allocated among the appropriate functions. Joint costs may include employee compensation, contract labor, professional fees, supplies, promotion expenses, facilities costs, among others. If certain criteria are met, your organization should allocate the costs of the joint activities to those clearly identifiable with the related program, management and general and fund-raising components. If the criteria are not met, professional standards may require that all the costs related to the joint activities be reported as fund-raising expenses, including costs otherwise identified with the other functions. One exception: the costs of goods or services provided in conjunction with a joint activity are not reported as fund-raising expenses.

We are a health association that distributes a brochure that describes the disease, steps to avoid and treat the disease, our activities to research for a cure, financial highlights, a request for support and directions on how to make a donation. The brochure also includes a return envelope for those who don't want to use the Internet to make the donation. We also use seminars that include a request for donations as well as other printed materials, radio & TV spots without a request for support to communicate similar information. The cost of this activity is material to our financial statements. Our independent CPA firm tells us that we may have joint activities which might require the cost of the brochure and its distribution to be allocated among several categories of expenses. Can you explain?

Organizations typically desire to allocate most costs to program services rather than to management and general, membership development or fund-raising expense. Certain criteria must be met to conclude which functions have been conducted in conjunction with a fund-raising appeal. If the criterion are not met, all joint activity cost may be required to be allocated to fund-raising expense. The criterion consider the purpose of the activity, the audience for the activity and the content of the activity.

The purpose criterion considers whether the joint activity accomplishes a program, management and general or membership development function. The activity must generally call for action by the audience that will help accomplish the Association's mission other than donating funds. The activity must be more than educating the audience about the causes, conditions, needs or concerns that the Association's programs address. It must be a call for specific action. For example, if the brochure asks the audience to take specific steps to avoid the disease and, if contracted, to take specific steps to treat the disease, the purpose criterion may have been met. Two other tests must also be considered: 1) does the majority of any party's fee or compensation related to brochure vary based on the funds raised; 2) does the Association use printed material, without a fund-raising component, and on a similar or greater scale, to call for the specific actions desired by the program activity? If the answer to 1) is yes, the purpose criterion fails and all the costs of the joint activities should be charged to fund-raising expense. If the answer to 1) is no and 2) is yes, the purpose criterion is met. If the answer to 2) is no, then all other evidence (as described in the related professional standards) should be considered. If the purpose criterion is ultimately met, the audience for the activity must be considered next.

Here careful consideration of the reasons for selecting the recipients of the brochure is critical. If the audience was selected primarily on the basis of the likelihood or ability to provide support, this criterion may not be met. Since the brochure recipients may be selected for more than one reason as documented by the Association, the presumption of failure here may be overcome. If the Association selected the audience 1) based on a need, current or future, by the audience to take specific steps to avoid the disease and, if contracted, to take specific steps to treat the disease, or 2) if the audience had the ability to act to assist the Association in meeting the program goals of the activity (other than financing the activity), the presumption of failure here may be overcome. If the audience criterion is met, the final test – content must be considered.

The joint activity must support the functions in a specific way. For example, the Association's brochure must call for a specific action that will assist the Association's mission or fulfill a specific management and general function requirement.

If criteria are met, the Association should allocate the costs of the joint activities to those clearly identifiable with the related program, management and general and fund-raising components. Certain incidental activities and immaterial costs can be allocated to any of the functions. Professional standards also require certain related disclosures in the Association's financial statements.

We are a trade association that represents family physicians in the central U.S. We conduct training seminars and provide other benefits to our members. We regularly conduct membership drives to increase our membership. We are required to report expenses by function in our financial statements. How should we categorize the cost of the membership drives?

Membership development is another category of supporting services expenses in addition to management and general and fund-raising. Membership development expenses include any expenses related to soliciting for prospective members, membership dues, membership relations and similar activities. If no significant benefits are received or duties required in connection with membership, the substance of the membership development activities may be fund-raising and reported as such.

We are a local church and a member of a national religious denomination. This membership requires our church to pay an amount annually for certain benefits provided by the denominational headquarters. Our business manager says that we should report expenses by functional classification but we aren't sure in what categories to report the payment to the denomination. Please advise.

To the extent possible, the payment should be allocated to the categories most closely related to the functions the denomination provides for your church, such as management and general. Any amounts that can't be allocated to a specific function are considered in a separate supporting service category titled "unallocated payments to affiliated organization."

I am the new controller for a non-profit organization. I understand that expenses must be reported by functional category in our Statement of Activities, in a Statement of Functional Expenses or in a footnote to the financial statements. Some expenses such as compensation or facilities cost cross multiple functions. Are there reasonable methods I can use to allocate those expenses?

Costs directly identifiable with a specific program or supporting activity should be recorded in those categories. Other expenses may apply to more than one program or supporting service and should be allocated among those functions. Though reasonable estimates can be used, many organizations use their general ledger chart of accounts or other detailed records to allocate expenses. An objective approach based on financial or nonfinancial data usually brings the best results. The approach should be reviewed at least annually for continued relevancy and consistency.

As a reminder, expenses generally considered as directly or indirectly assigned to <u>programs</u> (i.e., the costs of the activities for which purpose the organization exists) are usually identified by the program activity or by grant agreements. <u>Management and general</u> expenses include expenses for activities of the governing board, business management, finance, general recordkeeping, budgeting, soliciting funds other than contributions and membership dues, providing information about stewardship of contributions, appointments and producing the annual report. Compensation costs of the executive director and staff should be allocated to programs only to the extent that they are directly related to supervising the program or fund-raising activities. <u>Fund-raising costs</u> are those incurred to induce others to contribute money, securities, time, materials or facilities to the organization (there are some special accounting considerations related to the recognition of fund-raising costs). <u>Membership development</u> expenses include those related to the solicitation of new members and membership dues, membership relations and similar expenses. <u>Payments to affiliated organizations</u>, such as dues to a national organization, that can't be allocated to a specific function should be reported as unallocated payments to affiliated organizations in supporting services.

Here are some examples of allocation methods that might be used: 1) compensation, including benefits based on a time study or documented time incurred in each activity; 2) facilities cost, including rent or depreciation, utilities, cleaning, and building maintenance and supplies based on square footage used by each program or supporting service; 3) auto and travel costs based on employee expense reports; 4) supplies, postage and similar costs based on actual usage; 5) communications expenses, including telephone and internet based on use by location; 6) interest expense, including mortgage interest, based on related purpose or perhaps square footage. Interest costs that cannot be allocated should be reported as management and general expense.

Also note that GAAP requires that your financial statements include a footnote that describes the specific allocation methods applied to certain natural categories of expenses. For example:

Note X – Methods Used for Allocation of expenses Among Program and supporting Services

> The financial statements report certain categories of expenses to one or more programs or supporting services. The expenses are allocated on a reasonable basis consistently applied. Those expenses include compensation costs, depreciation and maintenance costs, interest on mortgage debt and certain information technology costs. Compensation costs are allocated based on time studies by activity. Depreciation and certain maintenance expense as well as interest on mortgage debt are allocated on the basis of square footage used by an activity. Information technology costs are based on a cost study of specific technology used.

Our external auditors tells us that we are required to disclose both quantitative and qualitative information in the footnotes and/or on the face of the balance sheet re: the availability of financial assets to meet cash needs. What would such disclosures look like?

Donors, creditors and charity watchdogs want more transparent information about how your organization manages its liquid resources and liquidity risks. Accordingly, professional standards require that your organization provide information on the availability of *financial assets* at the balance sheet date to meet cash needs for *general expenditures* (i.e., cash to pay the bills) within one year of the balance sheet date. Financial assets is defined as total assets less nonfinancial assets such as PP&E, inventory, prepaids, etc. The following is an example of such a disclosure:

Note Y – Liquidity and Availability of Resources

> The following reflects the organization's financial assets as of the date of the statement of financial position, reduced by amounts not available for general use because of contractual, donor-imposed restrictions or board limitations within one year of the date of the statement of financial position.

Cash and cash equivalents	$ 275,000
Short-term investments	350,000
Contributions receivable, net	1,250,000
Accounts receivable, net	120,000
Total financial assets available within one year	1,995,000
Less those unavailable for general expenditures within one year, due to:	
Contractual or donor imposed restrictions:	
Subject to satisfaction of donor restrictions	(750,000)
Restricted by donor with time restrictions	(450,000)
Board designations:	
Reserve for special projects	(350,000)
Reserve for contingencies	(150,000)
Total financial assets available to meet cash needs for general expenditures within year	$ 295,000

As part of the Organization's liquidity management, it has a policy to structure its financial assets to be available as its general expenditures, liabilities and other obligations become due. In addition, The Organization invests cash in excess of daily requirements in short-term investments. As shown above, $500,000 of financial assets are designated by the Board. These funds may be drawn upon with Board approval in the event of financial distress or an immediate liquidity need. The Organization can also draw on $250,000 in available lines of credit.

Our organization has a sizeable investment portfolio. We have always reported investment income by components and expenses separately from income. Our controller heard that the rules have changed. How should investment return be reported under the new rules?

Under the new rules, separate disclose of investment income components (interest, dividends, etc.) is no longer required. Direct and indirect investment-related expenses are usually to be grouped with investment income accounts and netted with investment income on the statement of activities. If your organization has both an endowment and a general investment portfolio, then splitting out the net investment return is generally encouraged as a means of providing some flexibility in the financial statement presentation.

Direct internal investment expenses include investment advice from employees, and salaries, benefits, travel and costs associated with the officer and staff responsible for the development and execution of investment strategy. They also include allocable costs associated with the internal investment management and supervising, selecting and monitoring of external investment managers. External expenses include the cost of investment advice, custodian services, valuation procedures and processes and other professional services such as legal and accounting. Investment-related expenses that should not be netted include:

- Costs associated with unitization and other such bookkeeping and accounting aspects of endowment and investment management and
- The costs of programmatic investing (investments that are directed at carrying out the organization's mission rather than investing for the production of income or appreciation).

Investment-related expenses are to be excluded from the statement of functional expenses. If expenses are disclosed, say in a footnote, they should be clearly labeled.

Our church is in a capital campaign for additional land and a major building addition. We have received substantial donor-restricted funds for these projects. When are these funds considered released from donor-restricted net assets?

Under previous rules, the donor-restricted net assets were released over the assets estimated useful life of when the asset was placed in service. Now the net assets are released when the funds are spent upon the acquisition of the asset, when the funds are disbursed during the construction (if it is more probable than not that the asset will be fully funded and completed) or when the asset is fully placed in service.

Our organization has a donor-restricted endowment for which the value of the fund at year-end is less than either the original gift amount or the amount required to be maintained by the donor or by law that extends donor restrictions. How are we to report this matter?

Previously, deficiencies in donor-restricted endowments were reported as decreases in endowments without donor restrictions. Now deficiencies in donor-restricted endowments are to be reported in donor-restricted net assets. In addition, certain enhanced disclosures are required such as shown in the example below:

Note Z - Underwater Endowment Funds

> From time to time, the value of assets associated with individual donor-restricted endowment funds may fall below the level that the donors or State Prudent Management of Institutional Funds Act requires the Organization to retain as a fund of perpetual duration. Deficiencies of this nature exist in three donor-restricted funds, which together have an original gift amount of \$350,000, a current fair value of \$330,000 and a deficiency of \$20,000 at year-end. These deficiencies resulted from unfavorable market fluctuations that occurred shortly after the investment of new contributions for donor-restricted endowment funds and continued appropriation for certain programs that was deemed prudent by the Board of Trustees.