Not-For-Profit Accounting: Reporting And Analysis

Not-For-Profit Accounting: Reporting and Analysis

The author is not engaged by this text or any accompanying lecture or electronic media in the rendering of legal, tax, accounting, or similar professional services. While the legal, tax, and accounting issues discussed in this material have been reviewed with sources believed to be reliable, concepts discussed can be affected by changes in the law or in the interpretation of such laws since this text was printed. For that reason, the accuracy and completeness of this information and the author's opinions based thereon cannot be guaranteed. In addition, state or local tax laws and procedural rules may have a material impact on the general discussion. As a result, the strategies suggested may not be suitable for every individual. Before taking any action, all references and citations should be checked and updated accordingly.

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional service. If legal advice or other expert advice is required, the services of a competent professional person should be sought.

—-From a Declaration of Principles jointly adopted by a committee of the American Bar Association and a Committee of Publishers and Associations.

Course Description

Business organizations obtain resources by providing goods and services. Many not-for-profit organizations (NFPOs) obtain resources from contributors and are accountable to the providers of those resources or to their representatives. In general, GAAP requires not-for-profit organizations to issue a statement of financial position, a statement of activities, and a statement of cash flows. The focus is on the organization as a whole and on reporting assets, liabilities, and net assets; changes in net assets; flows of economic resources; cash flows, borrowing and repayment of borrowing, and other factors affecting liquidity; and service efforts. This course addresses the accounting and financial reporting for NFPOs (or NPOs) ---colleges and universities, healthcare providers, voluntary health and welfare organizations (VHWOs), and other not-for-profit entities such as religious, educational, social, recreational entities. Also addressed is financial analysis and ratios that can be useful to analyze financial fitness of NFPOs.

Field of Study	Accounting
Level of Knowledge	Basic to Intermediate
Prerequisite	None
Advanced Preparation	None

Table of Contents

Chapter 1:

Not-For-Profit Organizations

Learning Objectives:

After completing this section, you should be able to:

1. Recognize the types of and components of financial statements mandated by GAAP for not-for-profit organizations.

2. Identify the difference between restricted and unrestricted assets for a NFPO and how these organizations should report contributions and other revenue sources.

3. Recognize the different reporting standards and statements between NFPOs and for-profit organizations.

Sources of GAAP

The key sources of authoritative GAAP relating to guidance in not-for-profit organizations (NFPOs) are:

- ASC 958-605-05-3, Not-for-Profit Entities: Revenue Recognition (FAS-116, Accounting for Contributions Received and Contributions Made).
- ASC 958-205-05-5, Not-for-Profit Entities: Presentation of Financial Statements (FAS-117, Financial Statements of Not-for-Profit Organizations).
- ASC 958-320-05-2, Not-for-Profit Entities: Investments—Debt and Equity Securities (FAS-124, Accounting for Certain Investments Held by Not-for-Profit Organizations).
- ASC 815, Derivatives and Hedging (FAS-133, Accounting for Derivative Instruments and Hedging Activities).
- ASC 958-20-15-3, Not-for-Profit Entities: Financially Interrelated Entities (FAS-136, Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others).
- ASC 360-10-05-4, Property, Plant, and Equipment: Overall (FAS-144, Accounting for the Impairment or Disposal of Long-Lived Assets).
- ASC 820-10-05, Fair Value Measurements and Disclosures: Overall (FAS¬157, Fair Value Measurements).

- ASC 825-10-10, Financial Instruments: Overall (FAS-159, The Fair Value Option for Financial Assets and Financial Liabilities).
- Additional Guidance: Related FASB Staff Positions or questions and answers previously issued as FASB Staff Implementation Guides

Note: Not-for-profit organizations (**NFPOs**), Not-for-profit entities (**NFPEs**), **not-for-profits**, and nonprofit organizations (**NPOs)** are used interchangeably in many literatures. We will use an abbreviation, **NFPO** throughout the course. Note that **organizations** and **entities** are also used interchangeably. Also note the following abbreviations used throughout the course:

1. **ASC (Account Standards Codification)**
2. **GASB (Governmental Accounting Standards Board)**
3. **ONFPO (other not-for-profit organization)**
4. **R/O (reporting organization)**
5. **SFP (statement of financial position)**
6. **SOA (statement of activities)**
7. **SCF (statement of cash flows)**
8. **VHWO (voluntary health and welfare organization)**

The accounting and financial reporting for governmental, not-for-profit entities is controlled by the **Governmental Accounting Standards Board (GASB).** Accounting and financial reporting for nongovernmental, not-for-profit entities is controlled by the **FASB**. Thus, it is important to determine the role the government has in not-for-profit organizations. Several FASB standards and statements are particularly relevant for private, not-for-profit entities.

Rules, Concepts, and Illustrations

Resource providers of not-for-profit (nonbusiness) organizations have as their primary concerns the services rendered by the organization and the continuing ability of the organization to render those services. Business organizations obtain resources by providing goods and services. Many not-for-profit organizations obtain resources from contributors and are accountable to the providers of those resources or to their representatives.

SFAC No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, superseded by SFAC No. 6, *Elements of Financial Statements* states that the objectives of financial reporting are derived from the common interests of those who provide the resources to nonbusiness organizations. Such organizations ordinarily have no single indicator of performance comparable to a business enterprise's profit. Thus, nonbusiness organization performance is usually evaluated in terms of management stewardship. SFAC No. 6 extends SFAC No. 3, *Elements of Financial Statements of Business Enterprises* to cover not-for-profit entities. It defines 10 interrelated elements of financial statements that are directly related to measuring the performance and status of an entity. Of these, seven are found in statements of both business and not-for-profit entities: assets, liabilities, equity or net assets, revenues, expenses, gains, and losses. Investments by owners, distributions to owners, and comprehensive income are elements of financial statements of business enterprises only. **Note:** The operating environments of nonbusiness and business organizations are similar in many ways. Both produce and distribute goods and services using scarce resources. Business organizations obtain resources by providing goods and services. Many nonbusiness organizations obtain resources from contributors and are accountable to the providers of those resources or to their representatives.

Financial reporting by nonbusiness organizations should provide information useful in

1. Making resource allocation decisions.
2. Assessing services and the ability to continue to provide services.
3. Assessing management stewardship and performance.

Additional objectives are to provide information about the liquidity of the organization, economic resources, obligations, net resources, and changes in them, including managers' explanations and interpretations.

ASC 958-205-05-5 (FAS-117) states that "a complete set of financial statements of a not-for-profit organization shall include a **statement of financial position** as of the end of the reporting period, a **statement of activities**, a **statement of cash flows** for the reporting period, and accompanying **notes to financial statements**."

The focus is on the organization as a whole. It is also on (1) reporting assets, liabilities, and net assets; (2) changes in net assets; (3) flows of economic resources; (4) cash flows, borrowing and repayment of borrowing, and other factors affecting liquidity; and (5) service efforts.

Note: The not-for-profit reporting model emphasizes information about the entity **as whole, not individual funds.** Consequently, fund accounting is *no longer required for external reporting* but is not precluded.

NFPOs' classification of net assets, revenues, expenses, gains, and losses are based on whether there are restrictions by donors. Net assets in the statement of financial position must be categorized as being **permanently restricted**, **temporarily restricted**, or **unrestricted.**

The amount of change in each of these classes must also be disclosed in a statement of activities. In addition, expiration of donor-imposed restrictions is required to be disclosed in the period in which the restrictions expire as are restrictions that increase one class of net assets and decrease another (reclassifications). The latter should be reported separately from other transactions in the statement of activities. Investments in equity securities with readily determinable fair values and all investments in debt securities should be reported at fair value with gains and losses disclosed in the statement of activities. <u>The total change in the fair value of the donated securities from the date of receipt to the statement of financial position date must be reported in the statement of activities.</u>

Typical users of financial reports of nonbusiness organizations include:

1. Resource providers.
2. Constituents.
3. Governing and oversight bodies.

Others potentially interested in the financial information provided by nonbusiness organizations include managers, organization members, taxpayers, contributors, grantors, lenders, suppliers, creditors, employees, directors and trustees, service beneficiaries, financial analysts and advisers, brokers, underwriters, lawyers, economists, taxing authorities, regulatory authorities, legislators, the financial press, labor unions, trade associations, researchers, teachers, and students.

Key GAAP

Under ASC 958-205-05-5, *Not-for-Profit Entities: Presentation of Financial Statements* (FAS-117, *Financial Statements of Not-for-Profit Organizations*), a complete set of financial statements for a not-for-profit organization (NFPO) consists of:

1. A statement of financial position (SFP) as of the end of the reporting period
2. A statement of activities (SOA), and
3. A statement of cash flows (SCF) for the reporting period
4. Accompanying notes to the financial statements

A voluntary health and welfare organization (VHWO) must also provide a **statement of functional expenses**, which reports expenses by functional as well as natural classification. VHWOs are tax exempt, are supported by public donations, and operate on a not-for-profit basis. They are primarily designed to solve the health and welfare problems of individuals and overall society. Exhibit 1 summarizes the financial statement issued by **nongovernmental** NFPOs.

Exhibit 1

Financial Statement Issued by Nongovernmental NFPOs

	Non-VHWO NFPOs	VHWOs
Statement of financial position	x	x
Statement of activities	x	x
Statement of cash flows	x	x
Statement of functional expenses		x

Statement of Financial Position

The Statement of Financial Position (SFP) reports the pertinent data about the entity's assets, liabilities, and net assets as well as their interrelationship to each other at a cumulative point in time. This information (together with data from other financial statements and disclosures) assists donors, creditors, members of the organization itself, and others to determine the entity's ability to continue to provide services. In addition, it allows for the assessment of the NFPO's liquidity, solvency, and financial flexibility needed to obtain external financing and satisfy its day-to-day debts.

An NFPO's SFP must report amounts for each of three classes of net assets: permanently restricted net assets, temporarily restricted net assets, and unrestricted net assets. Each of these classes is discussed below:

- Permanently restricted net assets. That part of an NFPO's net assets that result from:
    - Contributions and other inflows of assets whose use by the organization is limited by donor-imposed restrictions that do not expire or cannot be satisfied or removed by actions taken by the organization.
    - Other asset increases and reductions that are also restricted.
    - Reclassifications from or to other net asset classifications as a result of donor imposed terms.
- Temporarily restricted net assets. That part of an NFPO's net assets that results from:
    - Contributions and other inflows of assets whose use by the organization is limited by donor-imposed restrictions that either expire by the passage of time or can be satisfied or removed by actions taken by the organization.
    - Other asset augmentations and reductions that occur as a result of the conditions just described.
    - Reclassifications from or to other net asset classifications as a result of donor-imposed terms, expiration as a passage of time, or satisfaction and removal by actions of the organization.
- Unrestricted net assets. That part of the net assets of an NFPO's net assets that are neither permanently nor temporarily restricted by requests of the donor.

Information relating to the nature and amounts of varying permanent restrictions or temporary restrictions should be shown by reporting their amounts on the face of the SFP or including such data in the notes to the entity's financial statements.

Unrestricted net assets are generally constrained only by broad limits resulting from the nature of the organization, its operating environment, legal restrictions specified in the entity's articles of incorporation, or any contracts that the entity might have signed during the course of doing business. *An internal decision to designate a portion of unrestricted net assets as an endowment is not a restriction.* Any such constraints, together with self-imposed limits by the organization itself, should be shown in the notes of the financial statements.

It is very important to properly account for, and report, each class of net assets. Some not-for-profit entities use a **fund structure** to account for each type of net asset class because of the accounting discipline that fund accounting provides. These entities would have funds such as the general fund, specific-purpose fund, building fund, endowment fund, and so on. Other not-for-profit entities maintain only an accounting record to show the amounts in each net asset class. The specific identification of any restricted asset must be made when the asset comes into the entity, generally by donation or bequest. The gifting agreement must be examined fully to determine whether the gift has any donor-imposed restrictions on its principal and/or on the income generated from the principal. Revenue is recorded in only one net asset class when the contribution is made. Then, as restrictions are eliminated or met, the resources are released and transferred from the restricted net asset class to the unrestricted net asset class.

Exhibit 2 presents the statement of financial position for a voluntary health and welfare organization (VHWO).

Exhibit 2

Voluntary Health and Welfare Organization

Consolidated Statement of Financial Position
June 30, 2X13 (with comparative information as of June 30, 2X12)
(in thousands)

Assets	**2X13**	**2X12**
Current assets:		
Cash and cash equivalents	$ 214,606	$ 220,797
Investments	590,759	835,495
Trade receivables, net of allowance	130,969	70,150
Contributions receivable	78,464	95,010
Inventories, net of allowance	149,897	153,347
Other current assets	21,062	21,680
Total current assets	$1,185,757	$1,396,479
Investments	1,003,962	1,309,734
Contributions receivable	20,438	25,430
Land, buildings, and other property, net	1,143,697	1,163,805
Other assets	164,371	101,832
Total assets	**$3,518,225**	**$3,997,280**
Liabilities and net assets		
Current liabilities:		
Accounts payable and accrued expenses	$ 323,585	$ 341,535
Current portion of debt	115,613	256,489
Postretirement benefits	4,777	6,671
Other current liabilities	28,377	27,591
Total current liabilities	$ 472,352	$ 632,286
Debt	497,681	347,632
Pension and postretirement benefits	724,237	326,528
Other liabilities	151,489	131,197
Total liabilities	**$1,845,759**	**$1,437,643**
Net assets:		
Unrestricted net assets	$ 459,983	$1,035,920
Temporarily restricted net assets	620,214	930,160
Permanently restricted net assets	592,269	593,557
Total net assets	**$1,672,466**	**$2,559,637**
Total liabilities and net assets	**$3,518,225**	**$3,997,280**

This statement presents all assets and equities in a single statement. Note that the net assets are separated into three categories: (1) unrestricted, (2) temporarily restricted, and (3) permanently restricted. The unrestricted category includes all assets, including property, plant, and equipment, whose use is not restricted by the provider or donor. Temporarily restricted assets include those that the donor has designated for specific use or for use in subsequent periods. Term endowments, funds donated for support of special activities, and those donated for unrestricted (or other) use in future periods are included as temporarily restricted net assets. Permanently restricted assets typically include only the principal balance of permanent endowments.

An NFPO may classify its assets and liabilities as current or noncurrent. Current assets are defined as those reasonably expected to be realized in cash, sold, or consumed during the operating cycle or within 1 year, whichever is longer. Assets received with a donor-imposed restriction limiting their use to long-term purposes should not be classified with assets available for current use.

Statement of Activities

The Statement of Activities (SOA) (together with disclosures and information in the NFPO's other financial statements and note disclosures) enables donors, creditors, and other readers to:

- Determine the entity's performance during a given period of time.
- Gauge the organization's service efforts and its ability to continue to perform services.
- Appraise the success or failure of management's performance.

Specifically, the SOA measures:

- The results of transactions and other occurrences that change the amount and nature of the NFPO's net assets.
- The relationship of those transactions and occurrences to each other.
- How the entity's resources are being used in relation to its ongoing programs and services.

Note that the statement of financial position should report the amounts of permanently restricted, temporarily restricted, and unrestricted net assets. The statement of activities (SOA) should report the **changes in each category** for the period.

Expirations of donor-imposed restrictions that increase one class of net assets and decrease another through reclassification are required to be reported as separate items. Revenues should be reported as increases in unrestricted net assets unless use of the assets received is limited by donor imposed restrictions. In addition, an SOA should report expenses as decreases in unrestricted net assets. It should also report gains and losses recognized on investments and other assets (or liabilities) as increases or decreases in unrestricted net assets unless restricted by law or donor requests. An NFPO is not prevented from classifying its revenues, expenses, gains, or losses within classes of net assets with additional classifying captions within the SOA (e.g., operating, nonoperating, expendable, nonexpendable). If an intermediate determinant of operations is reported (e.g., operating income, operating surplus, operating profit, operating deficit), this information should be reported in a financial statement that, at the very least, reports the change in unrestricted net assets for the period.

To ensure that readers of the SOA clearly understand the NFPO's major operations and activities, the SOA should report the **gross amount** of its revenues and expenses. Investment revenues, on the other hand, may be shown net of related expenses, such as custodial fees or advisory costs. However, they must be disclosed either on the face of the SOA or in the notes to the financial statements. Costs of services, consumption of resources, and information about expenses should be reported by their functional classification, such as major classes of program services (activities resulting in goods and services being distributed to beneficiaries or customers, for example, that satisfy the objectives of the NFPO) and supporting activities (all activities other than program services, such as management and general activities, fund-raising, and membership activities). **Expenses of NFPOs are incurred for either program services and/or supporting services.** Program expenses relate directly to the primary mission of the organization. VHWOs should report this information by natural classification, such as salaries, rent, utilities, interest expense, and depreciation.

Note: Fund-raising activities include fund-raising campaigns, maintaining donor mailing lists, special fund-raising events, and preparing and distributing fund-raising materials.

If a NFPO has both members and donors, they should track the supporting services separately. Memberships typically imply a relationship where the member gets something relatively equivalent in return, such as a newsletter for a low-cost annual membership. They are unrestricted revenues. Donations are generally a non-reciprocal transfer, and can be restricted or unrestricted.

Exhibit 3 summarizes the composition of functional expenses for an NFPO.

Exhibit 3

Composition of Functional Expenses for an NFPO

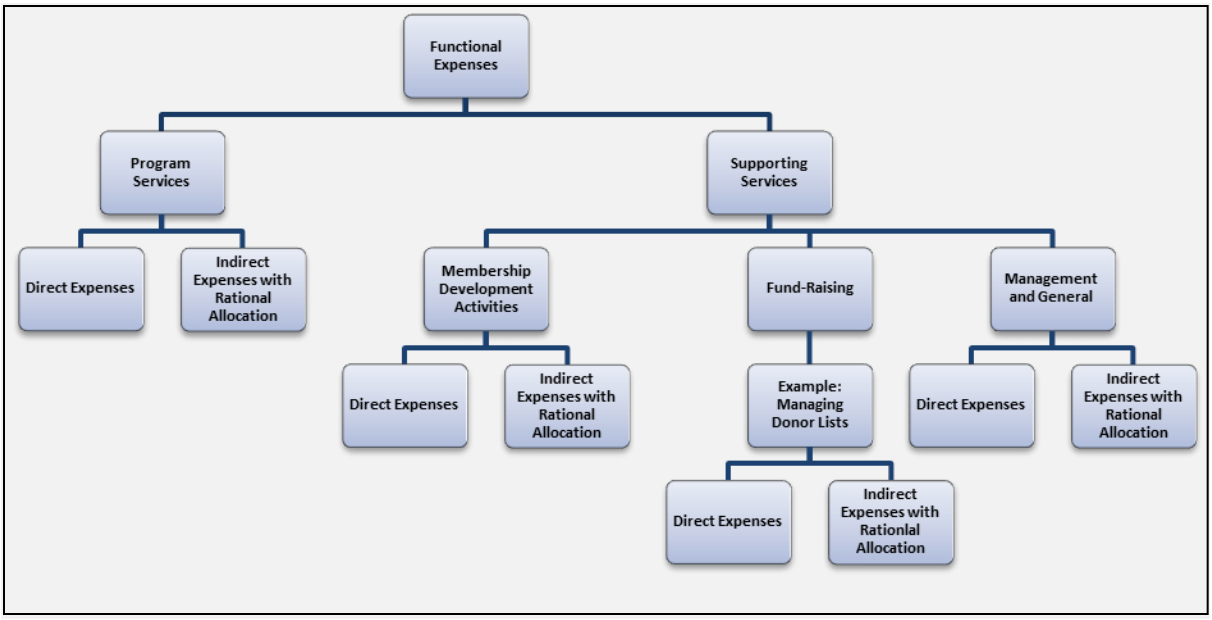

Exhibit 4 presents the statement of activities for a voluntary health and welfare organization (VHWO). The statement of activities presents separately the revenues and expenses of the unrestricted, temporarily restricted, and permanently restricted net asset categories.

Exhibit 4

Voluntary Health and Welfare Organization

Consolidated Statement of Activities
June 30, 2X13 (with comparative information as of June 30, 2X12)
(in thousands)

	Unrestricted	Temporarily Restricted	Permanently Restricted	Totals 2X13	Totals 2X12
Operating revenues and gains					
Contributions:					
Corporate, foundation, and individual giving	$ 195,326	$ 188,239	$ --	$ 383,565	$ 411,617
United Way and other federated	43,130	86,783	--	129,913	141,700
Legacies and bequests	58,880	7,601	25,883	92,364	115,921
Services and materials	21,870	27,913	--	49,783	45,064
Grants	26,342	55,304	--	81,646	68,578
Products and services:					
Biomedical	2,213,961	--	--	2,213,961	2,118,581
Program materials	149,473	135	--	149,608	150,653
Contracts, including federal government	129,778	--	--	129,778	51,363
Investment income	42,683	32,818	--	75,501	92,481
Other revenues	14,150	--	--	14,150	8,188
Net assets released from restrictions	546,949	(546,949)	--	--	--
Total operating revenues and gains	**$3,442,542**	**$ (148,156)**	**$ 25,883**	**$3,320,269**	**$3,204,146**
Operating expenses					
Program services:					
Services to the Armed Forces	$ 56,511	$ --	$ --	$ 56,511	$ 57,900
Biomedical services	2,216,730	--	--	2,216,730	2,204,010
Community services	113,846	--	--	113,846	127,450
Domestic disaster services	402,372	--	--	402,372	502,216
Health and safety services	215,492	--	--	215,492	238,992
International relief and development services	156,042	--	--	156,042	191,892
Total program services	**$3,160,993**	**$ --**	**$ --**	**$3,160,993**	**$3,322,460**
Supporting services:					
Fund raising	126,580	--	--	126,580	143,425
Management and general	152,473	--	--	152,473	218,477
Total supporting services	**$ 279,053**	**$ --**	**$ --**	**$ 279,053**	**$ 361,902**
Total operating expenses	**$3,440,046**	**$ --**	**$ --**	**$3,440,046**	**$3,684,362**
Change in net assets from operations	2,496	(148,156)	25,883	(119,777)	(480,216)
Nonoperating losses, net	(170,103)	(161,790)	(27,171)	(359,064)	(107,520)
Pension-related changes other than net periodic benefit cost	(408,330)	--	--	(408,330)	(76,930)
Change in net assets	**$ (575,937)**	**$ (309,946)**	**$ (1,288)**	**$ (887,171)**	**$ (664,666)**
Net assets, beginning of year	1,035,920	930,160	593,557	2,559,637	3,224,303
Net assets, end of year	$ 459,983	$ 620,214	$ 592,269	$1,672,466	$2,559,637

Statement of Cash Flows

The Statement of Cash Flows (SCF) provides readers with data regarding the cash receipts and cash payments of the organization during the year. Guidelines regarding the information that is provided to users of an NFPO's SCF and the standards for its preparation are covered in the statement of cash flows section relating to a business enterprise (ASC 230, *Statement of Cash Flows* (FAS-95, *Statement of Cash Flows*). ASC 230 as amended by ASC 958-205-05-5, *Not-for-Profit Entities: Presentation of Financial Statements* (FAS-117, *Financial Statements of Not-for-Profit Organizations*) requires a statement of cash flows as part of a full set of financial statements of all business entities (both publicly held and privately held) and NFPOs. Defined benefit pension plans, certain other employee benefit plans, and certain highly liquid investment companies, however, are exempted from this requirement by ASC 230-10-45-18, *Statement of Cash Flows: Overall* (FAS-102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*).

Exhibit 5 presents the statement of activities for a voluntary health and welfare organization (VHWO).

Exhibit 5

Voluntary Health and Welfare Organization Consolidated Statement of Cash Flows

June 30, 2X13 (with comparative information as of June 30, 2X12)
(in thousands)

	2X13	2X12
Cash flows from operating activities:		
Change in net assets	$(887,171)	$(664,666)
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation and amortization	98,874	112,032
Provision for doubtful accounts receivable	4,578	97
Provision for obsolete inventory	574	59
Net (gain)/loss on sales of property	(2,330)	299
Net investment and derivative losses	344,173	96,559
Pension-related changes other than net periodic benefit cost	408,330	76,930
Permanently restricted contributions	(25,883)	(39,095)
Changes in operating assets and liabilities:		
Receivables	(43,860)	40,689
Inventories	2,876	(740)
Other assets	(24,184)	5,428
Accounts payable and accrued expenses	(17,949)	(28,349)
Other liabilities	18,710	13,381
Pension and postretirement benefits	(12,514)	21,647
Net cash used in operating activities	**$(135,776)**	**$(365,729)**
Cash flows from investing activities:		
Purchases of property	$ (85,318)	$ (76,882)
Proceeds from sales of property	9,065	6,956
Purchases of investments	(93,788)	(424,572)
Proceeds from sales of investments	265,339	721,482
Net cash provided by investing activities	**$ 95,298**	**$ 226,984**
Cash flows from financing activities:		
Permanently restricted contributions	$ 25,292	$ 34,231
Proceeds from borrowings	87,504	186,493
Repayments of debt	(78,509)	(72,422)
Net cash provided by financing activities	**$ 34,287**	**$ 148,302**
Net (decrease)/increase in cash and cash equivalents	**$ (6,191)**	**$ 9,557**
Cash and cash equivalents, beginning of year	220,797	211,240
Cash and cash equivalents, end of year	**$ 214,606**	**$ 220,797**
Supplemental disclosures of cash flow information:		
Cash paid during the year for interest	$ 23,233	$ 29,687
Noncash investing and financing transactions:		
Acquisition of equipment under capital lease agreements	178	312

The statement of cash flows presented in Exhibit 5 is similar to that used for commercial entities. Either the direct or indirect method may be used to compute cash flows from operating activities. Activities in the restricted funds are noted **separately** from those in the unrestricted funds.

Note:

1. The terms *income statement* and *net income* apply to *statement of activities* and *change in net assets*, respectively for **NFPOs.**

2. **Cash inflows from operating activities** include receipts of unrestricted contributions. Operating activities may include *agency transactions*.

3. **Cash inflows from financial activities** include receipts that are donor-restricted for long-term purposes.

4. The payments to acquire, construct, or improve long-lived assets are **cash outflows from investing activities.**

5. *Noncash* investing and financing activities include receipt of a gift of a building or an investment asset.

Contributions Received

When contributions are received by an NFPO, they must be classified as permanently restricted, temporarily restricted, or without donor-imposed limitations. Contributions that are restricted increase permanently or temporarily restricted net assets, and those that do not have donor-imposed stipulations increase unrestricted net assets. Unconditional promises to make contributions (make payments) that are expected in future periods should be classified as restricted support unless the donor clearly indicated the money is to be used for activities in the current period. Specifically, unless indicated otherwise, receipts of unconditional support of cash in the future generally increase temporarily restricted net assets.

ASC 958-605-05-3, *Not-for-Profit Entities: Revenue Recognition* (FAS-116, *Accounting for Contributions Received and Contributions Made)* states

1. Contributions received should be accounted for **at fair value** as revenues or gains and as assets, decreases of liabilities, or expenses, depending on the form of benefits received. Contributions of services are recognized if they require special skills, are provided by individuals having those skills, and would have to be purchased if not received by donation.

2. Contributions of such items as art works and historical treasures need not be capitalized and recognized as revenues if they are added to collections that are (1) subject to a policy that requires the proceeds of sale of collection items to be used to acquire other collection items; (2) protected, kept unencumbered, cared for, and preserved; and (3) held for public exhibition, education, or research for public service purposes rather than financial gain.

Expiration of Donor-Imposed Restrictions

The expiration of a donor-imposed restriction on a contribution should be recognized in the period in which the restriction expires. This occurs when (1) the purpose for which the resource was restricted has been satisfied, (2) the time of the imposed restriction has elapsed, or (3) both of these criteria occur. For example, a donor established a memorial fund for a loved one that requires that the money (accounted for as revenue or a gain in the period in which it was received) be invested in a certain type of investment (i.e., Bonds) for 10 years. The contribution must be classified as restricted support in the period of receipt. After the donor-imposed restriction is satisfied (i.e., after the 10 years have passed), the entity must report a reclassification that shows that its unrestricted net assets have increased and temporarily restricted net assets of the entity has decreased.

Investments Held by NFPO

The following discussion relating to accounting for investments held by NFPOs does **not** apply to the following situations:

- Investments in equity securities that are accounted for under the equity method.
- Investments in consolidated subsidiaries.
- Investments in derivative instruments that are subject to ASC 815, *Derivatives and Hedging* (FAS-133, Derivative Instrument and Hedging Activities) and related pronouncements.

NFPOs are required to value all investments in equity securities with readily determinable fair values and all investments in debt securities should be measured **at fair value** in the statement of financial position. The total change in fair value includes the change in unpaid interest on debt securities (or unpaid dividends on equity securities until the ex-dividend date) and the holding gain or loss (realized or unrealized).

In general, quoted market prices or fair values are the best sources of this measure. If a fair value cannot be obtained for a debt security, a reasonable estimate (using market prices for similar securities, present value of expected future cash flows, and other such techniques) should be made for those debt securities for which fair value cannot easily be obtained because they are limitedly traded.

An NFPO concerned about the comparability of its financial statements with those of business entities in the same industry may report investment in debt and certain equity securities by identifying securities as available-for-sale or held-to-maturity. The NFPO may also exclude unrealized gains or losses on those securities from an operating measure with the statement of activities.

Disclosing Investment Income, Gains, and Losses

Gains and losses on investments must be reported in the SOA as increases or decreases in unrestricted net assets unless their use is temporarily or permanently restricted by the donor or by law. Similarly, interest, dividends, and other investment income must be reported as increases in unrestricted net assets in the period earned unless the use of the underlying assets that were received were restricted by the donor. Investment income that is restricted (depending on the type of restriction mandated by the donor) must be reported as an increase in temporarily restricted net assets or permanently restricted net assets. If restrictions relating to gains and investment income are satisfied in the same reporting period as these items are recognized, the gains and income limited by donor-restricted stipulations may be reported as increases in unrestricted net assets.

Endowment Funds that Are Donor Restricted

In a donor-restricted endowment fund, the donor stipulates that a gift must be invested in perpetuity or for a specified period of time. Gains and losses on investments of donor-restricted endowments should be reported as changes in unrestricted net assets unless the gains and losses are temporarily or permanently restricted by the donor or by law. That is, if a donor requires that a particular investment be permanently restricted, the gains and losses on this investment must also be permanently restricted unless otherwise specifically stipulated. On the other hand, if the donor does not require that the investment be held in such a manner—that is, the organization is allowed to choose whatever investments it desires—the gains are not permanently restricted unless the donor or law requires such a restriction. In general, losses on the investments of a donor-restricted endowment fund should be used to reduce temporarily restricted net assets to the extent that donor imposed temporary restrictions on net appreciation of the fund have not been met before the loss occurs. Any loss that remains after this shall be used to reduce unrestricted net assets. If a donor-restricted endowment fund is reduced by losses below the level required by the donor or law, any gains that restore the fair value of the assets of the endowment fund to that minimally required level should be classified as increases in unrestricted net assets.

The board of directors of the NFPO may create an **endowment fund** of unrestricted monies. Losses on investments of such a fund are classified in unrestricted net assets. All sources of such an endowment fund, including the original investment, gains and losses, interest and dividends, do not have any donor restrictions.

Financial Statement Disclosures

Statement of financial position

The SFP of an NFPO is required to present the following disclosures for each period:

- Carrying amounts of investments disclosed in the aggregate and classified by major types, including equity securities, U.S. Treasury securities, corporate debt securities, mortgage-backed securities, real estate, and oil and gas properties.
- A description of how the basis was determined for the carrying amounts for all debt and investments other than equity securities with readily determinable fair values.

- A description of the significant assumptions and methods used to estimate the fair values of investments other than financial instruments if those other investments are reported at fair value.
- Where the fair value of the assets at the reporting date for all donor-restricted endowment funds is less than the level required by donor restriction or law, the aggregate amount of these deficiencies.

Statement of activities

The SOA of an NFPO is required to have the following disclosures for each period presented:

- The details of the NFPO's investment return for the period, including:
    - Investment income.
    - Net realized gains or losses on investments reported at other than fair value.
    - Net gains or losses on investments reported at fair value.
- If investment return is separated into operating and nonoperating amounts, a reconciliation of this return to amounts reported in the statement of activities.
- A description of the policy used to determine the amount that is included in measuring operations and, if a change was made in that policy, a discussion of the cause leading to such a change.

Other Disclosure Requirements

Concentration of credit risk

An NFPO is required (for the most recent period for which an SFP is presented) to enumerate the nature of and carrying amount for each individual investment or group of investments that represents a significant concentration of market risk that results from lack of diversity of industry currency, geographic location, or nature of the investments itself. ASC 810-10-50 (FAS-133) requires that an entity disclose all significant concentrations of credit risk arising from financial instruments, whether from an individual counterparty or groups of counterparties. Group concentrations of credit risk exist if a number of counterparties are engaged in similar activities and have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions (e.g., if all an NFPO's receivables were from customers in the same industry or same region of the nation). If an economic downturn occurred affecting that industry or region, the collectibility of those receivables would be significantly reduced.

Transfers of assets by an NFPO to a charitable trust or another NFPO that raises or holds contributions for others

If an NFPO transfers assets to another organization (the recipient organization) and specifies itself or another as the beneficiary or its affiliate, the following disclosures must be presented in its SFP for each period:

- Recognition of the recipient organization of the transfer.
- Recognition of whether that recipient organization was given variance power and the terms of such power.
- The terms under which amounts will be distributed to the resource provider or its affiliate.
- The aggregate amount recognized in the SFP for those transfers and determination of whether that amount is recorded as an interest in the net assets of the recipient organization or as another asset (e.g., refundable advance or beneficial interest in assets held by others).

Related EITF Issues

The following is a title issued by Emerging Issues Task Force (EITF) relating to topics on not-for-profit organizations:

- ASC 958-205-45-35, Not-for-Profit Entities: Presentation of Financial Statements (Topic No. D-49).

Related AICPA Pronouncements

The following are titles issued by the Accounting Standards Executive Committee (AcSEC) of the AICPA relating to topics on NFPOs:

- ASC 958-810-15-3, Not-for-Profit Entities: Consolidation (SOP 94-3, Reporting of Related Entities by Not-for-Profit Organizations).
- ASC 958-720-05-5, Not-for-Profit Entities: Other Expenses (SOP 98-2, Accounting for Costs of Activities of Not-for-Profit Organizations and Local Government Entities That Include Fund Raising).
- ASC 954-815-25, Healthcare Entities: Derivatives and Hedging (SOP 02-2, Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Healthcare Organizations, and Clarification of the Performance Indicator).

Key Differences between NFPOs and For-Profit Corporations

	Not-for-Profits	For-Profit Corporations
Owners	None	Shareholders
Primary Objective	Provide services needed by society and individuals	Generate profits for shareholders
Tax Status	Exempt from taxes if recognized as NFPO by the IRS	Subject to corporate and/or individual taxes
Financial Statements	Statement of Financial Position Statement of Activities Statement of Cash Flows Statement of Functional Expenses (Non-VHWO NFPOs) Notes to Financial Statements	Balance Sheet Income Statement Statement of Cash Flows Stmt of Stockholder's Equity Notes to Financial Statements
Assets minus Liabilities =	Net Assets	Stockholders' Equity
Revenue	Membership dues, donor contributions, fundraising events, grants, investment income	Sales, fees, investments
Not-for-Profit Expenses	Program Services Supporting Services (Membership, Fundraising, Management and General)	
Tax Forms	Form 990	Form 1120

SHORT QUIZ

Indicate whether each of the following statements is true or false.

1. Board-designated funds are classified as restricted.
2. NFPOs must report functional expenses in a statement given equal prominence with the statement of activities.
3. Investments in debt and equity securities are reported at historical cost.

Answers

1. False. Funds can only be reported as restricted when the donor places a restriction on their investment or use.
2. False. A statement of activities or the notes should provide information about expense reported by functional classification. However, only voluntary health and welfare organizations (VHWOs) are required to publish this information in the form of a separate statement.
3. False. Equity securities with readily determinable fair values and all debt securities are to be measured at fair value in the statement of financial position.

Chapter 1 Review Questions

1. Which of the following is a characteristic of nonbusiness organizations?

A. Noneconomic reasons seldom underlie the decision to provide resources to nonbusiness enterprises.
B. Business and nonbusiness organizations usually obtain resources in the same way.
C. Both nonbusiness and business organizations use scarce resources in the production and distribution of goods and services.
D. The operating environment of nonbusiness organizations ordinarily differs from that of business organizations.

2. ASC 958-205-05-5, *Not-for-Profit Entities: Presentation of Financial Statements* (FAS-117, *Financial Statements of Not-for-Profit Organizations*) establishes standards for general-purpose external financial statements issued by not-for-profit organizations. A complete set of financial statements should include

A. Statements of financial position as of the beginning and end of the reporting period, a statement of cash flows, and a statement of activities.
B. A statement of financial position as of the end of the reporting period, a statement of cash flows prepared on the direct basis, and a statement of activities.
C. A statement of financial position as of the end of the reporting period, a statement of activities, a statement of cash flows, and accompanying notes to financial statements.
D. Statements of financial position as of the beginning and end of the reporting period, comparative statements of cash flows, and comparative statements of activities.

3. A stated purpose of SFAC No. 6, *Elements of Financial Statements* is to

A. Define three classes of net assets for businesses.
B. Define the elements necessary for presentation of financial statements of both business and not-for-profit organizations.
C. Apply the comprehensive income concept to not-for-profit organizations.
D. Apply its principles to reporting by state and local governmental units.

4. Contributions and other inflows of assets whose use by an organization is limited by door-imposed restrictions that do not expire or cannot be satisfied or removed by actions taken by the organization are categorized as

A. Unrestricted assets.
B. Temporarily restricted assets.
C. Permanently restricted assets.
D. Controlled assets.

5. The Cypress Museum, a not-for-profit organization, received a contribution of historical artifacts. It need NOT recognize the contribution if the artifacts are to be sold and the proceeds used to

A. Support general museum activities.
B. Acquire other items for collections.
C. Repair existing collections.
D. Purchase buildings to house collections.

6. A storm damaged the roof of a new building owned by K-9 Shelters, a not-for-profit organization. A supporter of K-9, a professional roofer, repaired the roof at no charge. In K-9's statement of activities, the damage and repair of the roof should

A. Be reported by note disclosure only.
B. Be reported as an increase in both expenses and contributions.
C. Be reported as an increase in both net assets and contributions.
D. Not be reported.

7. According to ASC 958-320-05, *Not-for-Profit Entities: Investments—Debt and Equity Securities* (FAS-124, *Accounting for Certain Investments Held by Not-for-Profit Organizations),* an NFPO should

A. Report debt securities at amortized cost if it has the positive intent and ability to hold them to maturity.
B. Recognize restricted investment gains, losses, and income when the restrictions are met.
C. Measure the change in fair value of equity securities with readily determinable fair values without regard to accrued dividends.
D. Measure the change in fair value of debt securities to include the change in unpaid interest.

Chapter 2:

Colleges and Universities

Learning Objectives:

After completing this section, you should be able to:

1. Identify reporting requirements of higher education including colleges, universities, and community or junior colleges.
2. Recognize depreciation and consolidation requirements.

Overview and Issues

The purpose of AICPA's **Audits of Colleges and Universities** is to assist in the auditing of and reporting on the financial statements of governmental institutions of higher education including colleges, universities, and community or junior colleges. Even though it does not apply, auditors of elementary, or secondary, schools or school systems may find the guide useful. Nongovernmental organizations should use the **AICPA Audit and Accounting Guide**, *Not-for-profit Organizations.* Since educational organizations emphasize service, the determination of net income is not the primary focus. Accounting and reporting should be structured so that the emphasis is on the accounting for resources received and used.

Both documents contain illustrations of the form and content of college and university financial statements, including a summary of significant accounting policies and notes to the financial statements. In addition, the SOP contains a chart of accounts.

ASC 958-360-35, *Not-for-Profit Entities: Depreciation* (FAS-93, *Recognition of Depreciation by Not-for-Profit Organizations)* requires all not-for-profit organizations, including colleges and universities to recognize depreciation in the financial statements and to disclose the depreciation expense, the balances of major classes of depreciable assets and the accumulated depreciation at the balance sheet date, and a description of the depreciation method used.

ASC 958-605-05-3, *Not-for-Profit Entities: Revenue Recognition* (FAS-116, *Accounting for Contributions Received and Contributions Made*), establishes standards of accounting and reporting for contributions. It applies to all organizations that receive or make contributions. ASC 958-205-05-5, *Not-for-Profit Entities: Presentation of Financial Statements* (FAS-117, *Financial Statements of Not-for-Profit Organizations*) addresses not-for-profit organizations, establishes standards for their general-purpose external statements and designates the statement of financial position, the statement of activities, the statement of cash flows and the accompanying notes as a complete set of financial statements. Inconsistent provisions in the SOPs or AICPA Guides are no longer acceptable specialized accounting and reporting.

Sources of GAAP

- ASC 958-360-35, *Not-for-Profit Entities: Depreciation* (FAS-93, *Recognition of Depreciation by Not-for-Profit Organizations)*
- ASC 958-605-05-3, *Not-for-Profit Entities: Revenue Recognition* (FAS-116, *Accounting for Contributions Received and Contributions Made*)
- ASC 958-205-05-5, *Not-for-Profit Entities: Presentation of Financial Statements* (FAS-117, *Financial Statements of Not-for-Profit Organizations*).
- FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations.*
- SFAC 4, *Objectives of Financial Reporting by Nonbusiness Organizations.*
- SFAC 6, *Elements of Financial Statements.*

Public Colleges and Universities

The accounting and reporting for public colleges and universities is specified by the GASB. **GASB Statement No. 35,** *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities* (GASB 35), issued in 1999, requires that these institutions follow the standards for governmental entities as specified in **GASB 34.** Most public institutions will be special-purpose government entities engaged in only business-type activities. This is so because most public colleges and universities do not have their own taxing authority. These special-purpose governmental entities present only the financial statements required for enterprise funds and then are included as component units of the state government. However, some community colleges do have their own taxing authority, and these are special-purpose government entities engaged in both governmental and business-type activities. These community colleges provide both fund-based financial statements and government-wide financial statement.

Private Colleges and Universities

The FASB specifies the accounting and financial reporting standards for private colleges and universities. Although many private colleges and universities are not-for-profit entities, some private colleges, such as the University of Phoenix, are profit-seeking. Accounting for profit-seeking educational entities is similar to accounting for any commercial entity.

Rules, Concepts, and Illustrations

Financial Statements

Colleges and universities present the following financial statements:

1. Statement of Financial Position
2. Statement of Activities
3. Statement of Cash Flows

The statements should be prepared on an **accrual basis**.

Private colleges and universities are free to select any account structure that best serves their management and financial reporting needs, but some choose to use **fund accounting** similar to that of governmental entities. Fund accounting creates an accounting discipline and provides an accounting vehicle to track revenues and expenses related to specific programs. Exhibit 1 presents an overview of the accounting and financial reporting of colleges and universities.

Exhibit 1

Overview of the Accounting and Financial Reporting of Colleges and Universities

	Public, Special-Purpose Governmental Entities: Engaged in Both Governmental and Business-Type Activities	Public, Special-Purpose Governmental Entities: Engaged in Only Business-Type Activities	Private Entities: Not-for-Profit	Private Entities: Profit-Seeking
Accounting and reporting standards	GASB	GASB	FASB	FASB
Accounting structure	Funds	Funds	Not required to, but many use fund-based structure	Account-based, same as for commercial businesses
Distinguishing features	Separate governmental entity with own taxing authority	Generally reported as a component unit of a state government	Net assets classified into three classes: 1. Unrestricted net assets 2. Temporarily restricted net assets 3. Permanently restricted net assets	Same as for profit-seeking businesses
Financial statements	Both fund-based and government-wide financial statements	Same as for an enterprise fund	Three basic financial statements: 1. Statement of Financial Position 2. Statement of Activities 3. Statement of Cash Flows	Same as for profit-seeking businesses

The statement of financial position for ABC University, a private, not-for-profit University, is presented in Exhibit 2. This statement presents all assets and equities in a single statement. Note that the net assets are separated into three categories: (1) unrestricted, (2) temporarily restricted, and (3) permanently restricted. The unrestricted category includes all assets, including property, plant, and equipment, whose use is not restricted by the provider or donor. Temporarily restricted assets include those that the donor has designated for specific use or for use in subsequent periods. Term endowments, funds donated for support of special activities, and those donated for unrestricted (or other) use in future periods are included as temporarily restricted net assets. Permanently restricted assets typically include only the principal balance of permanent endowments.

Exhibit 2

ABC University's Statement of Financial Position

June 30, 2X13 and 2X12

	2X13	**2X12**
Cash	$579,000	$514,000
Investments, at Fair Value	10,763,000	9,536,000
Deposits with Trustees	125,000	122,000
Accounts Receivable	161,000	182,000
Less: Allowance for Uncollectibles	(13,000)	(14,000)
Loans to Students, Faculty, and Staff	275,000	190,000
Inventories	45,000	40,000
Prepaid Expenses	14,000	10,000
Property, Plant, and Equipment (net)	20,330,000	19,970,000
Total Assets	$32,279,000	$30,550,000
Accounts Payable		$
Accrued Liabilities	10,000	8,000
Students' Deposits	15,000	18,000
Deferred Credits	15,000	10,000
Annuities Payable	1,080,000	1,155,000
Notes Payable	50,000	
Bonds Payable	1,300,000	1,200,000
Mortgage Payable	200,000	100,000
Deposits Held in Custody	55,000	45,000
Total Liabilities	$ 2,795,000	$ 2,589,000
Net Assets:		
Unrestricted	$20,221,000	$20,294,000
Temporarily Restricted by Donors	5,363,000	4,307,000
Permanently Restricted by Donors	3,900,000	3,360,000
Total Net Assets	$29,484,000	$27,961,000
Total Liabilities and Net Assets	$32,279,000	$30,550,000

The statement of activities presented in Exhibit 3 presents separately the revenues and expenses of the unrestricted, temporarily restricted, and permanently restricted net asset categories. It also shows the transfer of assets between the three categories of net assets during the period. For example, contributions received in 2X12 and available for use in 2X13 are shown as a transfer from temporarily restricted to unrestricted net assets in the statement of activities for 2X13. Auxiliary enterprises include activities such as a student union bookstore, cafeterias, and residence halls.

Exhibit 3

ABC University's Statement of Activities

For the Year Ended June 30, 2X13

	Unrestricted	**Temporarily Restricted**	**Permanently Restricted**	**Total**
Revenues, Gains, and Other Support:				
Tuition and Fees	$1,290,000			$1,290,000
Government Appropriations	650,000	$40,000		690,000
Government Grants and Contracts	20,000	300,000		320,000
Contributions	425,000	1,063,000	$495,000	1,983,000
Auxiliary Enterprises	1,100,000			1,100,000
Investment Income	265,000	139,000	15,000	419,000
Gain on Investments		69,000	25,000	94,000
Net Assets Transferred or Released from Program Use Restriction	601,000	(601,000)		
Transferred to Restricted Funds	(101,000)	101,000		
Expired Term Endowment	50,000	(50,000)		
Transferred to Endowment		(5,000)	5,000	
Total Revenue, Gains, and Other Support	$4,300,000	$1,056,000	$540,000	$5,896,000
Expenditures and Other Deductions:				
Instruction	$1,725,000			$1,725,000
Research	250,000			250,000
Public Service	77,000			77,000
Academic Support	125,000			125,000
Student Services	100,000			100,000
Scholarships and Fellowships	95,000			95,000
Institutional Support	275,000			275,000
Operation and Maintenance	110,000			110,000
Depreciation Expense	500,000			500,000
Interest Expense	106,000			106,000
Auxiliary Enterprises	915,000			915,000
Other Operating Costs	95,000			95,000
Total Expenses	$ 4,373,000	-0-	-0-	$ 4,373,000
Change in Net Assets	$(73,000)	$1,056,000	$540,000	$
Net Assets at Beginning of Year	20,294,000	4,307,000	3,360,000	27,961,000
Net Assets at End of Year	$20,221,000	$5,363,000	$3,900,000	$29,484,000

The statement of cash flows presented in Exhibit 4 is similar to that used for commercial entities. Either the direct or indirect method may be used to compute cash flows from operating activities. Activities in the restricted funds are noted separately from those in the unrestricted funds.

Exhibit 4
ABC University's Statement of Cash Flows
For the Year Ended June 30, 2X13

Cash flows from Operating Activities:			$1,523,000
Change in Net Assets			
Adjustments to Reconcile Changes in Net Assets			
to Net Cash Provided by Operating Activities:			
Depreciation		$500,000	
Increase in Deposits with Trustees		(3,000)	
Decrease in Accounts Receivable		20,000	
Increase in Loans to Students, Faculty, and Staff		(85,000)	
Increase in Inventories		(5,000)	
Increase in Prepaid Expenses		(4,000)	
Increase in Accounts Payable		17,000	
Increase in Accrued Liabilities		2,000	
Decrease in Students' Deposits		(3,000)	
Increase in Deferred Credits		5,000	
Restricted Contributions and Investment Income:			
Contributions, Grants, and Investment Income in Temporarily Restricted Funds	$(1,611,000)		
Contributions, Grants, and Investment Income in Permanently Restricted Funds	(535,000)		
Total Restricted Contributions and Investment Income	$(2,146,000)	(2,146,000)	
Total Adjustments		$(1,702,000)	(1,702,000)
Net Cash Provided by Operating Activities			$ (179,000)
Cash Flows from Investing Activities:			
Acquisition of Property, Plant, and Equipment		$(920,000)	
Sale of Used Equipment		60,000	
Net Acquisition of Investments		(65,000)	
Flows Related to Restricted Items:			
Net Acquisition of Temporarily Restricted Investments	$(112,000)		
Net Acquisition of Permanently Restricted Investments	(1,050,000)		
Net Cash Flow Related to Restricted Items	$(1,162,000)	(1,162,000)	
Net Cash Provided by Investing Activities			(2,087,000)
Cash Flows from Financing Activities:			
Decrease in Annuities Payable		$(75,000)	
Increase in Notes Payable		50,000	
Increase in Bonds Payable		100,000	
Increase in Mortgage Payable		100,000	
Increase in Deposits Held in Custody		10,000	
Flows Related to Restricted Items:			
Contributions, Grants, and Investment Income in Temporarily Restricted Funds	$ 1,611,000		
Contributions, Grants, and Investment Income in Permanently Restricted Funds	535,000		
Cash Flows Related to Restricted Items	$ 2,146,000	$185,000	
Net Cash Provided by Financing Activities			2,331,000
Net Change in Cash			$65,000
Cash at the Beginning of the Year			514,000
Cash at the End of the Year			$579,000

ASC 958-605-05-3, *Not-for-Profit Entities: Revenue Recognition* (FAS-116, *Accounting for Contributions Received and Contributions Made*) requires that contributions received by NFPOs be reported as restricted support or unrestricted support. Contributions with donor-imposed restrictions are reported as restricted support. Restricted support increases permanently restricted net assets or temporarily restricted net assets. Contributions without donor-imposed restrictions are reported as unrestricted support, which increases unrestricted net assets. Note that if an entity has an accounting policy to imply a time restriction on gifts of long-lived assets, then the gift must be reported as temporarily restricted support, even if the gift has no donor restrictions.

ASC 958-205-05-5, *Not-for-Profit Entities: Presentation of Financial Statements* (FAS-117, *Financial Statements of Not-for-Profit Organizations*) requires the Statement of Financial Position to show total assets, total liabilities and net assets. Net assets must be categorized as to (1) unrestricted, (2) temporarily restricted, or (3) permanently restricted. The same categories above are used in the Statement of Activities to show the changes in net assets. The Statement of Cash Flow should report the change in cash and cash equivalents.

NFPOs must present in the financials all information required by GAAP (unless specifically exempted) and all information required by specialized principles. This information includes display and disclosure provisions of:

1. Financial instruments
2. Loss contingencies
3. Extraordinary, unusual and infrequent events
4. Accounting changes

Aggregation and order of presentation should, generally, be similar to those of a business enterprise.

In the Statement of Cash Flow, the Statement of Activities takes the place of the Income Statement in a business enterprise and change in net assets takes the place of net income. Restricted resources that are used for long-term purposes because of donor stipulation are classified as financing activities.

In the year of application, ASC 958-205-05-5 does not need to be applied to interim periods. If reported with annual statements, however, interim periods should be reclassified for that year. In the initial year, disclosure is required, for each year presented, of (1) the nature of any restatements and (2) their effect on the change in net assets.

Restatement to reflect retroactive application is necessary if comparative financials are presented for earlier periods.

Contributions

ASC 958-605-05-3, *Not-for-Profit Entities: Revenue Recognition* (FAS-116, *Accounting for Contributions*

Received and Contributions Made) specifies that unconditional promises to give and contributions received (made) are recognized at fair value in the period received (made). When conditions are substantially met, conditional promises to give are recognized.

Not-for-profits are required to differentiate increases in net assets from contributions between (1) permanently restricted, (2) temporarily restricted, and (3) unrestricted. In the period of expiration, recognition of the expiration of donor-imposed restrictions on contributions must be given. Service contributions should not be recognized unless (1) nonfinancial assets are created or enhanced or (2) qualified individuals provide specialized skills that would otherwise need to be purchased. Collections held for public exhibition, education or research in furtherance of public service and comprised of works of art, historical treasures, etc., are not required to be capitalized and recognized as revenue.

In the year of change, retroactive application or recognition of a cumulative effect may be used. Recognition of restriction expirations may be prospectively applied.

Fund Accounting

Colleges and universities use fund accounting to comply with the requirements imposed by the organization's governing board, by donors, and by external entities. Funds consist of a self-balancing group of accounts composed of assets, liabilities, and fund balances (net assets). The following fund groups are often used for colleges and universities:

1. Current funds
2. Endowment and similar funds
3. Loan funds
4. Annuity and life income funds
5. Plant funds
6. Agency funds

The **audit guide** explains the accounting principles and reporting practices for each of the above fund groups. Internally designated and externally restricted funds must be appropriately indicated and disclosed in the financial statements.

Current Funds Revenues

Revenues are identified by source. Revenues represent the increase in resources to accomplish the objectives of the respective fund. *Restricted current funds* received, but not spent, and externally restricted resources to other than current funds are excluded from these revenues.

Current funds revenues (restricted and unrestricted) should be grouped by source of funds as follows:

1. Tuition and Fees
2. Federal Appropriations
3. State Appropriations
4. Local Appropriations
5. Federal Grants and Contracts
6. State Grants and Contracts
7. Local Grants and Contracts
8. Private Gifts, Grants, and Contracts
9. Endowment Income
10. Sales and Services of Educational Activities
11. Sales and Services of Auxiliary Enterprises
12. Sales and Services of Hospitals
13. Other Sources, including expired term endowments and expired life income agreements, if not material; otherwise a separate category
14. Independent Operations

Revenues from exchange transactions are normally recorded at *gross amounts*. Thus, in accounting for tuition and fees for colleges and universities, the full amount of the tuition assessed is usually reported as revenue. Tuition waivers, scholarships, and like items are recorded as expenses if given in exchange transactions, for example, as part of a compensation package. However, when the institution regularly provides discounts to certain students, revenues are recognized net of the discounts.

Current Funds Expenditures and Transfers

Expenditures are identified by function. Expenditures represent the using up of resources to accomplish the objectives of the respective fund.

SOP 74-8 defines current funds expenditures as amounts paid to operate the institution. Capital assets, such as equipment and library books are included if operating department's budget for and use current funds to acquire those assets.

SOP 74-8 defines transfers as amounts moved between fund groups. Mandatory and nonmandatory are two types of transfers. Mandatory transfers include transfers from current funds to other groups because of such things as legal or grant agreements. Nonmandatory transfers include transfers because of such things as internal board designations and retransfers back to current funds.

Expenditures and transfers should be grouped by function as follows:

a. Educational and General Expenditures

    Instruction

Research
Public Service
Academic Support
Student Services
Institutional Support
Operation and Maintenance of Plant
Scholarships and Fellowships Mandatory Transfers
Nonmandatory Transfers

b. Auxiliary Enterprises

Expenditures
Mandatory Transfers
Nonmandatory Transfers

c. Hospitals

Expenditures
Mandatory Transfers
Nonmandatory Transfers

d. Independent Operations

Expenditures
Mandatory Transfers
Non mandatory Transfers

Statements of Position

- SOP 94-2, The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations

This Statement of Position (SOP) provides guidance on the applicability of various sources of GAAP to NFPOs. The SOP's appendices provide a detailed discussion of the specific sources affected and should be consulted for further analysis. The appendices are categorized by (with respect to NFPOs):

1. Pronouncements that are specifically exempt
2. Pronouncements which do not apply due to subject matter
3. Pronouncements subject to additional criteria from other sources
4. Pronouncements' application of specialized industry practices
5. Pronouncements in effect excluding items listed in Appendices (A-D)
6. Cross-reference of all pronouncements

7. Hierarchy of GAAP

- ASC 958-810-15-3, Not-for-Profit Entities: Consolidation (SOP 94-3, Reporting of Related Entities by Not-for-Profit Organizations).

This SOP makes guidance uniform in regard to not-for-profit reporting of investments in for-profit entities and in regard to financial interrelationships with other NFPOs. It does not apply to entities covered by the AICPA's ***Audits of Providers of Healthcare Services*** **Audit Guide.**

If APB 51, as amended by ASC 958-810-15-3, *Not-for-Profit Entities: Consolidation* (SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations)* applies, a NFPO with a controlling financial interest through ownership of a majority voting interest should consolidate for-profit entities. The nature of the for-profit's activities will govern the manner of its presentation in the NFPO's financials. If ASC 323-10, *Equity Method and Joint Ventures: Overall* (APB 18) applies, an NFPO should use the equity method to report for-profit investments. An exception to the use of the equity method is made for NFPOs reporting investments at fair value in conformity with AICPA audit guides.

If ASC 840-10-45, *Leases: Overall* (FAS-94, para. 13) applies (temporary control or lack of control by majority ownership), consolidation is prohibited. Otherwise, a NFPO should consolidate another NFPO if:

1. It has a controlling financial interest through ownership of a majority interest.
2. It has both control (through majority ownership or majority voting on the board) and an economic interest.

Economic interest is present when:

a. Other entities solicit funds on behalf of the reporting organization (R/O).
b. A R/O transfers significant resources to another entity to be maintained for benefit of R/O.
c. A R/O delegates some significant functions to another entity.
d. A R/O gives or is committed to give funds to the other entity or guarantees material debt of the other entity.

Any restrictions imposed by outside entities regarding distributions and any resulting unavailability of net assets of the controlled NEP should be disclosed if consolidated statements are presented.

An NFPO may consolidate another NFPO, but is not required to if:

1. It currently consolidates under SOP 78-10 (even if prohibited under ASC 958-810-15-3, *Not-for-Profit Entities: Consolidation* (SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*).
2. It has control (other than by majority ownership or majority voting on the board) and an economic interest.

If consolidation is not selected in the previous case, the following disclosures are required:

1. Entity identification and the nature of the relationship that results in control (such as contract or oversight)
2. Summarized financial data of the controlled NEP
    a. Total assets, liabilities, net assets, revenues and expenses
    b. Resources held for or controlled by the reporting entity
    c. ASC 850-10, *Related Parties: Overall* (FAS-57) disclosures

The existence of control or economic interest, but not both, precludes consolidation but requires ASC 850-10, *Related Parties: Overall* (FAS-57) disclosures.

SHORT QUIZ

Indicate whether each of the following statements is true or false.

1. A gift designated by a college board of trustees for cancer research would be shown as a current restricted fund.
2. College and university accounting utilizes a series of funds and two groups of accounts, as does accounting for state and local governments.
3. Unlike local government, colleges account for enterprise activities in the Current Funds group, not in a separate fund.

Answers

1. False. Only funds that have been externally restricted may be shown as restricted. Internally designated resources must be disclosed as unrestricted.
2. False. College and university accounting places fixed assets and long-term debt within the fund structure, not in groups of accounts.
3. True. Colleges report auxiliary enterprise operations as a part of the Current Funds group, with disclosure as a line-item both among the revenue sources and the expenditure classifications.

Chapter 2 Review Questions

1. In its fiscal year ended June 30, 2X12, Barr College, a large private institution, received $100,000 designated by the donor for scholarships for superior students. On July 26, 2X12, Barr selected the students and awarded the scholarships. How should the July 26 transaction be reported in Barr's statement of activities for the year ended June 30, 2X13?

A. As both an increase and a decrease of $100,000 in unrestricted net assets.
B. As a decrease only in unrestricted net assets.
C. By footnote disclosure only.
D. Not reported.

2. Stanton College, a not-for-profit organization, received a building with no donor stipulations as to its use. Stanton does not have an accounting policy implying a time restriction on donated assets. What type of net assets should be increased when the building was received? I) Unrestricted; II) Temporarily restricted; or III) Permanently restricted

A. I only.
B. II only.
C. III only.
D. II or III.

3. For the fall semester of the current year, Ames University assessed its students $3 million for tuition and fees. The net amount realized was only $2.5 million because scholarships of $400,000 were granted to students and tuition remissions of $100,000 were allowed to faculty members' children attending Ames. These amounts were properly classified as expenses. What amount should Ames report for the period as revenues for tuition and fees?

A. $2,500,000
B. $2,600,000
C. $2,900,000
D. $3,000,000

Chapter 3:

Healthcare Providers

Learning Objectives:

After completing this section, you should be able to:

1. Recognize the financial statement reporting requirements for revenue for healthcare providers.

Healthcare Organization Classifications

There are four different types for healthcare organizations. They are:

1. Investor-owned Healthcare Organizations
2. Not-for-Profit, Business-Oriented Organizations
3. Governmental Healthcare Organizations
4. Not-for-Profit, Nonbusiness-Oriented Organizations (voluntary health and welfare organizations)

Although the major focus of this section of the chapter is on hospitals, the accounting and financial reporting guidelines for hospitals are the same as those used by all health for Healthcare Organizations. The AICPA's ***Audit and Accounting Guide*** **for Healthcare Organizations** applies to the following health care entities:

1. Clinics, medical group practices, individual practice associations, individual practitioners, emergency care facilities, laboratories, surgery centers, and other ambulatory care organizations.
2. Continuing-care retirement communities.
3. Health maintenance organizations (HMOs) and similar prepaid health care plans.
4. Home health agencies.
5. Hospitals.

6. Nursing homes that provide skilled, intermediate, and less intensive levels of health care.
7. Drug and alcohol rehabilitation centers and other rehabilitation facilities.

The **AICPA audit guide** serves as an important authoritative source in selecting accounting and financial reporting procedures for healthcare providers. The hospital financial statements incorporate the disclosure standards of ASC 958 (FAS-117), as presented and amplified in the AICPA's Audit and Accounting Guide for Health Care Organizations.

Sources of GAAP

The key sources of authoritative GAAP relating to guidance in the healthcare industry are:

- FASB Statement No. 105 (Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk)
- FASB Statement No. 107 (Disclosure about Fair Value of Financial Instruments)
- ASC 958-605-05-3, Not-for-Profit Entities: Revenue Recognition (FAS-116, Accounting for Contributions Received and Contributions Made)
- ASC 958-205-05-5, Not-for-Profit Entities: Presentation of Financial Statements (FAS-117, Financial Statements of Not-for-Profit Organizations)
- FASB Statement No. 124 (Accounting for Certain Investments Held by Not-for-Profit Organizations)
- FASB Statement No. 125 (Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities)
- FASB Interpretation 42 (Accounting for Transfers of Assets in Which a Not-for-Profit Organization Is Granted Variance Power)
- AICPA Audit and Accounting Guide (Healthcare Organizations)

Rules, Concepts, and Illustrations

Accounting in the healthcare industry consists of reporting on the financial statements of enterprises whose primary functions consist of providing healthcare services to individuals. Financial statements of healthcare entities should be prepared in conformity with GAAP. Governmental healthcare entities should prepare their financial statements in accordance with GASB statements and their interpretations as well as in accordance with FASB Statements and other related pronouncements required by the GASB.

Note: A big difference with healthcare NFPOs and other NFPOs is that healthcare organizations usually derive a major portion of their revenue from patient services, and contributions, donations and fund-raising may be infrequent or incidental transactions.

Hospital Accounting

There are about 6,500 hospitals in the United States. Some of these are not-for-profit hospitals managed by charities. A large number of hospitals are managed by government agencies. For example, many universities operate a university-affiliated hospital. The federal government operates several hundred hospitals, including those offering health care to veterans. About 1,400 hospitals are investor-owned, for-profit companies.

1. The not-for-profit hospitals use the FASB's accounting and reporting requirements for NFPOs.
2. The governmental hospitals follow the GASB's accounting and reporting requirements.
3. The investor-owned, for-profit hospitals follow the FASB's accounting and reporting requirements the same as other profit-seeking business entities.

Investor-owned hospitals seek additional financial resources through the sale of stocks and the issuance of large amounts of debt. These profit-seeking hospitals provide the same types of financial reports as commercial entities. Not-for-profit hospitals present their financial results using a specific format required by the FASB. Not-for-profit hospitals are often affiliated with a religious group or a civic association. Governmental hospitals are managed by or affiliated with a government unit. Governmental hospitals follow the GASB's accounting and reporting requirements and are considered special-purpose entities engaged in business-type activities. As such, they present financial statements that are required for **enterprise funds.**

Governmental hospitals then are included in the government entity's government-wide financial statements. Two professional associations, the **American Hospital Association (AHA)** and the **Hospital Financial Management Association (HFMA),** are active in developing and improving hospital management, accounting, and financial reporting. Publications of both organizations can be useful to individuals seeking additional information on hospital accounting and reporting practices.

Hospital Fund Structure

Although not required to do so, many hospitals have used a fund accounting structure for accounting purposes. In general, operating activities are carried on in the general fund, and a series of restricted funds can be used to account for assets whose use has been restricted by the donor. If separate funds are not maintained, then all transactions are recorded in the general fund, and memorandum records show restricted amounts in the general fund. The presentation of financial statement information under ASC 958 (FAS-117) requires a distinction between those net assets that are unrestricted, temporarily restricted, and permanently restricted. The discussion of accounting and financial reporting for hospitals that follows assumes that unrestricted net assets are accounted for in the general fund and that one or more separate funds are used to account for temporarily restricted and permanently restricted net assets.

All transactions involving the use of unrestricted net assets are recorded in the general fund. As such, the general fund is the hospital's primary operating fund. Assets that were restricted as to the period of use or that must be used for particular purposes are accounted for in restricted funds until the restriction is satisfied. When the restriction is satisfied, the assets are transferred (reclassified) from the restricted fund to the general (unrestricted) fund. Any expenses that are incurred in satisfying the restrictions are reported as expenses in the general fund.

Restricted funds account for assets received from donors or other third parties who have imposed certain restrictions on their use. The restricted funds are often termed "holding" funds because they must hold the restricted assets and transfer expendable resources to the general fund for expenditure. Exhibit 1 presents an overview of the fund structure and the typical financial reporting for hospitals.

General Fund. The *general fund* accounts for the resources received and expended in the hospital's primary health care mission. The basis of accounting is the accrual method in order to measure fully all expenses of providing services during the period. Depreciation is included in the operating expenses. Fixed assets are included in the fund based on the theory that the governing board may use these assets in any manner desired.

The governing board may establish *board-designated resources* within the general fund. For example, the board may designate resources for the expansion of the hospital, for retirement of debt, or for other purposes. Funds designated in this manner are considered to be part of the unrestricted funds, but this designation provides information on the intended use of the resources.

Donor Restricted Funds. All *restricted funds* account for resources whose use is restricted by the donor. For financial reporting purposes, a distinction is made between temporarily and permanently restricted funds. The major ***temporarily restricted*** funds are (1) specific-purpose funds, (2) time-restricted funds, and (3) plant replacement and expansion funds. ***Permanently restricted funds*** are assets that must be held into perpetuity and generally are included in an endowment fund. Hospitals also may have restricted loan funds and annuity and life income funds; however, few hospitals use these funds.

Specific purpose funds are restricted for *specific operating purposes.* For example, a donor may specify that a donation may be used only for maternity care. The donation is held in the specific-purpose fund until the maternity expenditure is approved in the general fund. Once approved, the specific-purpose fund transfers the resources to the general fund.

Time-restricted funds account for assets received or pledged by donors for use in future periods. The donor's restriction is satisfied by the passage of time. A pledge received in 2X12 to contribute a stated amount in 2X13 to be used for unrestricted purposes is included in the time-restricted fund in the balance sheet prepared at December 31, 2X12.

Plant replacement and expansion restricted funds account for contributions to be used only for additions to fixed assets. When the general fund approves or makes the appropriate expenditures for the fixed assets, the plant replacement and expansion fund transfers the resources to the general fund.

Endowment funds account for resources when the principal must be preserved. The income from these resources is usually available for either a restricted or a general purpose. Endowments may be either permanent or term. Term endowments are for limited time periods, for example, 5 or 10 years, or until a specific event occurs, such as the death of the donor. After the term expires, the governing board uses the principal of the fund in accordance with the gift agreement.

Key GAAP

Required Financial Statements

Investor-owned healthcare enterprises are required to prepare the same financial statements as those of any investor-owned enterprise. Not-for-profit and governmental healthcare entities, on the other hand, are required to prepare the following financial statements:

1. Statement of financial position
2. Statement of operations (also often called *statement of activities*)
3. Statement of changes in net assets/fund balance (or equity if *for-profit*)
4. Statement of cash flows
5. Notes to the financial statements

Comparative data for prior fiscal periods are normally presented within each statement.

Exhibit 1 presents an overview healthcare accounting and reporting.

Exhibit 1
Overview of Healthcare Accounting and Reporting

	Fund Groups				
	Unrestricted	**Restricted Funds**			
	General Fund	**Specific Purpose**	**Time Restricted**	**Plant Replacement and Expansion**	**Endowment**
Distinguishing features		Resources restricted for specific operating purposes.	Resources not available until date specified by donor.	Resources restricted for additions to plant assets.	Principal preserved as specified by donor.
Financial statements		**Balance Sheet**			
		Statement of Operations			
		Statement of Changes in Net Assets			
		Statement of Cash Flows			

ASC 230, *Statement of Cash Flows* (FAS-95, *Statement of Cash Flows*) and GASB Statement Number 9 *(Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities)* establish the required guidelines for reporting cash flows for investor owned entities as well as governmental healthcare enterprises. In both groups, the direct method is considered the preferable method; however, the indirect method of reporting for cash flows is allowed. The statement of cash flows should always be reported in cash and cash equivalents. In addition, entities' balance sheets must disclose (1) total assets, (2) total liabilities, and (3) net assets.

The statement of operations for healthcare NFPOs should contain a **performance indicator** that reports results of operations. It should be clearly labeled with a descriptive term such as *revenues over expenses, revenues and gains over expenses and losses, earned income,* or *performance earnings.* NFPOs report this item in a statement that presents the changes in unrestricted net assets.

The last category should, in turn, be subdivided into the following groups:

1. Unrestricted
2. Temporarily restricted or
3. Permanently restricted

These categories should also be used to report changes in equity in the statement of changes in equity.

NFPOs require all the information of GAAP as well as other specialized requirements. For example, NFPOs must fully disclose the information relating to the following items and areas:

1. Financial instruments
2. Contingencies
3. Extraordinary items
4. Cumulative effect of a change in accounting principle

For all of the aforementioned areas and in general, presentation and order in the financial statements should parallel that of profit-generating entities.

Healthcare entities should record all revenue on an accrual basis. Examples of classes of revenue are patient service revenue, premium revenue, and resident service revenue. This often requires that certain adjustments be accounted for and then deducted from gross revenue to derive what is termed net service revenue. The amount that should be recorded is the amount that the health service enterprise is contractually entitled to. Revenue payments to providers generally come from health insurance companies, Medicare, and Medicaid. Although not included in revenue, a healthcare provider should fully disclose the level of charity care it provides. Revenues of a healthcare provider include patient service revenue, premium revenue, and other revenue, gains, or losses.

Other revenue, gains, or losses may appropriately be recognized by a hospital for services other than healthcare or coverage provided to patients. Other revenue may include:

1. Fees from educational programs

2. Proceeds from sale of cafeteria meals and guest trays
3. Interest and dividends
4. Certain realized changes in market values of marketable securities
5. Rent paid by others for healthcare facility space
6. Sales of medical and pharmaceutical supplies
7. Fees charged for transcripts for lawyers, insurance companies, and others
8. Proceeds from sale of scrap, used X-ray film, etc.
9. Proceeds from sales at other service facilities operated by the healthcare provider
10. Contributions, if fund-raising is a major, ongoing activity

Revenue or expense results from an entity's ongoing major or central operations. *Gains* or *losses* result from peripheral or incidental transactions and from all transactions and other events and circumstances that do not generate revenue or expense. Thus, contributions, either unrestricted or for a specific purpose, should be treated as gains or losses unless fund-raising is an ongoing major activity of the hospital. They are recognized at fair value.

Contributions Made to Not-For-Profit Healthcare Entities

The following are some general guidelines that should be followed in accounting for contributions made to not-for-profit healthcare entities.

Contributions made should be disclosed as resulting in increases in net assets from amounts that are

1. permanently restricted
2. temporarily restricted or
3. unrestricted

In healthcare organization accounting, the term "restricted" is used to describe resources that have been restricted as to their use by the donors or grantors of those resources. Temporarily restricted net assets are those donor-restricted net assets that can be used by the NFPO for their specified purpose once the donor's restriction is met. Permanently restricted net assets (for example, endowment funds) are those with donor restrictions that do not expire with the passage of time and cannot be removed by any actions taken by the entity.

Contributed collections consisting of historical works, art, etc., that are held for education, research, or public exhibition are *not* required to be capitalized and recognized as revenue in the financial statements.

Contributions in service should *not* be recognized in the financial statements *unless* the following conditions are met:

1. Individuals providing the service contribution are qualified to do so with unique, specialized skills.

2. The service contribution resulted in the production or enhancement of nonfinancial assets.

Some not-for-profit healthcare entities are charitable enterprises that must conform with donor and grantor fiduciary responsibilities and guidelines. Therefore, these entities must use fund accounting in preparing their financial statements.

Summary of Healthcare Accounting and Financial Reporting

- The major operating activities of a healthcare service take place in the general fund.
- The restricted funds are holding funds that transfer resources to the general fund for expenditures upon satisfaction of their respective restrictions.
- The **accrual basis of accounting** is used in the general fund to fully measure the revenue and costs of providing healthcare.
- Patient services revenue is reported at gross amounts measured at standard billing rates. A deduction for contractual adjustments is then made to arrive at net patient services revenue.
- Other revenue is recognized for ongoing nonpatient services, such as cafeteria sales and television rentals, and donated supplies and medicines.
- Charity care services are presented only in the footnotes; no revenue is recognized for them.
- Operating expenses in the general fund include depreciation, bad debts, and the value of recognized donated services that are in support of the basic services of the hospital.
- Not all donated services are recognized.
- Donated property and equipment are typically recorded in a restricted fund, such as the plant fund, until placed into service, at which time they are transferred to the general fund.
- Donated assets are recorded at their fair market values at the date of gift.

Short Quiz

Indicate whether each of the following statements is true or false.

1. Funds set aside by the governing board for the eventual construction of a hospital addition would be recorded in the plant replacement and expansion funds.

2. Long-term debt related to hospital plant would be recorded in the unrestricted funds.

3. Equipment purchased from restricted resources should be recorded in the Plant Replacement and Expansion Fund.

4. When resources from the plant replacement and expansion fund are expended for hospital plant, the plant is recorded as an asset in the unrestricted funds.
5. If a gift to a hospital specifies that the principal be maintained intact for ten years and then may be expended, this would be an example of a term endowment.

Answers

1. False. The governing board may establish *board-designated resources* within the general fund. Only funds so restricted by outside donors would be recorded in the restricted funds.
2. True. The hospital plant is also recorded in the unrestricted funds.
3. False. The equipment should be recorded in the unrestricted funds.
4. True. All plant used for hospital purposes would be recorded in the unrestricted funds.
5. True. This is in contrast to a permanent endowment, in which the principal is to be maintained intact in perpetuity.

Chapter 3 Review Questions

1. General purpose external financial reporting by a healthcare organization requires presentation of

A. Fund group information by a not-for-profit organization.
B. A statement of operations.
C. A separate statement of changes in equity, net assets, or fund balance.
D. A performance indicator only by for-profit entities.

2. Los Al's community hospital normally includes proceeds from the sale of cafeteria meals in

A. Deductions from dietary service expenses.
B. Ancillary service revenues.
C. Patient service revenues.
D. Other revenues.

3. Amounts received by a research hospital in the form of grants specified by the donor for research would normally be included in

A. Nonoperating gains.
B. Other revenue.
C. Patient service revenue.
D. Ancillary service revenue.

4. In healthcare accounting, restricted net assets are

A. Not available unless the directors remove the restrictions.
B. Restricted as to use only for board-designated purposes.
C. Not available for current operating use; however, the income generated is available for current operating use.
D. Restricted as to use by the donor, grantor, or other source of the resources.

5. Which of the following normally would be included in the revenue of a hospital?

A. Neither Revenue from Educational Programs, nor Unrestricted Contributions
B. Unrestricted Contributions, but not Revenue from Educational Programs
C. Revenue from Educational Programs, but not Unrestricted Contributions
D. Both Revenue from Educational Programs and Unrestricted Contributions

Chapter 4:

Voluntary Health and Welfare Organizations

Learning Objectives:

After completing this section, you should be able to:

1. Identify the auditing of and reporting requirements on the financial statements of governmental voluntary health and welfare organizations (VHWOs).
2. Recognize the typical funds used to account for VHWO transactions.

Overview and Issues

Voluntary health and welfare organizations (VHWOs) provide a variety of social services. Examples of such organizations are United Way, the American Heart Association, the March of Dimes, the American Cancer Society, the Red Cross, and the Salvation Army. These organizations solicit funds from the community at large and typically provide their services for no fee, or they may charge a nominal fee to those with the ability to pay.

The purpose of *Audits of Voluntary Health and Welfare Organizations* is to assist in the auditing of and reporting on the financial statements of *governmental* voluntary health and welfare organizations. The financial statements should be prepared in accordance with GAAP, unless they are inapplicable. Because the value of the services provided by most voluntary health and welfare organizations cannot be measured quantitatively, the primary purpose of the financial statements is to disclose the acquisition and use of the organization's resources. *Nongovernmental* organizations should use the **AICPA Audit and Accounting Guide, *Not-for-Profit Organizations.*** The guide contains an example of an auditor's report, financial statements, and an investment pool.

ASC 958-605-05-3, *Not-for-Profit Entities: Revenue Recognition* (FAS-116, *Accounting for Contributions Received and Contributions Made*) establishes standards of accounting and reporting for contributions. It applies to all organizations that receive or make contributions. ASC 958-205-05-5, *Not-for-Profit Entities: Presentation of Financial Statements* (FAS-117, *Financial Statements of Not-for-Profit*

Organizations) addresses NFPOs, establishes standards for their general-purpose external statements and designates the statement of financial position, the statement of activities, the statement of cash flows and the accompanying notes as a complete set of financial statements.

Not-for-profits with annual expense of less than $1 million and total assets of less than $5 million can delay the effective date of ASC 958-605-05-3 and ASC 958-205-05-5 until fiscal years beginning after December 15, 1995.

SOURCES OF GAAP

- FASB Statement No. 93, *Recognition of Depreciation by Not-for-Profit Organizations*.
- ASC 958-605-05-3, *Not-for-Profit Entities: Revenue Recognition* (FAS-116, *Accounting for Contributions Received and Contributions Made*)
- ASC 958-205-05-5, *Not-for-Profit Entities: Presentation of Financial Statements* (FAS-117, *Financial Statements of Not-for-Profit Organizations*).
- ASC 958-810-15-3, *Not-for-Profit Entities: Consolidation* (SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations).*
- SOP 94-2, The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations.

Concepts, Rules, and Examples

Financial Statements

Voluntary health and welfare organizations present the following financial statements:

1. Balance sheet
2. Statement of activities
3. Statement of cash flows
4. Statement of functional expenses in support of the total program and supporting services for the period

Note: Exhibit 1 (financial statement issued by nongovernmental NFPOs) of Chapter 1 is repeated below:

	Non-VHWO NFPOs	VHWOs
Statement of financial position	x	x
Statement of activities	x	x
Statement of cash flows	x	x
Statement of functional expenses		**x**

Current unrestricted funds and current restricted funds should be shown separately in the financial statements. Unrestricted funds that have been designated for specific purposes by the governing board should be identified.

A supplemental schedule of changes in the designation of portions of the current unrestricted fund for specific purposes may be included.

The financial statements should be prepared on **an accrual basis**. Cash basis or modified accrual basis may be used if there is no material difference from the accrual basis.

ASC 958-205-05-5, *Not-for-Profit Entities: Presentation of Financial Statements* (FAS-117, *Financial Statements of Not-for-Profit Organizations*) requires the Statement of Financial Position to show total assets, total liabilities and net assets. Net assets must be categorized as to (1) unrestricted, (2) temporarily restricted or (3) permanently restricted. The same categories above are used in the Statement of Activities to show the changes in net assets. The Statement of Cash Flow should report the change in *cash and cash equivalents.*

NFPOs must present in the financials all information required by GAAP (unless specifically exempted) and all information required by specialized principles. This information includes display and disclosure provisions of:

1. Financial instruments
2. Loss contingencies
3. Extraordinary, unusual and infrequent events
4. Accounting changes

Aggregation and order of presentation should, generally, be similar to those of a business enterprise.

In the Statement of Cash Flow, the Statement of Activities takes the place of the Income Statement in a business enterprise and change in net assets takes the place of net income. Restricted resources that are used for long-term purposes because of donor stipulation are classified as financing activities.

In the year of application, ASC 958-205-05-5, *Not-for-Profit Entities: Presentation of Financial Statements* (FAS-117, *Financial Statements of Not-for-Profit Organizations*) does not need to be applied to interim periods. If reported with annual statements, however, interim periods should be reclassified for that year. In the initial year, disclosure is required, for each year presented, of (1) the nature of any restatements and (2) their effect on the change in net assets.

Restatement to reflect retroactive application is necessary if comparative financials are presented for earlier periods.

VHWOs must provide information about expenses by both their functional classification (major classes of program services and supporting activities) and their natural classification (salaries, rent, etc.) in a matrix format. The major functional classes include: 1) program services, and 2) supporting services. Program services expenses are those directly related to the programs, such as research costs. Management, administrative and general expenses, along with fund-raising expenses, are classified in the supporting services category.

Fund Accounting

Voluntary health and welfare organizations usually use fund accounting because donors and/or external authorities may restrict or prohibit the use of some assets for operations. Unrestricted funds may be used as needed by the organization's governing board. Restricted funds are limited in use by the governing board due to external restrictions. Funds consist of a self-balancing group of accounts composed of assets, liabilities, and fund balances (net assets). The following fund groups are often used by voluntary health and welfare organizations:

1. Current unrestricted funds
2. Current restricted funds
3. Land, building, and equipment fund (plant fund)
4. Endowment funds
5. Custodian funds
6. Loan and annuity funds

Investments

Investments include investment of 1) endowment and other restricted funds and 2) investment of unrestricted funds. Purchased investments should be recorded at cost, including all costs associated with their purchase. Donated investments should be recorded at fair market value at the date of gift, unless they have declined in value. Investments may be carried at either cost or market value. The same basis should be used for all funds and should be disclosed in the financial statements. Investments of several funds are often pooled to increase investment flexibility. The market value method should be used for investment pools in order to fairly allocate the investment pool's income, gains, and losses among the funds.

Investment pools, including investments from contributions with different restrictions, are created for portfolio management. Ownership interests are assigned (ordinarily in terms of units) to the pool categories (participants) based on the market value of the cash and securities obtained from each participant. Current market value also determines the units allocated to additional assets placed in the pool and to value withdrawals. Investment income, realized gains and losses, and recognized unrealized gains and losses are allocated based on the units assigned.

Depreciation

Depreciation should be recognized. FASB Statement No. 93, *Recognition of Depreciation by Not-for-Profit Organizations,* also requires the disclosure of depreciation expense, balances of the major classes of depreciable assets, accumulated depreciation at the balance sheet date, and a description of the depreciation method used. Depreciation is not required for individual works of art or historical treasures with extremely long useful lives.

Public Support and Revenue

Public support is usually received from the following sources:

1. Direct mail campaigns
2. Door-to-door solicitation
3. Radio and television solicitation
4. Street sales and solicitation
5. Contributions from uncontrolled organizations (United Way, etc.)
6. Special events

Cash and pledges should be recorded when they are obtained. An allowance for uncollectible pledges should be used and should be disclosed in the financial statements. Cash and pledges that are designated for future use should be recorded as a deferred credit. Revenues are recorded for such items as membership dues and investment income.

Contributions

ASC 958-605-05-3, *Not-for-Profit Entities: Revenue Recognition* (FAS-116, *Accounting for Contributions Received and Contributions Made*) specifies that unconditional promises to give and contributions received (made) are recognized at fair value in the period received (made). When conditions are substantially met, conditional promises to give are recognized.

Not-for-profits are required to differentiate increases in net assets from contributions between (1) permanently restricted, (2) temporarily restricted, and (3) unrestricted. In the period of expiration, recognition of the expiration of donor-imposed restrictions on contributions must be given. Service contributions should not be recognized *unless* (1) nonfinancial assets are created or enhanced or (2) qualified individuals provide specialized skills that would otherwise need to be purchased. Collections held for public exhibition, education or research in furtherance of public service and comprised of works of art, historical treasures, etc., are not required to be capitalized and recognized as revenue.

The contribution to a permanent endowment is an increase in permanently restricted net assets. Income from donor-restricted permanent endowments is an increase in restricted support if the donor restricts its use. However, if the restriction is met in the period the income is recognized, it may be reported as an increase in unrestricted net assets if the entity has (1) a similar policy for reporting contributions received, (2) reports consistently, and (3) makes adequate disclosure. The temporary restriction on the income and appreciation was met and is deemed to have expired only to the extent it was expended during the year. Absent donor stipulation or contrary law, losses on a permanent endowment reduce temporarily restricted net assets to the extent that a temporary restriction on net appreciation has not expired prior to the losses. Any remaining losses reduce unrestricted net assets. Thus, absent such a restriction, the decrease in the fair value of the endowment's investments reduced unrestricted net assets.

In the year of change, retroactive application or recognition of a cumulative effect may be used. Recognition of restriction expirations may be prospectively applied.

Expenditures

Expenditures should be identified by function and should include expenditures for program services, management and general costs, and fund-raising costs. Costs which are attributable to more than one function should be allocated on a reasonable basis.

Joint Costs of Informational Materials and Activities

In cases where joint costs include a fund-raising appeal, such costs should be reported as fund-raising expense unless it can be shown that a bona fide program or management and general function has been conducted in connection with the fund raising appeal (SOP 87-2). In that case, joint costs should be allocated between fund-raising and the legitimate program or management and general function.

Statement of Functional Expenses

The fourth statement specified by ASC 958 for VHWOs is the **statement of functional expenses.** This statement details the items reported in the expenses section of the statement of activities. Exhibit 1 is a standard format for the statement of functional expenses. The expense categories are presented across the columns. The rows provide the specific nature of the items composing these expense categories from the various funds.

Exhibit 1

Statement of Function Expenses for a VHWO

Year Ended June 30, 2X13

(with summarized information for the year ended June 30, 2X13)
(in thousands)

	Program Services						
	Service to Armed Forces	Biomedical Services	Community Services	Domestic Disaster Services	Health and Safety Services	Int'l Relief & Development Services	Total Program Services
Salaries and wages	$30,420	$ 966,717	$ 45,187	$ 98,327	$101,357	$ 18,419	$1,260,427
Employee benefits	7,672	253,506	11,416	25,502	24,755	4,892	327,743
Subtotal	$38,092	$1,220,223	$ 56,603	$123,829	$126,112	$ 23,311	$1,588,170
Travel and maintenance	1,476	31,461	1,890	30,578	2,864	3,441	71,710
Equipment maintenance and rental	1,002	64,562	4,919	19,125	4,382	986	94,976
Supplies and materials	4,102	529,942	14,787	17,069	33,232	851	599,983
Contractual services	8,116	310,428	19,224	76,401	38,218	27,465	479,852
Financial and material assistance	2,263	2,064	12,587	120,758	2,548	99,100	239,320
Depreciation and amortization	1,460	58,050	3,836	14,612	8,136	888	86,982
Total expenses	$56,511	$2,216,730	$113,846	$402,372	$215,492	$156,042	$3,160,993

	Supporting Services			Total Expenses	
	Fund Raising	Management and General	Total Supporting Services	2X13	2X12
Salaries and wages	$ 51,627	$ 66,847	$118,474	$1,378,901	$1,394,034
Employee benefits	12,716	17,203	29,919	357,662	393,111
Subtotal	$ 64,343	$ 84,050	$148,393	$1,736,563	$1,787,145
Travel and maintenance	2,976	2,898	5,874	77,584	84,751
Equipment maintenance and rental	1,334	3,285	4,619	99,595	105,275
Supplies and materials	13,958	2,988	16,946	616,929	607,902
Contractual services	39,206	48,559	87,765	567,617	602,413
Financial and material assistance	1,799	1,765	3,564	242,884	384,841
Depreciation and amortization	2,964	8,928	11,892	98,874	112,035
Total expenses	$126,580	$152,473	$279,053	$3,440,046	$3,684,362

Summary of Accounting and Financial Reporting for VHWOs

The accounting and financial reporting requirements for VHWOs are specified in ASC 958 and the AICPA *Audit and Accounting Guide for Not-for-Profit Organizations*. The accrual basis of accounting is used. Primary activities of the VHWO are reported in the unrestricted asset class. Resources restricted by the donor for specific operating purposes or future periods are reported as temporarily restricted assets. Assets contributed by the donor with permanent restrictions are reported as permanently restricted assets.

A VHWO provides four financial statements: (1) a statement of financial position, (2) a statement of activities, (3) a cash flow statement, and (4) a statement of functional expenses. The statement of functional expenses is required of all VHWOs to provide an analysis of all of the organization's expenses, including depreciation. Expenses are broken down into types, such as salaries, supplies, and travel, and are summarized by individual program services and individual supporting services.

Not-For-Profit Organizations and Financial Reporting

Accounting and reporting standards applicable to NFPOs are similar to the standards for governmental units. There often exist segregations of activities by fund. Exhibit 2 presents a summary in terms of the basis of accounting used, related major pronouncements, and fund types of NFPOs.

Exhibit 2

Basis of Accounting, Major Pronouncement, and Fund Types of Not-for-profit Organizations

Nonprofit Organizations	*Basis of Accounting and Major Pronouncements*	*Fund Types*
Hospitals	Primarily accrual basis American Hospital Association (AHA) AICPA Hospital Audit Guide	General Funds (Unrestricted Funds) Operating Fund Board-Designated Funds Restricted Funds Specific-Purpose Funds Endowment Funds Plant Repl. and Expansion Funds
Colleges and Universities	Accrual basis with some modifications National Association of College and University Business Officers AICPA Audits of Colleges and Univ.	Current Fund Unrestricted Restricted Loan Funds Endowment and Similar Funds Annuity and Life Income Funds Plant Funds Agency Funds
Voluntary Health and Welfare Organizations	Primarily accrual basis AICPA Audit and Accounting Guide	Operating Funds Unrestricted Restricted Endowment Funds Plant Funds

Short Quiz

Indicate whether each of the following statements is true or false.

1. Accounting for voluntary health and welfare organizations utilizes the fund accounting concept.

2. Depreciation is recognized as an expense by voluntary health and welfare organizations.

3. Unlike hospitals, voluntary health and welfare organizations are not required to prepare a statement of changes in net assets.

4. Donated services are always recorded as revenue by a voluntary health and welfare organization.

Answers

1. True. Voluntary health and welfare organizations usually use fund accounting because donors and/or external authorities may restrict or prohibit the use of some assets for operations.

2. True. Depreciation expense, like other object classifications, is also reclassified to the appropriate functional expense categories.

3. True. The AICPA *Audits of Voluntary Health and Welfare Organizations* takes the position that the essential information provided in that statement is disclosed elsewhere.

4. False. Donated services are recorded only when the service is one that would otherwise be paid for. Hence, most volunteer services are not recorded. When volunteer services are recorded, the amount is classified as "public support," not "revenue."

Chapter 4 Review Questions

1. Voluntary health and welfare organizations (VHWOs) must report information about expenses by

A. Functional classification only.
B. Natural classification only.
C. Functional and natural classifications.
D. Major classes of program services and supporting services only.

2. Which of the following nongovernmental not-for-profit organizations must report information about expenses by natural classification?

A. Private hospitals.
B. Colleges and universities.
C. "Other" not-for-profit organizations (NFPOs).
D. Voluntary health and welfare organizations (VHWOs).

3. Health Policy Foundation (HPF), a voluntary health and welfare organization supported by contributions from the general public, included the following costs in its statement of functional expenses for the year: Fund-raising = $1,000,000; Administrative (including data processing) = $600,000; Research = $200,000. HPF's functional expenses for program services included

A. $1,800,000.
B. $1,000,000.
C. $600,000.
D. $200,000.

4. A not-for-profit voluntary health and welfare entity received a $500,000 permanent endowment. The donor stipulated that the income be used for a mental health program. The endowment fund reported a $60,000 net decrease in fair value and $30,000 of investment income. The entity spent $45,000 on the mental health program during the year. What amount of change in temporarily restricted net assets should the entity report?

A. $75,000 decrease.
B. $15,000 decrease.
C. $0
D. $425,000 increase.

5. A voluntary health and welfare entity received a $700,000 permanent endowment during the year. The donor stipulated that the income and investment appreciation be used to maintain its senior center. The endowment fund reported a net investment appreciation of $80,000 and investment income of $50,000. The entity spent $60,000 to maintain its senior center during the year. What amount of change in temporarily restricted net assets should the entity report?

A. $50,000
B. $70,000
C. $130,000
D. $770,000

Chapter 5:

Other Not-For-Profit Entities

Learning Objectives:

After completing this section, you should be able to:

1. Recognize the auditing of and reporting on the financial statements of other not-for-profit organizations (ONFPOs).
2. Calculate depreciation financial reporting for ONFPOs.

SOURCES OF GAAP

The key sources of authoritative GAAP relating to guidance in not-for-profit organizations are:

- ASC 958-605-05-3, *Not-for-Profit Entities: Revenue Recognition* (FAS-116, *Accounting for Contributions Received and Contributions Made).*
- ASC 958-205-05-5, *Not-for-Profit Entities: Presentation of Financial Statements* (FAS-117, *Financial Statements of Not-for-Profit Organizations).*

There are many types of not-for-profit entities in addition to colleges and universities, hospitals, and voluntary health and welfare organizations. Our society depends heavily on such organizations for religious, educational, social, and recreational needs. Exhibit 1 shows examples of other not-for-profit organizations (ONFPOs).

Exhibit 1
Examples of Other Not-for-Profit Organizations

Cemetery organizations	Private and community foundations
Civic organizations	Private elementary and secondary schools
Fraternal organizations	Professional associations
Labor unions	Public broadcasting stations
Libraries	Religious organizations
Museums	Research and scientific organizations
Other cultural institutions	Social and country clubs
Performing arts organizations	Trade associations
Political parties	Zoological and botanical societies

Accounting for ONFPOs

The issuance of ASC 956 (FAS-116) and ASC 958 (FAS-117) has done much to bring the financial reporting standards of hospitals, voluntary health and welfare organizations, and other not-for-profit organizations into agreement. In addition to the two FASB statements, the AICPA Audit Guide for Not-for-Profit Organizations provides guidance for accounting and financial reporting standards for ONFPOs.

ONFPOs vary significantly in size and scope of operations. While **accrual accounting** is required for all ONFPOs, some small organizations operate on a cash basis during the year and convert to an accrual basis at year-end. ONFPOs have thousands or even millions of members and hold assets worth substantial sums of money. From the viewpoint of asset management and control procedures, such organizations may be virtually identical to a large business entity. The fact that they are not in business to earn profits from selling goods and services continues to distinguish some aspects of financial reporting for ONFPOs from that of business entities, however.

In the past, it has been assumed that fund accounting would be used by ONFPOs in a manner similar to accounting for VHWOs. With the adoption of ASC 956 (FAS-116) and ASC 958 (FAS-117), it is likely that the procedures used by ONFPOs and VHWOs will move away from the traditional funds used and account for all transactions in a single entity or by establishing separate accounts for unrestricted, temporarily restricted, and permanently restricted net assets.

Financial Statements of ONFPOs

The principal purpose of the financial statements of an ONFPO is to explain how the available resources have been used to carry out the organization's activities. Therefore, the statements should disclose the nature and source of the resources acquired, any restrictions on the resources, and the principal programs and their costs; they also should provide information on the organization's ability to continue to carry out its objectives. ASC 958 (FAS-117) requires that an ONFPO provide the following financial statements: (1) a statement of financial position, (2) a statement of activities, and (3) a statement of cash flows. Although the statement of functional expenses is not required of ONFPOs, it may be appropriate to prepare a statement providing information on expenses by function for each major program when an ONFPO is involved in a broad range of activities or conducts activities that are very distinct from one another.

Summary of Accounting and Financial Reporting for ONFPOs

Accounting for ONFPOs is similar to that for VHWOs. The **accrual basis of accounting** is used for financial reporting purposes. A statement of financial position, a statement of activities, and a statement of cash flows are required for financial reporting purposes. When a large number of programs or a number of very different types of programs are part of the operations of an ONFPO, it may be desirable to prepare a statement of expenses by functional area or major program as well. As a result of ASC 956 (FAS-116) and ASC 958 (FAS-117), the reporting requirements of ONFPOs are substantially the same as for VHWOs.

Short Quiz

Indicate whether each of the following statements is true or false.

1. The reporting requirements of ONFPOs are different from those for VHWOs.

2. All ONFPOs are required to use the accrual basis of accounting.

Answers

1. False. As a result of ASC 956 (FAS-116) and ASC 958 (FAS-117), the reporting requirements of ONFPOs are substantially the same as for VHWOs.

2. True. However, some small organizations operate on a cash basis during the year and convert to an accrual basis at year-end.

Chapter 5 Review Questions

1. The following expenditures were made by Green Services, a society for the protection of the environment: Printing of the annual report = $12,000; Unsolicited merchandise sent to encourage contributions = $25,000; and cost of an audit performed by a CPA firm = $3,000. What amount should be classified as fund-raising costs in the society's statement of activities?

A. $37,000
B. $28,000
C. $25,000
D. $0

2. Molko, a community foundation, incurred $10,000 in management and general expenses during Year 4. In Molko's statement of activities for the year ended December 31, Year 4, the $10,000 should be reported as

A. A direct reduction of fund balance.
B. Part of supporting services.
C. Part of program services.
D. A contra account to offset revenue.

Chapter 6:

Not-for-Profit Financial Analysis and Metrics; Avoiding Bankruptcy

Learning Objectives:

After completing this section, you should be able to:

1. Recognize different examples of trend analysis.

Managers of not-for-profit organizations (NFPOs) generally are not skilled in financial matters. Or, managers are often preoccupied with its welfare objectives and fund raising and ignore the operations efficiency and operating cost controls. A series of appropriate questions that not-for-profit financial managers must address in connection with an organization's financial condition and activity include:

1. Do we have a profit or a loss?
2. Do we have sufficient reserves?
3. Are we liquid?
4. Do we have strong internal controls?
5. Are we operating efficiently?
6. Are we meeting our budget?
7. Are our programs valid?
8. Are we competing successfully? 9. Is our prioritizing of programs and activities reasonable?

This chapter is an attempt to help answer these questions.

Financial statement analysis is undertaken by those working within the NFPO, such as managers, and outsiders evaluating the NFPO's financial statements. Financial statement preparers are provided with red flags as to impending financial problems that need to be identified and corrected. Areas of strength are also identified and taken further advantage of. Financial statement users include resource providers, such as contributors and grantors. They want to know how well their funds are being spent for the purposes solicited. Financial statements reveal this fiduciary trust. Further, donors do not want to pour money into a sinking ship. Suppliers and loan officers analyze the financial statements to determine whether to give credit, and if so, how much and for what time period. Companies and government (federal and local) agencies awarding contracts appraise financial statements as to whether contractual provisions are being adhered to. Government regulators (watchdogs) evaluate the financial statements to ascertain if compliance is being made to prescribed regulations and limitations. An NFPO serves the public, so concerned citizens may want to analyze the financial statements to determine if service goals are being met.

Financial statement analysis reveals how well a not-for-profit organization (NFPO) did in meeting its targets. Interrelated ratios reveal the financial standing and areas of financial trouble. Each ratio should be compared over the years for a trend, to an industry norm (e.g., healthcare standard ratio), and to comparable NFPOs to obtain a relative standing. Ratios vary depending on the service provided, complexity of operations, funding sources, and donor restrictions. A cost-benefit analysis should be undertaken for new programs. Risk-return analysis is also essential. When evaluating the service efforts of an NFPO, look to see how much of every dollar goes to the primary mission as opposed to the fundraiser's commissions and the executive director's salary. Carefully monitor the relationship of supporting services to program services expenses.

The primary objectives of the chapter are twofold. First, the chapter focuses on ways NFPOs can assess the progress and health of their businesses. It takes you through step-by-step procedures in performing financial statement analysis. The procedure involves:

- Appraising the balance sheet for financial position and flexibility
- Analyzing the Statement of Activities for operating performance
- Evaluating the Statement of Cash Flows for cash position
- Referring to footnote information
- Evaluating the auditor's opinion
- Reviewing internal documents related to financial health
- Reviewing budgets to determine if plans are practical and for future directions

The chapter discusses some key financial ratios that are critical for assessing the financial health of NFPOs. Second, the chapter introduces some key financial metrics for NFPOs. Also, as a giver or donor, you need know how to distinguish among NFPOs in the same field. You want address questions, such as:

How do you figure out who does the most with the contributions and who spends inordinate sums, however well intentioned, on raising the money and excessive overhead? Several indexes would be helpful to answer those questions: charity commitment, fundraising efficiency, and donor dependency.

A case study, presented at the end of the chapter, analyzes an NFPO, including trend analysis, ratio computations, and analytical evaluation.

Note: Many of the financial analysis metrics use figures from Form 990, which is the required tax form for NFPO's.

Trend Analysis

Trend (horizontal) analysis is a time series analysis of financial statements of the NFPO, covering more than one accounting period. It looks at the percentage change in an account or category over time. The percentage change equals the change over the prior year. For example, if salaries expense increased from $140,000 to $165,000 from 2X12 to 2X13, the percentage increase is 18 percent ($25,000/$140,000). The reason (or reasons) for such an increase should be determined. Does the increase indicate more staff was needed because operations improved, or does it indicate a lack of cost control, or is there some other cause? Is the situation an unfavorable one requiring management attention? By evaluating the magnitude of direction of a financial statement item over the years, the analyst can appraise its reasonableness.

EXAMPLE 1

Membership fee revenue declined from $100,000 to $80,000 over the last year. The percentage decline equals:

Amount of Change	=	$20,000	= 20%
Base Year Amount		$100,000	

Why such a significant decline in membership fees? Is this a problem peculiar just to this NFPO, or does it affect all NFPOs in the industry? Is the problem controllable or uncontrollable by management? Is the decline due to dissatisfaction among members of the NFPO, who object to its policies, or was it caused by overall poor economic conditions? Trend analysis reveals direction, positive or negative, requiring further study of the causes. The decline may indicate a problem requiring corrective action.

Analysis of the Balance Sheet

An evaluation of the balance sheet considers the NFPO's liquidity, asset utilization, solvency, financial flexibility, and capital structure. Assets, liabilities, and net assets (fund balance) must be scrutinized. Besides looking at book values for ratio computations, market values may also be used to express current values.

Liquidity Analysis

ASC 958-205-05-5, *Not-for-Profit Entities: Presentation of Financial Statements* (FAS-117) requires NFPOs to present information about their liquidity. Liquidity is the ability of the NFPO to pay current debt as they come due. Liquidity is how fast the NFPO's assets turn into cash. A liquid asset has less risk than an illiquid one. In evaluating liquidity, exclude restricted funds because they are unavailable for use.

Liquidity considers the seasonality of cash flows. Wide fluctuations in cash flows may result in a liquidity problem.

Working Capital. Working capital equals current assets less current liabilities. The higher the working capital amount, the better the liquidity.

***Current Ratio*.** The current ratio is a measure of liquidity equal to:

Current Ratio = Current Assets / Current Liabilities

Current assets are those assets to be converted to cash within one year or the normal operating cycle of the NFPO whichever is greater. Current liabilities are due within one year.

In general, the current ratio should be a minimum of 2:1. A low ratio means poor liquidity.

An excessively high ratio may also be a negative sign because it may indicate too much money is being tied up in current assets rather than invested in noncurrent assets for a higher return.

A limitation of the current ratio is that not all current assets have the same degree of liquidity. For example, accounts receivable is more liquid than inventories of suppliers. Prepaid expenses are not redeemable for cash but rather a prepayment for future benefits (e.g., prepaid advertising).

Current unrestricted assets include cash and cash equivalents (marketable securities), accounts receivable, investment income receivable, inventories of supplies, and prepaid expenses. Current unrestricted liabilities include accounts payable, prepaid services, and the current portion of mortgage payable.

C**urrent Ratio for Unrestricted Current Assets and Current Liabilities** =
Current Unrestricted Assets / Current Unrestricted Liabilities

Temporarily restricted assets should also be considered. An example is Pledges Receivable arising from gifts to finance operating activities. However, another type of Pledges Receivable exists, namely unconditional and unrestricted Pledges Receivable. Another temporarily restricted asset is Grants Receivable.

With respect to temporarily restricted net assets, determine when the resources will be available. For example, if temporarily restricted net assets include term endowments and annuities it may be best to consider them permanently restricted.

Current Ratio for Unrestricted and Temporarily Restricted =
(Current Unrestricted Assets + Current Temporarily Restricted Assets for Operations)
/ (Current Unrestricted Liabilities)

A determination should be made as to the nature of the restrictions on pledges receivable.

Acid-Test (Quick) Ratio. The quick unrestricted assets are the most liquid assets. Excluded are inventories of supplies and prepaid expenses. The quick unrestricted assets include cash and cash equivalents, accounts receivable, and investment income receivable.

Quick Ratio = Quick Unrestricted Assets / Current Unrestricted Liabilities

A higher ratio is better. It should be at least 1:1.

Accounts Receivable Ratios. Useful ratios are turnover and the collection period.

Accounts Receivable Turnover = Fees for Services on Credit / Average Net Accounts Receivable

Net Accounts Receivable = Accounts Receivable less Allowance for Uncollectible Accounts

The ratio shows the number of times average net accounts receivable turn over relative to fees generated. The more turnover, the better.

Days to Collect on Receivables = 365 / Turnover

The ratio indicates the amounts owed the NFPO as well as its accounts receivable management success. A lower ratio is better because it takes fewer days to collect on receivables. Cash received earlier can be reinvested for a return. A high ratio is bad because money is being tied up in receivables that could be invested elsewhere. Further, the longer days receivables are held the greater is the chance of uncollectibility. Perhaps billing is deficient. Receivables must be kept under control.

In looking at the collection period, consider terms of sale, account profile, service mix, collection policies, and the collection period of comparable NFPOs.

An aging of receivable balances should be prepared broken down by current, past due (0-30 days), past due (3l-60 days), past due (61-90 days), and past due (91 days - 120 days). The aging listing should be in both alphabetical order and by magnitude of receivable balances outstanding. The older the receivables are, the less the chance of collection. A determination should be made of both time distribution and size distribution. How many billing periods has a particular account been unpaid?

A determination should be made of what percent receivables are to total assets equal to:

Total Accounts Receivable / Total Assets

A high ratio is a problem especially if most of the accounts receivable are from a few sources.

***Pledges Receivable and Turnover*.** The turnover ratio for pledges receivable is similar to that of accounts receivable.

Turnover = Net Contributions from Pledges / Average Net Pledges Receivable

A lower turnover for pledges receivables means a longer collection period.

Collection Period = 365 / Turnover

Is the collection period for pledges less than expected? If so, is it because of inadequate collection efforts. Compare to industry averages. Determine the reasonableness of the provision for uncollectible pledges. Analyze pledges receivable in terms of time and size diversification.

The turnover and age of grants receivable should be determined in a similar way.

Inventory. The inventory turnover ratio establishes the relationship between the volume of goods sold and inventory. The inventory turnover is computed as follows:

Inventory turnover = (Cost of Goods Sold) / (Average Inventory)

Inventory may have a low turnover because they are too costly, poor quality, or lack appeal.

Days in Cash. The ratio equals:

Days = (Cash + Cash Equivalents) x 365 / Operating Expenses - Depreciation

The days' cash is the number of days the NFPO can continue in operation if cash inflow stops. It is the number of days of average cash payments the NFPO can manage without cash inflow. The more days, the better.

EXAMPLE 2

An NFPO expends $30,000 daily on average in a one-year period. If it has $900,000 of cash and cash equivalents on hand, it has 30 days' cash.

Cash Flow to Total Debt. The ratio equals:

Net Income + Depreciation / Total Liabilities

The ratio indicates how much of internally generated cash is available to pay debt. A higher ratio is better because there is better liquidity in that cash flow from operations is being generated.

Days Purchases Unpaid. The ratio equals:

Accounts Payable / Daily Purchases

Daily Purchases = (Purchases/360)

The ratio is used to evaluate trade credit. It shows how long (how many days) trade credit remains unpaid.

If the suppliers payment terms are 30 days and the NFPO pays in 90 days on average it may mean there are liquidity problems.

Current Liability Coverage. The ratio equals:

Cash + Marketable Securities (unrestricted) / Current Liabilities

The ratio reveals how much of current liabilities can be paid from cash and short-term investments if cash inflows cease.

Financial Flexibility

The greater the amount of unrestricted net assets the greater the amount of financial flexibility. NFPOs with huge permanently restricted endowments and minimal unrestricted net assets may not enjoy much flexibility. Can the NFPO respond and adapt to financial adversity and unexpected needs and opportunities? Which resources are available when needed?

Asset Utilization

Asset utilization applies to the efficiency with which the assets are used in the operating activities of the NFPO. For example, a higher ratio of revenue to assets indicates more efficiency of assets in generating profit. What assets are excessive relative to the optimal level?

The efficiency usage of supplies may be determined as follows:

Turnover of Supplies = Annual Total Supplies Expense / Average Total Inventory of Supplies

A low turnover is a negative sign because it means supplies are excessive and not being used efficiently.

The available days of supplies' use = 360/Turnover

It will tell you about the rate of supplies' usage. It also indicates how fast the current usage level would deplete supplies inventory?

Average Daily Total Supplies Expense equals:

Annual Total Supplies Expense / Average Number of Days of Supplies' Use

The ratio shows how often supplies are used such as in a particular program.

Analysis of Fixed Assets

In the long run, buying assets is cheaper than renting. The NFPO also has more control by buying because it doesn't have to concern itself with lessors unexpectedly raising rental rates or demanding certain prohibitions of using the property.

The ***average accounting age of equipment*** (e.g., computers) may be determined as follows:

Accumulated Depreciation / Depreciation Expense

The ratio reveals how old the equipment is. It shows the rate equipment is being used and replaced. A lower ratio is better.

The ratio is of particular interest to hospitals because it must buy expensive up-to-date technological medical equipment and keep facilities in good working order for the best patient care.

A low depreciation charge may indicate the NFPO is making significant use of rentals. Does a reduction in fixed assets mean there is less capacity and utilization?

Analysis of Liabilities

Short-term borrowing may be used to fill the gap resulting from the temporary shortfall in contributions or other sources of cash inflow.

If long-term debt is used to finance fixed assets, the NFPO has greater financial leverage risk. The NFPO must be able to pay principal and interest.

Analyze the long-term indebtedness of the NFPO including:

- Interest rate being charged.
- Excessiveness of debt.
- Reason for borrowings. How is the money to be used?
- Maturity dates of debt. Are debt payments staggered? Can the debt be repaid?
- Lines of credit.
- Loan restrictions such as collateral requirements. Are such restrictions tying the hands of the manager?
- Understated liabilities such as the liability for severance payments or for earned but unused vacation time?

Appraisal of Solvency, Capital Structure, and Net Assets (Fund Balance)

A healthy capital structure will help assure the NFPO's ability to engage in its daily activities. High leverage (debt to net assets or fund balance) means risk. The debt ratio will increase if the NFPO must finance fixed asset expansion with borrowed funds.

The ratio of long-term debt to total unrestricted net assets (fund balance) reveals the NFPO's long-term credit commitments to its ability to pay the debt. It relates borrowed funds to owned funds. A ratio over 1 may indicate a problem in handling additional debt. Can the NFPO pay existing interest and principal payments?

Analysis of the net assets (fund balance) depends on the facts and circumstances. A surplus indicates better financial health than a deficit. An increasing trend in the surplus is a favorable sign. Surpluses provide savings for financing the future and the ability to pay off debt.

Evaluation of the Statement of Activities

An NFPO should communicate to the users of the financial statements which specific revenues and expenses are included in the operating measure. If the NFPO's use of the term operating is not clear from the details on the face of the statement, ASC 958-205-05-5, *Not-for-Profit Entities: Presentation of Financial Statements* (FAS-117) requires a footnote describing the nature of the measure of operating performance. The financial analyst should carefully review the NFPO's definition of the operating measure. A comparison should be made with similar NFPOs and the definition should be consistently applied. Generally, the operating income measure is a subtotal in arriving at the net change in unrestricted net assets.

In analyzing the Statement of Activities, determine:

- Whether the entity is self-sustaining and operating well.
- If service efforts are being successful.
- Whether management has discharged its stewardship responsibilities.

In the long run, if an NFPO does not spend all of its revenues, it is not funding as much services as possible to the public. On the other hand, if it keeps spending more than its revenues, it will go bankrupt.

In analyzing an NFPO, consider "operating capital maintenance" which means whether the NFPO is maintaining its capital by having its revenues at least equal to its expenses. Why did a surplus or deficit occur?

An NFPO should not report a profit consistently each year. If it always shows a profit, the NFPO may not be accomplishing its objective of providing as much service as possible with available resources. It should either provide more service and thereby increase its costs or reduce prices it charges for services. The objective of an NFPO's financial policy should be to break-even.

An NFPO (such as a membership organization) may have a policy of having an operating excess one year but a deficit in another year, which balances out. For example, member dues may be increased only once each three years. In the year of the dues increase, an operating surplus may arise. In the second year, there may be a break-even, and in the third year a deficit may exist. Dues are then increased again.

In a similar vein, an NFPO may want an operating excess one year to eliminate a deficit from the previous year.

An operating surplus may also be desired to have adequate funding for expansion, to subsidize programs, or as a result of a lawsuit. A surplus may be desired as a contingency for unexpected problems, and to replace assets.

An NFPO may want to operate at a deficit in one year to reduce an accumulated surplus or to meet a special need.

In conclusion, an NFPO does not have to break-even each year. It may have a surplus in one year(s) and a deficit in another year(s) to meet its unique circumstances as long as it balances out over a number of years.

Revenue

The revenue base should be diversified to reduce risk. For example, overdependence on one revenue source may be dangerous (e.g., grants).

A decline in revenue may indicate ineffectiveness. For example, a decline in college tuition may mean problems in attracting students at a college. How does actual revenue compare to expected revenue?

Total revenue needed daily on average equals: Total Revenue (prior year) / 365

Costs

Expenses should be analyzed in terms of program and object of expense. Variances between actual and budgeted expenses should be investigated.

Determine the reason for a sizable increase or decrease in an expense. For example, a significant increase to a specific expense may not be due to a change in organizational plan but may reflect contributed services instead.

A determination should be made of the cost per unit of service. A lower rate means better cost containment. When costs need to be reduced, the first thing to cut is lower priority programs least accomplishing the NFPO's goals. However, consider how changes in program activities would affect donor contributions and volunteer support. Identify controllable and uncontrollable costs. Ask these questions:

- Can costs be reduced by replacing obsolete and/or inactive equipment?
- Can costs be reduced by improved technology?
- Will an improved repairs and maintenance program lower costs?
- Can staff improvements be made to lower costs?
- Can energy costs be reduced through improved traffic management?
- Can productivity be improved?

Ratios include:

Operating Expenses / Total Revenue

A lower ratio indicates better cost control.

Fund Raising Costs / Total Donations

The ratio evaluates the effectiveness of fund raising efforts. Is fund raising cost excessive for funds obtained?

The Statement of Functional Expenses is required of VHWOs. The Statement is helpful to the financial analyst because it provides a detailed breakdown of expenses by program. It is analogous to segment reporting in business enterprises.

Profitability

Profitability is needed, for NFPOs trying to expand, enter new areas, are unstable, and are ever changing. Profitability measures include:

Profit Margin = (Revenue - Expenses)/ Revenue

A higher ratio shows better operational performance (profit).

Operating Margin = (Operating Revenue - Operating Expenses)/ Operating Revenue

Operating revenue excludes nonoperating sources such as fund raising revenue, dividends, and extraordinary items. The operating profit is derived solely from operating activities without having to rely on contributors. A higher ratio is better.

Return on Net Assets (Fund Balance) (Net Assets)

= (Total Revenue - Total Expenses) / Average Net Assets

The ratio shows how efficiently the net assets (fund balance) has created the year's profit.

Ratios of investment performance include:

Interest and/or Dividend Income / Investments at Cost

Interest and/or Dividend Income / Investment at Market Value

Higher ratios indicate better returns on investments.

Disclosures

In examining footnote disclosures, identify contingencies including positive and negative developments affecting the NFPO. Disclosure of possible future funding problems is a "red light." An example is changing political policies directed toward reducing government funding. A lawsuit against the NFPO is a negative sign particularly if it is reasonably possible that the NFPO will lose.

Performance Metrics

We have to examine the quality of the services and programs offered by the NFPO besides just looking at dollars. The NFPO's objective is to render an amount and quality of services. For example, measures of performance (or metrics) for a college include number of enrollments, number of courses, and ratio of faculty to students. Some general performance measures to keep in mind include:

- Capital per unit of service.
- Number of patients treated daily by a doctor.
- Number of welfare cases handled by a social worker.
- Input/output relationships such as what was the cost and time of performing a service and what was the quality and quantity of service provided.
- Number of complaints.

How do you figure out who does the most with the contributions and who spends inordinate sums, however well intentioned, on raising the money and excessive overhead? Several indexes would be helpful to answer those questions: charity commitment, fundraising efficiency, and donor dependency.

Charity Commitment

Charity commitment percentage =

$$\frac{\text{Charitable expense (program support or program service expense)}}{\text{Total expenses}}$$

Essentially, the resulting figure excludes such overhead as management and fundraising.

Fundraising Efficiency

This measures how much of the money raised from private sources remains after accounting for fundraising. This is computed by taking the total funds raised from the public through direct contributions, indirect contributions (such as from United Way) and proceeds from one-time special events, subtracting fundraising costs, then expressing the result as a percentage of the total amount from the public (private support).

Donor Dependency

It tries to measure how badly a charity needs your contribution--as opposed to money raised from selling products or tickets or reaping investment gains--to fund its current operations. We figure this by subtracting a charity's annual surplus (excess of revenue over expenses) from public donations (private support), then dividing this figure by the public donations (private support). A percentage at or above 100% means that the NFPO is totally dependent on donations and is not salting away funds for a rainy day. A *negative* index number means surpluses exceeding all donations for the reporting year.

Exhibit 1 presents these indexes for a selected charity organization

Exhibit 1				
Charitable Commitment, Fundraising Efficiency, and Donor Dependency				
Alzheimer's Disease & Related Disorders Association (Alzheimer's disease research)				
Chicago IL (www.alzfdn.org)				
All figures in $mil except where otherwise noted				
Private support	Gvt support	Total support	Other income	Total revenue
97	0	97	17	114
Program service expenses		Mgmt & gen'l	Fundraising	Total expenses
84		9	16	109
Surplus (Loss)	Net Assets	**Charitable commitment***	**Fundraising efficiency[2]**	**Donor dependency[3]**
5		77.1%	83.5%	94.8%

* 77.1%= 84/109; 2. 83.5% = (97-16)/97; 3. 94.8% = (97-5)/97

SOURCES: IRS Form 990; annual reports, statements of individual charities**;** www.guidestar.org

Note: Donors are becoming increasingly discerning about how charities spend their contributions, thanks to the growing availability of information about not-for-profits on the Internet. In particular, donors are looking at two metrics. One is the efficiency ratio, which compares how much an NFPO spends on fulfilling its mission (known as its programs) with what it spends on overhead and fund-raising. The other is the fund-raising ratio, which compares fund-raising costs as a percentage of contributions. The higher a NFPO's efficiency ratio and the lower its fund-raising percentage, the more comfortable donors will feel about giving money, knowing that most of it will be spent on programs.

Fund Raising Ability

Creditors evaluate the NFPO's fund raising ability as a major source of debt repayment for nonrevenue-generating projects. Donated funds are important to consider when appraising the NFPO's creditworthiness. Refunding is issuing new debt to replace existing debt and may occur if (1) market interest rates have decreased (2) excessive restrictions exist in current debt, or (3) there is a desire to lengthen debt maturity.

Analysis of Pledges

In appraising pledges, consider:

- Are pledges decreasing among a particular category of donors or all donors?
- Does poor economic activity result in fewer pledges?
- Have new tax laws made gift giving less advisable?
- Do donors feel the objectives of the NFPO no longer match with their views?

Creditors may not assign a value to pledges receivable when analyzing the NFPO because donors are not legally bound to honor their dollar pledge or time promised. For example, if the donor goes bankrupt, although unlikely, the promise will not be kept. The donor may change his or her mind in giving because of a change in circumstances. However, the creditor should examine who the donors are, their past history of giving, their current financial status, and their reliability. If the donor's profile indicates a high probability of giving the amount promised, creditors will give loans based on security or the pledges receivable. For example, pledges may be used to secure debt service or construction loans.

The analyst considers pledges due within one year of higher quality than pledges due in five years. Thus, the shorter the time period associated with the pledge the less risk involved.

Analysis of Contributions

A potential cash problem is indicated when actual contributions significantly fall short of expectations. Restricted contributions are unavailable for operating purposes and to pay short-term debt. How much funds are available and when? What are the restrictions (e.g., scholarship fund, building fund)? Are the restrictions very specific or excessive? It is better to have a higher ratio of unrestricted contributions to total contributions because unrestricted contributions are available to be used by the NFPO in its regular activities. Restricted contributions do little to improve the NFPO's liquidity unless the terms of the donor allow for the transfer of funds for operating purposes.

NFPOs with substantial contributed services need special attention. The footnote on contributed services should be closely read because it describes the program or activities that use volunteer services, the nature and extent of contributed services in monetary and nonmonetary terms, and the amount of contributed services recognized as revenue for the year.

Looking At Endowments

An endowment represents long-term investments. Investment income from the endowment may be unrestricted and available to finance operating activities or restricted as to use. Donors want financial feedback as to whether the NFPO has expended resources received, if expenditures are in accord with promises made, if services and activities provided are of high quality, and the remaining balance of resources. Constraints and commitments made to donors regarding fund use are disclosed in the financial statements including status thereto. Are legal requirements being met?

A decrease in endowments is a negative sign because it may indicate less interest or dissatisfaction with the NFPO. However, poor economic conditions may be the reason.

Answer these questions about the portfolio in which endowment funds are invested:

- How much fluctuation exists in the securities portfolio?
- Is diversification of the portfolio adequate?
- Are the securities negatively or positively correlated?

Total return on endowment investments may be estimated by computing it as a percentage of the average balance of endowment investments.

EXAMPLE 3

The return on an endowment portfolio is \$60,000. The beginning and ending balances are \$1,000,000 and \$1,200,000, respectively.

$$\text{Return Rate} = \frac{\text{Return}}{\text{Average Balance}} = \frac{\$60{,}000}{\$1{,}100{,}000} = 5.5\%$$

A lower return rate is a negative sign.

The return on the endowment investment should be higher as the risk of the investment increases.

Evaluation of Grants

In analyzing grants, answer the following questions:

- Has there been a sufficient attempt to obtain public and private grants?
- Was reference made to suitable sources such as The Foundation Directory?
- Does the foundation's objective match the grant proposal?
- Are matching funds required to receive the grant?
- Was the proposal completely done (e.g., detailed information, clear discussion of how funds will be used)?

- Were due date filings met?

Risk/Return Analysis

Is the return sufficient to justify the risk? The greater the risk, the greater should be the return. Risk means the probability of an activity accomplishing its objective. For example, there may be a high degree of risk associated with a new specialized academic program in a university or a new medical procedure at a hospital. There is always risk in allocating human and financial resources to new programs.

Ways to control or reduce risk include:

- Use agents and representatives including volunteers.
- Carry adequate insurance protection. For example, insurance should be sufficient relative to the value of the insured property.
- Carefully hire qualified staff to avoid damages and injuries to others.
- Have written policies and communicate them carefully through the organization.
- Have proper supervision over new hires.
- Have protective provisions in contracts to limit the NFPO's liability for contractor malfeasance.
- Have proper security over assets to guard against theft or destruction.
- Diversify operations.
- Avoid dealings with selected groups that may result in legal liability problems such as young children when dealing with hazardous items.

Audit Reliability

Many state and local governments require audits to be conducted of NFPOs. Has the NFPO's financial statements been subject to an audit, review, or compilation? A big difference exists between these processes in terms of the reliability of the NFPO's financial statements. The highest level of reliability and testing is in an audit. In a review, no testing exists but rather a determination of whether the financial statements make sense. A compilation, the least reliable, involves just collecting and reformatting financial records.

In looking at the audit opinion, an "except for" qualification or a disclaimer may indicate a problem. An unqualified opinion is best.

Software

Software exists in analyzing NFPOs. For example, The Functional Cost Analysis Program develops credit union income and cost information along functional lines and gives comparisons of data among credit unions and banks.

Spotting Potential Bankruptcy and Avoiding Financial Problems

A negative net assets (fund balance) (total liabilities exceed total assets) indicates a worrisome deficit position that is an indicator of potential bankruptcy. Cash forecasts showing expected cash outflows exceed expected cash inflows may point to financial distress. If cash is a problem, timely steps may be needed to improve cash flow and solve problems. How long will the current cash position last if all cash inflows were to cease?

A balanced budget, using conservative revenue estimates, is its own way to avoid financial ruin. A balanced budget requires difficult choices, such as curtailment or elimination in certain services or programs.

Answer the following questions in gauging the probability of potential failure:

- Is there adequate insurance?
- Does excessive legal exposure exist? What is the nature of pending lawsuits? Is the NFPO abreast with all current laws and regulations affecting it?
- What government adjustments are expected regarding rate charges and reimbursements?
- Is there inadequate control over expenditures?
- Is there deferred maintenance, which can no longer be postponed?
- Are loan restrictions excessive?
- What effect will contractual violations have?
- Are costs skyrocketing? Why?
- Are bills past due?
- Is debt excessive?
- Are debt repayment schedules staggered?
- Should maturity dates be extended?
- Is the public or government criticizing the NFPO?
- Is there a decreasing trend in donor interest?
- To what extent are donor contributions restricted? Restricted donations cannot be used to pay current expenses unless the restriction is satisfied or lifted.

- Is there less community interest in the NFPO (e.g., fewer members, patients)?
- Are fewer volunteers available?
- Are more grant applications being rejected?
- Is there a cash shortage?
- Is the NFPO anticipating future trends (e.g., social, political, technological)?
- Does the NFPO have sufficient expertise in the areas it is involved in?
- Is there a buildup in assets (e.g., receivables)?
- Is a hedging approach used to finance assets by matching against them the maturity dates of liabilities?
- Are long-term fixed-fee contracts hurting the NFPO?
- Is there a sharp increase in the number of employees per unit of service?
- Are there open lines of credit?
- Does a lack of communication exist?

Ways to avoid financial problems include:

- Merging with another financially stronger similar NFPO. Will a merger aid in financing, lower overall operating costs, synergy and efficiency, and program expansion?
- Restructure the organization.
- Sell off unproductive assets.
- Defer paying bills.
- Discard programs and activities no longer financially viable.
- Implement a cost reduction program including layoffs and attrition. But will this eliminate programs that will be hard to start up again? Are we getting rid of scarce talents? These are referred to as irreversible reductions, which in the long run may not be wise.
- Increase service fees.
- Increase fund raising efforts and contributions.
- Apply for grants.
- Stimulate contracts.

EXAMPLE 4

A not-for-profit organization provides the following financial information:

Summary of Income, Expenses, and Cash Balances

Income	*2x11*	*2x12*	*Percentage Change*
Membership and program fees	$125,000	$130,000	4%
Contributions	126,000	130,000	3
Other	13,000	35,000	169
Total income	$254,000	$295,000	12
Expenses			
Salaries	$100,000	160,000	60
Rent	40,000	70,000	43
Insurance	10,000	20,000	100
Supplies	20,000	40,000	100
Total expenses	$170,000	$290,000	71
Excess of income over expenses	94,000	$ 5,000	95
Cash balance, beginning of year	50,000	144,000	
Cash balance, end of year	$144,000	$149,000	

From 2x11 to 2x12, total expenses have increased 71% while total revenue has increased only 12%. This is a very negative sign. Among the things it may indicate are a failure to control costs, or declining fees for services, possibly due to membership dissatisfaction. Then, why have contributions only increased by 3%. Are donors upset with the NFPO's policies, objectives, or management?

It is particularly alarming that profitability has declined by a stunning 95%. The sharp increase in each expense category must be closely scrutinized for cause and corrective action immediately taken. Unless something is done to correct this unfavorable trend, the NFPO is in serious trouble!

Case Study in Financial Statement Analysis:

Family Service Agency of Utopia

This case study is based on a sample NFPO provided by the Internal Revenue Service in *Form 990.* The sample-completed tax return is prepared only for *illustrative* purposes and presented in the Appendix.

Trend Analysis (All line references are to Form 990)			
	12/31/2011	*12/31/2012*	*Percent change*
Total Cash (Lines 45 and 46)	$ 248,700	$ 228,500	-8.1%
Pledges Receivable (Line 48c)	$ 46,000	$ 58,900	28.0%
Grants Receivable (Line 49)	$ 4,600	$ 5,800	26.1%
Inventories (Line 52)	$ 6,100	$ 7,000	14.8%
Fixed Assets (Line 57c))	$ 168,500	$ 174,800	3.7%
Total Assets (Line 59)	$ 916,000	$ 964,800	5.3%
Total Liabilities (Line 66)	$ 111,200	$ 112,300	1.0%
Current Unrestricted Fund (Line 67)	$ 446,300	$ 485,100	8.7%
Current Restricted Fund (Lines 68 and 69)	$ 358,500	$ 367,400	24.8%
Total Net Assets (Fund Balances) (Line 73)	$ 804,800	$ 852,500	5.9%
	For the Year Ended		
	2011	*2012*	*Percent change*
Contributions, Gifts, and Similar Amounts (2012 from Line 1)	$ 742,300*	$ 710,800	-4.2%
Membership Dues (2012 from Line 3)	$ 1,100*	$ 1,600	45.5%

* Given from the previous year.

An analysis of the trends from 2011 to 2012 reveals the following:

- The cash position declined having a negative effect on liquidity.
- Pledges and grants receivable have both significantly increased reflecting success in obtaining pledges and grants to the NFPO, which is a favorable sign. However, it may be that there is a problem in collecting the pledges and grants due to higher receivable balances.

- The buildup in inventories may mean greater realization risk.
- Fixed assets were fairly constant.
- The increase in total assets is a favorable indicator.
- Total liabilities were about the same.
- While the balance in current unrestricted funds increased, a favorable sign, there was a decline in the current restricted fund. However, the dollar amount of the decline is small even though it's a higher percentage.
- More funds are available for fixed asset expansion.
- The NFPO has been successful in having more endowment funds.
- The increase in total net assets (fund balances of about 6% is a positive sign.
- Contributions, gifts, grants and similar items decreased about 5%. The reasons for the decrease should be determined. Is there less interest in the NFPO among donors? If so, why?
- The membership revenue almost doubled reflecting greater interest in the NFPO's policies as indicated by more enrollments or an increase in per member fees. Perhaps there was a successful membership drive.

Liquidity Analysis

Total Current Assets / Total Assets =

$315,600/$964,800 = .33

Each $1 of total assets is comprised of $.33 of current assets.

Current Ratio =

Current Assets / Current Liabilities = $315,600 / $98,900 = 3.2

The high ratio means good liquidity.

Current Ratio for Unrestricted Current Assets and Current Unrestricted Liabilities =

(Current Unrestricted Assets) / (Current Unrestricted Liabilities) =

$304,000 / $98,900 = 3.1

The high ratio further indicates good liquidity.

Quick Ratio =

Quick Unrestricted Current Assets * / Current Unrestricted Liabilities =

$283,600 / $98,900 = 2.87

* Quick Unrestricted Current Assets = Total Current Assets - Inventories - Prepaid Expenses =

$304,400 - $7,000 - $13,800 = $283,600

Because the quick ratio (2.87) exceeds the norm of 1.0, good liquidity is evident.

Accounts Receivable Turnover =

Program Service Revenue (Form 990, Line 2) /_ Average Net Accounts Receivable (Form 990, Line 47c) =

$2,600 / $1,700 = 1.5

Receivables turn over 1.5 times per year relative to fees generated. The low turnover rate indicates less liquidity. Perhaps there is risk in collecting.

Days to Collect on Receivables =

365 / Turnover = 365 / 1.5 = 243 days

It takes 243 days to collect on receivables indicating a possible collection problem.

Total Accounts Receivable (Form 990, Line 47c) / Total Assets (Form 990, Line 59) =

$1,600 / $964,800 = 0.2%

The very low ratio means receivables are insignificant relative to total assets.

Pledges Turnover =

[Net Contributions from Pledges (From Statement of Revenue, Expenses, and Changes in Net Assets/Fund Balance (SRECF)]] / Average Net Pledges Receivable (Form 990,Line 48c)

= $473,700 / $52,450 = 9 times

The high turnover rate means faster collection on pledges, which is a favorable liquidity indicator.

Collection Period on Pledges =

365/ Turnover = 365 / 9 = 40.6 days

It takes about 41 days to collect on pledges. This is favorable.

Cash Flow to Total Debt =

(net income + depreciation) / (total liabilities) =

(Form 990, Line 18 + Line 42) / (Form 990, Line 66) =

($47,700 + $5,200) / $112,300 = .47

This computation indicates that $.47 of internally generated cash is available to pay $1 of debt.

Current Liability Coverage =

[Cash + Marketable Securities (Unrestricted) (BS)] / [Total Current Liabilities (BS)] =

$221,100 / $98,900 = 2.2

For each $1 in current liabilities there is $2.20 of cash and short-term investments available to pay it.

Total Current Liabilities to Total Liabilities =

$98,999 / $112,300 = .88

Current debt is a high proportion of total liabilities. This is an unfavorable liquidity indicator.

Analysis of Solvency

Total Assets (Form 990, Line 59) to Total Liabilities (Form 990, Line 66) =

$964,800 / $112,300 = 8.6

There is $8.60 in assets for each $1 in liabilities indicating a good solvency position.

Total Liabilities (Form 990, Line 66) / Total Net Assets/Fund Balance (Form 990, Line 73) =

$112,300 / $852,500 = 0.13

The low ratio of debt to net assets/fund balance is a favorable indicator of the ability of the NFPO to meet its obligations. It indicates less risk.

[Long-term Debt (BS)] / [Total Unrestricted Net Assets/Fund Balance (BS)] =

$13,400 / $485,100 = 2.8%

This ratio is a further indication of a solid solvency position. The NFPO is able to fulfill its long-term debt commitments.

Analysis of the Statement of Activities

Daily Revenue (2012) =

Total Revenue for Current Year / 365 = Form 990, Line 12 / 365 = $760,300 / 365 = $2,083

Daily Revenue (2011) =

Total Revenue for Prior Year / 365 = Form 990, Line 12 / 365 = $800,600* / 365 = $2,193

*Give from year 2011.

The declining revenue per day from 2011 to 2012 is a negative sign for operating performance.

Total Expenses (Form 990, Line 17) / Total Revenue (Form 990, Line 12) =

$712,600 / $760,300 = 93.7%

Total expenses are a high percentage of total revenue cuttings into surplus.

Fund raising Costs (Form 990, Line 15) / Total Donations (SRECF) =

$65,400 / $473,700 = 13.8%

Fund raising costs as a percentage of contributions is reasonable indicating an effective fund raising campaign.

Profit Margin =

Excess of Revenue over Expenses / Total Revenue =

Form 990, Line 18 / Form 990, Line 12 = $47,700 / $760,300 = 6.3%

The profit margin should be compared to other similar NFPOs. If it is lower, it indicates less operational performance.

Return on Net Assets (Fund Balance) =

Excess of Revenue over Expenses / Average Net Assets =

Form 990, Line 18 / Form 990, Line 59 $47,700 / $940,400* = 5.1%

* ($964,800 + $916,000)/2 = $940,400

This ratio reflects reasonable efficiency of the net assets/fund balance in generating yearly surplus for the year.

Dividends and Interest from Securities / Investments =

Form 990, Line 5 / Form 990, Line 54 = $ 16,400 / $474,400 = 3.5%

The rate of return earned on the investment portfolio is low

Exhibit 2 summarizes financial statement analysis covered throughout the chapter.

Exhibit 2
Financial Ratio Analysis

	12/31/2011	*12/31/2012*
Assets		
Total Cash (Lines 45 and 46)	$ 248,700	$ 228,500
Accounts Receivable (Line 47c)	$ 1,800	$ 1,600
Pledges Receivable (Line 48c)	$ 46,000	$ 58,900
Grants Receivable (Line 49)	$ 4,600	$ 5,800
Other Receivables (Line 50)	$ -	$ -
Other Notes and Loans Receivable (Line 51c)	$ -	$ -
Inventories (Line 52)	$ 6,100	$ 7,000
Prepaid Expenses and Deferred Charges (Line 53)	$ 9,600	$ 13,800
Total Current Assets (Line 45 through Line 53)	$ 316,800	$ 315,600
Investments - Securities (Line 54)	$ 430,700	$ 474,400
Investments - Land, Buildings (Line 55c)	$ -	$ -
Fixed Assets (Line 57c)	$ 168,500	$ 174,800
Other Fixed Assets (Line 58)	$ -	$ -
Total Assets (Line 59)	$ 916,000	$ 964,800

Liabilities		
Accounts Payable and Accrued Expenses (Line 60)	$ 46,000	$ 39,300
Grants Payable (Line 61)	$ -	$ -
Support and Revenue Designed for Future Periods (Line 62)	$ 61,600	$ 59,600
Loans from Officers (Line 63)	$ -	$ -
Total Current Liabilities (Line 60 through Line 63)	$ 107,600	$ 98,900
Tax-exempt Bond (Line 64a)	$ -	$ -
Mortgages (Line 64b)	$ 3,600	$ 3,200
Other Liabilities (Line 65)	$ -	$ 10,200
Total Liabilities (Line 66)	$ 111,200	$ 112,300
Net Assets or Fund Balances		
Current Unrestricted Fund (Line 67a)	$ 446,300	$ 485,100
Current Restricted Fund (Line 67b)	$ 10,000	$ 6,400
Land, Buildings, and Equipment (Line 68)	$ 156,800	$ 166,200
Endowment Fund (Line 69)	$ 191,700	$ 194,800
Other Funds (Line 70)	$ -	$ -
Capital Stock (Line 71)		
Paid-In Capital (Line 72)		
Retained Earnings (Line 73)	$ -	$ -
Total Net Assets (Fund Balances) (Line 74)	$ 804,800	$ 852,500
Total Liabilities and Fund Balances (Line 75 = Line 66 + Line 74)	$ 916,000	$ 964,800

	For the Year Ended	
	2011	*2012*
Program Service Revenue (Line 2)		$ 2,600
Dividends and Interest from Securities (Line 5)		$ 16,400
Total Revenue (Line 12)	$ 800,600*	$ 760,300
Fund Raising Costs (Line 15)		$ 65,400
Total Expenses (Line 17)		$ 712,600
Excess or (Deficit) (Line 18)		$ 47,700
Depreciation (Line 42)		$ 5,200

Liquidity Analysis	
(1)Total Current Assets/Total Assets	0.33
(2)Current Ratio =Current Assets/Current Liabilities	3.2
(3)Accounts Receivable Turnover	
=Program Service Revenue/Accounts receivable	1.5
(4)Days to Collect on Receivables = 365 days/Accounts Receivable Turnover	239
(5)Total Accounts Receivable/Total Assets	0.2%
(6)Cash Flow to Total Debt	
=(Net Income + Depreciation)/Total Liabilities	0.47
(7)Total Current Liabilities/Total Liabilities	0.88

Analysis of Solvency		
(8)Total Assets/Total Liabilities		8.6
(9)Total Liabilities/Total Fund Balance (Net Assets)		0.13
(10)Long-Term Debt/Total Unrestricted Fund Balance		2.8%
Analysis of the Statement of Activities		
<u>(11)Daily Revenue</u> = Total Revenue/365 days	2193	2083
(12)Total Expenses/Total Revenue		93.7%
<u>(13)Profit Margin</u>=		
Excess of Revenue over Expenses/Total Revenue		6.3%
<u>(14)Return on Net Assets (Fund Balances)</u>=		
Excess of Revenue over Expenses/Net Assets		5.1%
(15)Dividends and Interest from Securities/Investments		3.5%

*Given from the previous year 2011.

Chapter Summary

The NFPO's liquidity is favorable meaning it is able to pay its short-term obligations. Its solvency is also favorable meaning it can satisfy its long-term debt when due. The NFPO is having difficulty in its operating performance as indicated by declining daily revenue, high expenses to revenue, and low investment return. However, fund raising costs are being controlled resulting in successful fund raising efforts. Profit margin and return on net assets or fund balance appears reasonable. There is more interest in the NFPO as indicated by the increasing membership base.

SHORT QUIZ

Indicate whether each of the following statements is true or false.

1. An NFPO’s efficiency ratio compares fund-raising costs as a percentage of contributions.

2. NFPOs analyze their *statement of activities* to determine whether or not they are maximizing their revenue and minimizing their costs.

Answers

1. False. The efficiency ratio compares how much a nonprofit spends on fulfilling its mission (known as its programs) with what it spends on overhead and fund-raising. The higher a nonprofit's efficiency ratio, the more comfortable donors will feel about giving money, knowing that most of it will be spent on programs.

2. False. NFPOs try to address and answer if (1) the NFPO is self-sustaining and operating well, (2) if service efforts are being successful, and (3) whether management has discharged its stewardship responsibilities.

Form **990**

Department of the Treasury
Internal Revenue Service

Return of Organization Exempt From Income Tax

Under section 501(c), 527, or 4947(a)(1) of the Internal Revenue Code (except black lung benefit trust or private foundation)

▶ The organization may have to use a copy of this return to satisfy state reporting requirements.

OMB No. 1545-0047

2012

Open to Public Inspection

A For the) calendar year, or tax year beginning _______ and ending _______ , 20

B Check if applicable:
☐ Address change
☐ Name change
☐ Initial return
☐ Final return
☐ Amended return
☐ Application pending

Please use IRS label or print or type. See Specific Instructions.

C Name of organization: Family Service Agency of Utopia, Inc.

Number and street (or P.O. box if mail is not delivered to street address) | Room/suite: 1414 West Ash Drive

City or town, state or country, and ZIP + 4: Utopia, PA 11111

D Employer identification number 12 : 3456789

E Telephone number ( )

F Accounting method: ☐ Cash ☑ Accrual ☐ Other (specify) ▶

• **Section 501(c)(3) organizations and 4947(a)(1) nonexempt charitable trusts must attach a completed Schedule A (Form 990 or 990-EZ).**

H and I are not applicable to section 527 organizations.

H(a) Is this a group return for affiliates? ☐ Yes ☐ No

H(b) If "Yes," enter number of affiliates ▶ ....

H(c) Are all affiliates included? ☐ Yes ☐ No
(If "No," attach a list. See instructions.)

H(d) Is this a separate return filed by an organization covered by a group ruling? ☐ Yes ☐ No

I Group Exemption Number ▶

M Check ▶ ☐ if the organization is **not** required to attach Sch. B (Form 990, 990-EZ, or 990-PF).

G Website: ▶

J Organization type (check only one) ▶ ☑ 501(c) ( ) ◀ (insert no.) ☐ 4947(a)(1) or ☐ 527

K Check here ▶☐ if the organization is not a 509(a)(3) supporting organization **and** its gross receipts are normally **not** more than $25,000. A return is not required, but if the organization chooses to file a return, be sure to file a complete return.

L Gross receipts: Add lines 6b, 8b, 9b, and 10b to line 12 ▶

Part I — Revenue, Expenses, and Changes in Net Assets or Fund Balances *(See the instructions.)*

	Line	Description	(A) Securities	Box	Amount / (B) Other	Line	Amount
Revenue	1	Contributions, gifts, grants, and similar amounts received:					
	a	Contributions to donor advised funds		1a	$483,300		
	b	Direct public support (not included on line 1a)		1b	227,500		
	c	Indirect public support (not included on line 1a)		1c			
	d	Government contributions (grants) (not included on line 1a)		1d			
	e	**Total** (add lines 1a through 1d) (cash $______ noncash $______)				1e	$710,800
	2	Program service revenue including government fees and contracts (from Part VII, line 93)				2	2,600
	3	Membership dues and assessments				3	1,600
	4	Interest on savings and temporary cash investments				4	14,800
	5	Dividends and interest from securities				5	16,400
	6a	Gross rents		6a			
	b	Less: rental expenses		6b			
	c	Net rental income or (loss). Subtract line 6b from line 6a				6c	
	7	Other investment income (describe ▶)				7	
	8a	Gross amount from sales of assets other than inventory	24,200	8a			
	b	Less: cost or other basis and sales expenses	23,700	8b			
	c	Gain or (loss) (attach schedule)	500	8c			
	d	Net gain or (loss). Combine line 8c, columns (A) and (B)				8d	500
	9	Special events and activities (attach schedule). If any amount is from **gaming,** check here ▶ ☐					
	a	Gross revenue (not including $ ______ of contributions reported on line 1b)		9a	28,400		
	b	Less: direct expenses other than fundraising expenses		9b	18,000		
	c	Net income or (loss) from special events. Subtract line 9b from line 9a				9c	10,400
	10a	Gross sales of inventory, less returns and allowances		10a	1,400		
	b	Less: cost of goods sold		10b	1,000		
	c	Gross profit or (loss) from sales of inventory (attach schedule). Subtract line 10b from line 10a				10c	400
	11	Other revenue (from Part VII, line 103)				11	2,800
	12	**Total revenue.** Add lines 1e, 2, 3, 4, 5, 6c, 7, 8d, 9c, 10c, and 11				12	$760,300
Expenses	13	Program services (from line 44, column (B))				13	$577,400
	14	Management and general (from line 44, column (C))				14	57,400
	15	Fundraising (from line 44, column (D))				15	65,400
	16	Payments to affiliates (attach schedule)				16	12,400
	17	**Total expenses.** Add lines 16 and 44, column (A)				17	$712,600
Net Assets	18	Excess or (deficit) for the year. Subtract line 17 from line 12				18	$ 47,700
	19	Net assets or fund balances at beginning of year (from line 73, column (A))				19	804,800
	20	Other changes in net assets or fund balances (attach explanation)				20	0
	21	Net assets or fund balances at end of year. Combine lines 18, 19, and 20				21	$852,500

For Privacy Act and Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 11282Y Form **990**

Form 99 Page 2

Part II Statement of Functional Expenses All organizations must complete column (A). Columns (B), (C), and (D) are required for section 501(c)(3) and (4) organizations and section 4947(a)(1) nonexempt charitable trusts but optional for others. (See instructions.)

Do not include amounts reported on line 6b, 8b, 9b, 10b, or 16 of Part I.		(A) Total	(B) Program services	(C) Management and general	(D) Fundraising
22 Grants and allocations (attach schedule) (cash $ 35,900 noncash $)	22	$ 35,900	$ 35,900		
23 Specific assistance to individuals (attach schedule)	23	45,800	45,800		
24 Benefits paid to or for members (attach schedule)	24				
25 Compensation of officers, directors, etc.	25	62,800	46,600	$ 8,800	$ 7,400
26 Other salaries and wages	26	184,700	131,000	24,300	29,400
27 Pension plan contributions	27	300	200	100	
28 Other employee benefits	28	13,000	9,400	2,100	1,500
29 Payroll taxes	29	23,800	17,700	3,000	3,100
30 Professional fundraising fees	30				
31 Accounting fees	31				
32 Legal fees	32				
33 Supplies	33	30,000	26,500	1,800	1,700
34 Telephone	34	15,400	11,600	1,500	2,300
35 Postage and shipping	35	23,100	13,100	1,000	9,000
36 Occupancy	36	37,750	34,900	1,500	1,350
37 Equipment rental and maintenance	37	8,750	5,900	1,500	1,350
38 Printing and publications	38	14,100	12,200	300	1,600
39 Travel	39	22,000	16,700	2,300	3,000
40 Conferences, conventions, and meetings	40	17,700	12,800	4,500	400
41 Interest	41	900	100	800	
42 Depreciation, depletion, etc. (attach schedule)	42	5,200	4,200	600	400
43 Other expenses (itemize): a Dues	43a	500	500		
b Professional Fees	43b	127,900	124,500	2,600	800
c Insurance	43c	26,300	25,650	600	50
d Miscellaneous	43d	4,300	2,150	100	2,050
e	43e				
44 **Total functional expenses** (add lines 22 through 43) *Organizations completing columns (B)-(D), carry these totals to lines 13-15*	44	$700,200	$577,400	$57,400	$65,400

Reporting of Joint Costs.—Did you report in column (B) (Program services) any joint costs from a combined educational campaign and fundraising solicitation? ▶ ☒ Yes ☐ No

If "Yes," enter (i) the aggregate amount of these joint costs $ 9,600 ; (ii) the amount allocated to Program services $ 2,800 ; (iii) the amount allocated to Management and general $ 700 ; and (iv) the amount allocated to Fundraising $ 6,000

Part III Statement of Program Service Accomplishments (See instructions.)

What is the organization's primary exempt purpose? ▶ Family counseling All organizations must describe their exempt purpose achievements. State the number of clients served, publications issued, etc. Discuss achievements that are not measurable. (Section 501(c)(3) and (4) organizations and 4947(a)(1) nonexempt charitable trusts must also enter the amount of grants and allocations to others.)	**Program Service Expenses** (Required for 501(c)(3) and (4) orgs., and 4947(a)(1) trusts; but optional for others.)
a Counseling - The organization provided 5,954 hours of counseling to individuals and families. A total of 635 cases were assisted involving 2,426 individuals. The agency also made a grant to its national affiliate for a research project. (Grants and allocations $ 3,000)	$257,800
b Adoption Services - The agency placed 50 children in adoptive families. This included counseling for 189 birth parents. Five adoptions involved children from foreign countries. There were 65 home studies completed during this year. (This program was assisted (Grants and allocations $)	
c by $8,000 of donated services in 1994.) Under the Adoption Services program, the agency made grants to three organizations for related services. (Grants and allocations $ 21,000)	187,800
d Foster Care - The agency placed 28 children in 16 foster homes. The agency also made grants to two other organizations providing foster home care for hard-to-place children. (Grants and allocations $ 11,900)	131,800
e Other program services (attach schedule) (Grants and allocations $)	
f **Total of Program Service Expenses** (should equal line 44, column (B), Program services). ▶	$577,400

Form 990   Page 3

Part IV Balance Sheets

	Note: *Where required, attached schedules and amounts within the description column should be for end-of-year amounts only.*			(A) Beginning of year		(B) End of year
	Assets					
45	Cash—non-interest-bearing			$ 4,000	45	$ 6,400
46	Savings and temporary cash investments			244,700	46	222,100
47a	Accounts receivable	47a	$ 1,800			
b	Less: allowance for doubtful accounts	47b	200	1,800	47c	1,600
48a	Pledges receivable	48a	70,100			
b	Less: allowance for doubtful accounts	48b	11,200	46,000	48c	58,900
49	Grants receivable			4,600	49	5,800
50	Receivables due from officers, directors, trustees, and key employees (attach schedule)				50	
51a	Other notes and loans receivable (attach schedule)	51a				
b	Less: allowance for doubtful accounts	51b			51c	
52	Inventories for sale or use			6,100	52	7,000
53	Prepaid expenses and deferred charges			9,600	53	13,800
54	Investments—securities (attach schedule)			430,700	54	474,400
55a	Investments—land, buildings, and equipment: basis	55a				
b	Less: accumulated depreciation (attach schedule)	55b			55c	
56	Investments—other (attach schedule)				56	
57a	Land, buildings, and equipment: basis	57a	188,000			
b	Less: accumulated depreciation (attach schedule)	57b	13,200	168,500	57c	174,800
58	Other assets (describe ▶)				58	
59	**Total assets** (add lines 45 through 58) (must equal line 75)			$916,000	59	$964,800
	Liabilities					
60	Accounts payable and accrued expenses			$ 46,000	60	$ 39,300
61	Grants payable				61	
62	Support and revenue designated for future periods (attach schedule)			61,600	62	59,600
63	Loans from officers, directors, trustees, and key employees (attach schedule)				63	
64a	Tax-exempt bond liabilities (attach schedule)				64a	
b	Mortgages and other notes payable (attach schedule)			3,600	64b	3,200
65	Other liabilities (describe ▶ Payable under capital lease)				65	10,200
66	**Total liabilities** (add lines 60 through 65)			$111,200	66	$112,300
	Fund Balances or Net Assets					
	Organizations that use fund accounting, check here ▶ ☒ and complete lines 67 through 70 and lines 74 and 75 (see instructions).					
67a	Current unrestricted fund			$446,300	67a	$485,100
b	Current restricted fund			10,000	67b	6,400
68	Land, buildings, and equipment fund			156,800	68	166,200
69	Endowment fund			191,700	69	194,800
70	Other funds (describe ▶)			-0-	70	-0-
	Organizations that do not use fund accounting, check here ▶ ☐ and complete lines 71 through 75 (see instructions).					
71	Capital stock or trust principal				71	
72	Paid-in or capital surplus				72	
73	Retained earnings or accumulated income				73	
74	**Total fund balances or net assets** (add lines 67a through 70 OR lines 71 through 73; column (A) must equal line 19 and column (B) must equal line 21)			$804,800	74	$852,500
75	**Total liabilities and fund balances/net assets** (add lines 66 and 74)			$916,000	75	$964,800

Form 990 is available for public inspection and, for some people, serves as the primary or sole source of information about a particular organization. How the public perceives an organization in such cases may be determined by the information presented on its return. Therefore, please make sure the return is complete and accurate and fully describes the organization's programs and accomplishments.

* This form has been revised in 2011, but the financial analysis discussed in this chapter remains valid.

Chapter 6 Review Questions

1. In financial statement analysis, looking at the percentage change in an account over time is called

   A. Vertical common-size analysis.
   B. Regression analysis.
   C. Horizontal (trend) analysis.
   D. Ratio analysis.

2. Which one of the following ratios would provide the best measure of liquidity for NFPOs?

   A. Revenue minus returns to total debt.
   B. Current assets minus inventories to current liabilities.
   C. Total assets minus goodwill to total equity.
   D. Current liabilities to long-term debt.

3. An NFPO's _______________ compares fund-raising costs as a percentage of contributions.

   A. Efficiency ratio
   B. Donor dependency
   C. Variance
   D. Cash flow to total debt ratio

4. What type of ratio is return on net assets or fund balances?

   A. Activity ratio.
   B. Liquidity ratio.
   C. Profitability ratio.
   D. Leverage ratio.

Glossary

Activity classification. A grouping of expenditures on the basis of specific lines of work performed by organization units. For example, sewage treatment and disposal, garbage collection, garbage disposal, and street cleaning are activities performed in carrying out the function of sanitation, and segregation of the expenditures made for each of these activities constitutes an activity classification.

Control. The ability to determine the direction of management and policy for purposes of presenting combined financial statements.

Functional classification. A grouping of expenditures on the basis of the principal purposes for which they are made. Examples are public safety, public health, public welfare, etc.

Restricted Current Funds. The funds which may be used for operations, but can only be used for the specific purpose designated by a donor or other external agency.

Unrestricted Current Funds. The funds of educational organizations that may be used for any operational purpose and have not been restricted or designated for any other purpose.

Not-for-profit organizations. Not operated for the financial benefit of specific individuals or groups of individuals.

Voluntary health and welfare organizations (VHWOs) Tax exempt, not-for-profit supported by public donations. They are primarily designed to solve the health and welfare problems of individuals and overall society.

Index

Review Question Answers

Chapter 1 Review Questions

1. Which of the following is a characteristic of nonbusiness organizations?

A. Incorrect. Many noneconomic factors affect decisions to provide resources to nonbusiness enterprises.
B. Incorrect. Business organizations obtain resources by providing goods and services. Many nonbusiness organizations obtain resources from contributors and are accountable to the providers of those resources or to their representatives.
C. **Correct.** The operating environments of nonbusiness and business organizations are similar in many ways. Both produce and distribute goods and services using scarce resources.
D. Incorrect. The operating environments of nonbusiness and business organizations are similar.

2. ASC 958-205-05-5, *Not-for-Profit Entities: Presentation of Financial Statements* (FAS-117, *Financial Statements of Not-for-Profit Organizations*) establishes standards for general-purpose external financial statements issued by not-for-profit organizations. A complete set of financial statements should include

A. Incorrect. The statement of financial position should be as of the end of the reporting period.
B. Incorrect. ASC 958-205-05-5 (FAS-117) does not specify how the statement of cash flows is to be prepared.
C. **Correct.** ASC 958-205-05-5 (FAS-117) states that "a complete set of financial statements of a not-for-profit organization shall include a statement of financial position as of the end of the reporting period, a statement of activities, a statement of cash flows for the reporting period, and accompanying notes to financial statements."
D. Incorrect. The statement of financial position should be as of the end of the reporting period, and comparative statements are not required.

3. A stated purpose of SFAC No. 6, *Elements of Financial Statements* is to

A. Incorrect. SFAC No. 6 defines three classes of net assets of not-for-profit entities and the changes therein during the period.

B. **Correct.** SFAC No. 6 extends SFAC No. 3, Elements of Financial Statements of Business Enterprises to cover not-for-profit entities. It defines 10 interrelated elements of financial statements that are directly related to measuring the performance and status of an entity. Of these, seven are found in statements of both business and not-for-profit entities: assets, liabilities, equity or net assets, revenues, expenses, gains, and losses. Investments by owners, distributions to owners, and comprehensive income are elements of financial statements of business enterprises only.
C. Incorrect. The comprehensive income concept is not applicable to not-for-profit organizations.
D. Incorrect. SFAC No. 6 does not apply its principles to reporting by state and local governmental units.

4. Contributions and other inflows of assets whose use by an organization is limited by door-imposed restrictions that do not expire or cannot be satisfied or removed by actions taken by the organization are categorized as

A. Incorrect. These are assets that are neither permanently nor temporarily restricted by a donor.
B. Incorrect. These are donor imposed restrictions that either expire by the passage of time or can be satisfied or removed by actions taken by the organization.
C. **Correct.** NFPOs classify net assets, revenues, expenses, gains and losses based on whether there are restrictions by donors.
D. Incorrect. Control is the ability to determine the direction of management and policy for purposes of presenting combined financial statements.

5. The Cypress Museum, a not-for-profit organization, received a contribution of historical artifacts. It need NOT recognize the contribution if the artifacts are to be sold and the proceeds used to

A. Incorrect. If the proceeds are used to support general museum activities, the contribution must be recognized.
B. **Correct.** Contributions of such items as art works and historical treasures need not be capitalized and recognized as revenues if they are added to collections that are (1) subject to a policy that requires the proceeds of sale of collection items to be used to acquire other collection items; (2) protected, kept unencumbered, cared for, and preserved; and (3) held for public exhibition, education, or research for public service purposes rather than financial gain (ASC 958-605-05-3 (FAS-116)).
C. Incorrect. If the proceeds are used to repair existing collections, the contribution must be recognized.
D. Incorrect. If the proceeds are used to purchase buildings to house collections, the contribution must be recognized.

6. A storm damaged the roof of a new building owned by K-9 Shelters, a not-for-profit organization. A supporter of K-9, a professional roofer, repaired the roof at no charge. In K-9's statement of activities, the damage and repair of the roof should

A. Incorrect. Contributions received must be recorded in the accounts.
B. **Correct.** According to ASC 958-605-05-3, Not-for-Profit Entities: Revenue Recognition (FAS-116, Accounting for Contributions Received and Contributions Made), contributions received should be accounted for at fair value as revenues or gains and as assets, decreases of liabilities, or expenses, depending on the form of benefits received. Contributions of services are recognized if they require special skills, are provided by individuals having those skills, and would have to be purchased if not received by donation. Hence, K-9 should report an expense and contribution revenue for the services received.
C. Incorrect. The repair of a roof is an expense, not an asset.
D. Incorrect. Contributions received must be recorded.

7. According to ASC 958-320-05, *Not-for-Profit Entities: Investments—Debt and Equity Securities* (FAS-124, *Accounting for Certain Investments Held by Not-for-Profit Organizations),* an NFPO should

A. Incorrect. All debt securities of an NFPO are reported at fair value.
B. Incorrect. Restricted gains and losses are recognized when they occur and restricted income is recognized when earned.
C. Incorrect. The total change in fair value includes accrued dividends until the ex-dividend date.
D. **Correct.** Equity securities with readily determinable fair values and all debt securities are to be measured at fair value in the statement of financial position. The total change in fair value includes the change in unpaid interest on debt securities (or unpaid dividends on equity securities until the ex-dividend date) and the holding gain or loss (realized or unrealized).

Chapter 2 Review Questions

1. In its fiscal year ended June 30, 2X12, Barr College, a large private institution, received $100,000 designated by the donor for scholarships for superior students. On July 26, 2X12, Barr selected the students and awarded the scholarships. How should the July 26 transaction be reported in Barr's statement of activities for the year ended June 30, 2X13?

A. **Correct.** When Barr College received the contribution, it should have been classified as temporarily restricted because it was to be used for a specified purpose. Once the purpose has been fulfilled, the temporary restriction expires, and the amount should be reclassified as a decrease in temporarily restricted net assets and an increase in unrestricted net assets. When the scholarships are awarded, unrestricted net assets are decreased.
B. Incorrect. Unrestricted net assets must also be increased.
C. Incorrect. It should be reported in Barr's statement of activities. Unrestricted net assets must be increased and decreased.
D. Incorrect. The transaction must be reported. Unrestricted net assets must be initially increased and then decreased as the scholarship is awarded.

2. Stanton College, a not-for-profit organization, received a building with no donor stipulations as to its use. Stanton does not have an accounting policy implying a time restriction on donated assets. What type of net assets should be increased when the building was received? I) Unrestricted; II) Temporarily restricted; or III) Permanently restricted

A. **Correct.** ASC 958-605-05-3, Not-for-Profit Entities: Revenue Recognition (FAS-116, Accounting for Contributions Received and Contributions Made) requires that contributions received by not-for-profit organizations be reported as restricted support or unrestricted support. Contributions with donor-imposed restrictions are reported as restricted support. Restricted support increases permanently restricted net assets or temporarily restricted net assets. Contributions without donor-imposed restrictions are reported as unrestricted support, which increases unrestricted net assets.
B. Incorrect. Temporarily restricted net assets are increased by contributions classified as restricted support.
C. Incorrect. Permanently restricted net assets are increased by contributions classified as restricted support.
D. Incorrect. Temporarily and permanently restricted net assets are increased by contributions classified as restricted support.

3. For the fall semester of the current year, Ames University assessed its students $3 million for tuition and fees. The net amount realized was only $2.5 million because scholarships of $400,000 were granted to students and tuition remissions of $100,000 were allowed to faculty members' children attending Ames. These amounts were properly classified as expenses. What amount should Ames report for the period as revenues for tuition and fees?

A. Incorrect. The amount of $2,500,000 assumes that only net tuition is recorded.

B. Incorrect. The amount of $2,600,000 assumes that scholarships are deducted before recording tuition revenues.
C. Incorrect. The amount of $2,900,000 assumes that tuition remissions are deducted before recording tuition revenues.
D. **Correct.** Revenues from exchange transactions are normally recorded at gross amounts. Thus, in accounting for tuition and fees for colleges and universities, the full amount of the tuition assessed is usually reported as revenue. Tuition waivers, scholarships, and like items are recorded as expenses if given in exchange transactions, for example, as part of a compensation package. However, when the institution regularly provides discounts to certain students, revenues are recognized net of the discounts. Accordingly, given that scholarships and tuition remissions were expenses, revenues should be reported at their gross amount of $3,000,000.

Chapter 3 Review Questions

1. General purpose external financial reporting by a healthcare organization requires presentation of

A. Incorrect. Fund accounting may be used for internal purposes but is not required or encouraged for external reporting.
B. **Correct.** The basic financial statements of a healthcare organization include a statement of financial position, a statement of operations, a statement of changes in equity, net assets, or fund balance; and a statement of cash flows.
C. Incorrect. The statement of changes in equity, net assets, or fund balance may be combined with the statement of operations.
D. Incorrect. The statement of operations of all healthcare organizations, including not-for-profit organizations, should report a performance indicator and other changes in net assets.

2. Los Al's community hospital normally includes proceeds from the sale of cafeteria meals in

A. Incorrect. Expenses are not usually netted against revenues.
B. Incorrect. Ancillary service revenues are not a proper classification of hospital revenues.
C. Incorrect. Patient service revenues are derived from fees charged for patient care.
D. **Correct.** Other revenues are derived from services other than providing healthcare services or coverage to patients, residents, or enrollees. This category includes proceeds from sale of cafeteria meals and guest trays to employees, medical staff, and visitors.

3. Amounts received by a research hospital in the form of grants specified by the donor for research would normally be included in

A. Incorrect. Gains are incidental to the provider's ongoing major or central operations.
B. **Correct.** Revenues derive from the major ongoing or central operations of the entity, e.g., research by a research institution. The two major classes of revenues for hospitals are healthcare services revenues and other revenues. Other revenues may include research and other gifts or grants.
C. Incorrect. Patient service revenue only includes revenues received from the direct provision of healthcare to patients, such as room, board, nursing, and ancillary department fees.
D. Incorrect. Ancillary service revenue is not a proper classification.

4. In healthcare accounting, restricted net assets are

A. Incorrect. Donor restrictions are not removable by the board. Temporary restrictions expire by passage of time or by actions by the entity consistent with the donor's restrictions.
B. Incorrect. Board-designated restrictions are board-removable.
C. Incorrect. Income generated by restricted net assets can be restricted for specific purposes.
D. **Correct.** In healthcare organization accounting, the term "restricted" is used to describe resources that have been restricted as to their use by the donors or grantors of those resources. Temporarily restricted net assets are those donor-restricted net assets that can be used by the not-for-profit organization for their specified purpose once the donor's restriction is met. Permanently restricted net assets (for example, endowment funds) are those with donor restrictions that do not expire with the passage of time and cannot be removed by any actions taken by the entity.

5. Which of the following normally would be included in the revenue of a hospital?

A. Incorrect. A hospital recognizes revenue from its educational programs as other revenue.
B. Incorrect. A hospital recognizes revenue from its educational programs as other revenue, but unrestricted contributions are usually classified as gains. .
C. **Correct.** Other revenue, gains, or losses may appropriately be recognized by a hospital for services other than health care or coverage provided to patients, residents, or enrollees. Other revenue may include cafeteria sales, tuition from educational programs, sales of medical supplies, and office space rentals. Revenue or expense results from an entity's ongoing major or central operations. Gains or losses result from peripheral or incidental transactions and from all transactions and other events and circumstances that do not generate revenue or expense.

Thus, contributions, either unrestricted or for a specific purpose, should be treated as gains unless fund-raising is an ongoing major activity of the hospital. They are recognized at fair value.

D. Incorrect. Unrestricted Contributions are usually classified as gains.

Chapter 4 Review Questions

1. Voluntary health and welfare organizations (VHWOs) must report information about expenses by

A. Incorrect. VHWOs must report information about expenses by natural classification as well.
B. Incorrect. VHWOs must report information about expenses by functional classification as well.
C. **Correct.** VHWOs must report information about expenses by both functional classification (major classes of program services and supporting services) and natural classification (salaries, rent, interest, depreciation, etc.) in a matrix format in a separate statement of functional expenses. Other not-for-profit organizations (ONFPOs) are not required to provide information about expenses by natural classification.
D. Incorrect. VHWOs must report information about expenses by major classes of program services and supporting services and by natural classification as well.

2. Which of the following nongovernmental not-for-profit organizations must report information about expenses by natural classification?

A. Incorrect. Private hospitals must report expenses by functional classification.
B. Incorrect. College and universities are not required to present by natural classicization.
C. Incorrect. Nongovernmental NFPOs must provide information about expenses by function (major classes of program services and supporting activities).
D. **Correct.** VHWOs (e.g., the United Way or the American Cancer Society) must report information about expenses by both functional classification and natural classification (salaries, rent, interest, depreciation, etc.) in a matrix format in a separate statement of functional expenses. Other nongovernmental NFPOs must provide information about expenses by function (major classes of program services and supporting activities) but are merely encouraged to provide information about expenses by natural classification (ASC 958-205-05-5 (FAS-117)).

3. Health Policy Foundation (HPF), a voluntary health and welfare organization supported by contributions from the general public, included the following costs in its statement of functional

expenses for the year: Fund-raising = $1,000,000; Administrative (including data processing) = $600,000; Research = $200,000. HPF's functional expenses for program services included

A. Incorrect. $1,800,000 includes $1,000,000 of fund-raising expenses and $600,000 of administrative expenses, which should be included in supporting services expenses.
B. Incorrect. $1,000,000 of fund-raising expenses should be classified as supporting services expenses.
C. Incorrect. $600,000 of administrative expenses should be classified as supporting services expenses.
D. **Correct.** An NFPO's statement of activities or notes thereto should classify expenses by function. The major functional classes include program services and supporting services. Management and general expenses, along with fund-raising expenses, are classified in the supporting services category. Program services expenses are those directly related to the administration of programs. Of the costs given, only the research costs ($200,000) are program services expenses.

4. A not-for-profit voluntary health and welfare entity received a $500,000 permanent endowment. The donor stipulated that the income be used for a mental health program. The endowment fund reported a $60,000 net decrease in fair value and $30,000 of investment income. The entity spent $45,000 on the mental health program during the year. What amount of change in temporarily restricted net assets should the entity report?

A. Incorrect. The amount of $75,000 is the sum of the fair value decrease and the excess of expenditures over income.
B. Incorrect. The excess of the amount spent over the income is $15,000.
C. **Correct.** The contribution to a permanent endowment is an increase in permanently restricted net assets. Income from donor-restricted permanent endowments is an increase in restricted support if the donor restricts its use. However, if the restriction is met in the period the income is recognized, it may be reported as an increase in unrestricted net assets if the entity has (1) a similar policy for reporting contributions received, (2) reports consistently, and (3) makes adequate disclosure. The restriction on the income expired when it was spent (along with an additional $15,000, presumably from other sources). Absent donor stipulation or contrary law, losses on a permanent endowment reduce temporarily restricted net assets to the extent that a temporary restriction on net appreciation has not expired prior to the losses. Any remaining losses reduce unrestricted net assets. Thus, absent such a restriction, the decrease in the fair value of the endowment's investments reduced unrestricted net assets. The effect on temporarily restricted net assets of (1) creation of the endowment, (2) the receipt and expenditure in the same period of income, and (3) the loss on the principal of the endowment (absent a donor restriction) is $0.

D. Incorrect. The amount of $425,000 equals the contribution minus the sum of the fair value decrease and the excess of expenditures over income.

5. A voluntary health and welfare entity received a $700,000 permanent endowment during the year. The donor stipulated that the income and investment appreciation be used to maintain its senior center. The endowment fund reported a net investment appreciation of $80,000 and investment income of $50,000. The entity spent $60,000 to maintain its senior center during the year. What amount of change in temporarily restricted net assets should the entity report?

A. Incorrect. The amount of income is $50,000.
B. **Correct.** The contribution to a permanent endowment is an increase in permanently restricted net assets. Income or appreciation from donor-restricted permanent endowments is an increase in restricted support if the donor restricts its use. (However, if the restriction is met in the period the income is recognized, it may be reported as an increase in unrestricted net assets if the entity (1) has a similar policy for reporting contributions received, (2) reports consistently, and (3) makes adequate disclosure.) The temporary restriction on the income and appreciation was met and is deemed to have expired only to the extent it was expended during the year. Accordingly, the change in temporarily restricted net assets was $70,000 ($80,000 appreciation + $50,000 income - $60,000 spent).
C. Incorrect. The amount of $130,000 is the sum of appreciation and income.
D. Incorrect. The amount of $770,000 is the sum of the appreciation and the permanent endowment.

Chapter 5 Review Questions

1. The following expenditures were made by Green Services, a society for the protection of the environment: Printing of the annual report = $12,000; Unsolicited merchandise sent to encourage contributions = $25,000; and cost of an audit performed by a CPA firm = $3,000. What amount should be classified as fund-raising costs in the society's statement of activities?

A. Incorrect. The amount of $37,000 classifies all of the expenses as fund-raising expenses when only the unsolicited merchandise is related to fund-raising.
B. Incorrect. The cost of an audit is a management-related expense.
C. **Correct.** There are two major classifications of expenses for an ONFPO: program service expenses and supporting services expenses. Program service expenses relate directly to the primary purpose or mission of the organization. Supporting services expenses are further

classified as management and general expenses, fund-raising expenses, and membership development costs. The only fund-raising-related cost here is the unsolicited merchandise sent to encourage contributions.

D. Incorrect. This answer assumes that none of the expenses listed are related to fund-raising when, in fact, the unsolicited merchandise is a fund-raising expense.

2. Molko, a community foundation, incurred $10,000 in management and general expenses during Year 4. In Molko's statement of activities for the year ended December 31, Year 4, the $10,000 should be reported as

A. Incorrect. A direct reduction of fund balance would be the result of a transfer or a refund to a donor. Moreover, fund accounting information is not required to be externally reported.
B. **Correct.** Two functional categories of expenses for an ONFPO are program services expenses and supporting services expenses. Supporting services expenses, which do not relate to the primary mission of the organization, may be further subdivided into (1) management and general expenses, (2) fundraising expenses, and (3) membership development costs.
C. Incorrect. Program services expenses relate directly to the primary mission of the ONFPO.
D. Incorrect. Only costs directly related to a certain source of support, such as a special event or estimated uncollectible pledges, may be offset against revenue.

Chapter 6 Review Questions

1. In financial statement analysis, looking at the percentage change in an account over time is called

A. Incorrect. Vertical common-size (percentage) analysis presents figures for a single year expressed as percentages of a base amount on the balance sheet (e.g., total assets) and on the income statement (e.g., sales).
B. Incorrect. The term regression analysis is most often applied to the quantitative techniques used in estimating the relationship among variables.
C. **Correct.** Trend (horizontal) analysis is a time series analysis of financial statements of the NFPO, covering more than one accounting period. It looks at the percentage change in an account or category over time. The percentage change equals the change over the prior year.
D. Incorrect. It is a general term for ratio calculations and interpretations.

2. Which one of the following ratios would provide the best measure of liquidity for NFPOs?

A. Incorrect. It does not refer to expenses that have to be paid out of the revenue dollars. Also, the revenue available to pay liabilities is indeterminable. Thus, revenue minus debt service is not a liquidity measure.
B. **Correct.** Liquidity is the degree to which assets can be converted to cash in the short run to meet maturing obligations. The usual measures of liquidity are the current ratio and the quick (acid-test) ratio, where quick ratio = quick unrestricted assets/current unrestricted liabilities. The quick unrestricted assets are the most liquid assets. Excluded are inventories of supplies and prepaid expenses. The quick unrestricted assets include cash and cash equivalents, accounts receivable, and investment income receivable. A higher ratio is better. It should be at least 1:1.
C. Incorrect. Fixed assets are included in the numerator of the ratio; hence, this ratio is not a measure of liquidity.
D. Incorrect. Using only liabilities in the calculation ignores the assets available to pay the liabilities.

3. An NFPO's _______________ compares fund-raising costs as a percentage of contributions.

A. **Correct.** The efficiency ratio compares how much an NFPO spends on fulfilling its mission (known as its programs) with what it spends on overhead and fund-raising. The higher a not-for-profit's efficiency ratio, the more comfortable donors will feel about giving money, knowing that most of it will be spent on programs.
B. Incorrect. It tries to measure how badly a charity needs your contribution--as opposed to money raised from selling products or tickets or reaping investment gains--to fund its current operations.
C. Incorrect. Variances between actual and budgeted expenses should be investigated in order to analyze expenses in terms of program and object of expense.
D. Incorrect. Cash flow to total debt indicates how much of internally generated cash is available to pay debt.

4. What type of ratio is return on net assets or fund balances?

A. Incorrect. Activity ratios measure management's efficiency in using specific resources.
B. Incorrect. Liquidity ratios indicate the ability of a company to meet short-term obligations.
C. **Correct.** The return on net assets (fund balances) is a profitability ratio. This ratio reveals the profit margin of the business.
D. Incorrect. Leverage or equity ratios concern the relationship of debt to equity ratios concern the relationship of debt to equity and measure the impact of the debt on profitability and risk.