Accounting Standards for Not-For-Profit Organizations: A New Direction

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Introduction

In March 1996, The Canadian Institute of Chartered Accountants released new accounting recommendations[1] that will dramatically affect the way many not-for-profit organizations account for capital assets and contributions and change the basic financial statement presentation for such organizations. The new recommendations should make not-for-profit organizations' financial statements easier to understand and reduce inconsistent accounting practices among organizations. Although the recommendations are not effective until years beginning on or after April 1, 1997, organizations and their boards should begin now to understand the new recommendations and their impact, and possibly consider adopting them earlier.

A clear understanding of the new recommendations is essential to their effective implementation for two principal reasons. First, there are some complexities within the recommendations. These complexities arise because of the recognized need to provide not-for-profit organizations with flexibility in their financial reporting. The most significant relate to an organization's use of fund accounting and the method of accounting for externally restricted contributions. Second, for many not-for-profit organizations the impact of the new recommendations will go beyond basic accounting changes. For example, some organizations will need to review their current information systems capabilities in light of the new reporting and disclosure requirements. In addition, because financial statements prepared under the new recommendation place greater emphasis on donor restrictions, fund-raising policies and practices may be affected. Organizations should begin the process of understanding the recommendations to provide them with sufficient time to make any necessary modifications to their information systems and financial statements.

The purpose of this article is to help you become familiar with the key provisions of the new accounting recommendations, to alert you to the availability of certain alternatives, and to help you begin to organize and prioritize your organization's implementation efforts.

Contributions and Financial Statement Presentation

The selection of the method of accounting for contributions will be the most significant decision an organization will be required to make in connection with implementing the new recommendations. As discussed in more detail below, the chosen method of accounting for contributions will dictate how and when restricted contributions are recognized in the financial statements and the basic financial statement presentation. Unfortunately, there is no simple or easy guidance that can be provided to assist organizations in making their decision because the selection must take into account the unique characteristics of the organization and the organization structure. In addition, each organization must select the method that satisfies both the reporting objectives of the organization and the needs of the financial statement users. However, the selection of methods does provide organizations with the opportunity to re-examine their accounting policies and financial statement presentation in light of the new recommendations. Organizations should be encouraged to experiment and recast their financial statements to offer alternative ways of presenting information. This process will assist them to select the most appropriate method.

Contributions are revenue to a not-for-profit organization. They can be received as cash, other assets, or the settlement or cancellation of a liability. There are three types of contributions: restricted contributions, endowment contributions, and unrestricted contributions. It is important to understand the distinctions between the different types of contributions because they are recognized differently in the financial statements.

A restricted contribution is subject to an externally imposed restriction that specifies the purpose for which the contributed asset can be used. Externally imposed restrictions may be explicitly or implicitly stated by the contributor. Implicit restrictions must bind the organization to use the contribution for the purpose for which it was solicited by the organization. A restriction imposed by the board of directors of an organization is not considered a restricted contribution for purposes of these recommendations. The restriction must come from a source external to the organization, usually the contributor of the resources, or from the conditions implicit in the solicitation of the funds.

An endowment contribution is a type of restricted contribution. The restriction usually stipulates that the principal amount of the resources contributed must be maintained permanently.

An unrestricted contribution is one that is neither a restricted contribution nor an endowment contribution.

There are two methods of accounting for contributions: the deferral method and the restricted fund method. An organization must select one method for recognizing contributions and apply that method consistently to all contributions received. Organizations will recognize and report restricted contributions differently depending on the method selected.

Before describing the different methods of accounting for contributions it is necessary to understand the concept of fund accounting. Fund accounting is an accounting process that results in a self-balancing set of accounts for each fund established by legal, contractual or voluntary actions of the organization. Fund accounting involves an accounting segregation, although not necessarily a physical segregation, of resources. Not-for-profit organizations have historically used fund accounting to either segregate restricted resources from unrestricted resources or to report on different programs or geographic locations in a way that includes both restricted and unrestricted resources. Fund accounting is permitted under both approaches.

The recommendations require that most not-for-profit organizations provide a statement of financial position (a balance sheet), a statement of operations, a statement of changes in net assets and a statement of cash flows. The focus of these financial statements is the organization as a whole. Because many not-for-profit organizations currently report information on a disaggregated basis, such as by fund groups, adoption of the recommendations will significantly change the financial statements of many organizations. These changes will largely depend on the selection of the method of accounting for contributions.

Deferral Method

The deferral method is generally considered less complex than the restricted fund method. Under the deferral method, restricted contributions are recognized as revenue in the period in which the related expenses are incurred. The related expenses are those which are incurred to comply with the externally imposed restriction. Contributions for which externally imposed restrictions remain unfulfilled at a reporting date are reported as deferred contributions on the balance sheet rather than as revenue.

Endowment contributions are reported as direct increases to net assets (net assets may also be referred to as fund balance or accumulated surplus or deficit). This accounting recognizes that endowment contributions increase an organization's net assets but their principal amount is not available for any of the organization's current or future expenses. Accordingly, they are never recognized as revenue.

Unrestricted contributions are recognized as revenue when they are received.

Contributions for capital asset purchases are considered restricted contributions. Under the deferral method, if the capital asset will be amortized, the related contribution should be deferred and amortized as revenue on the same basis as the amortization expense related to the acquired capital asset. When the related asset—land, for example—will not be amortized, the contribution should be recognized as a direct increase in net assets.

Organizations selecting the deferral method would combine the results of their unrestricted and restricted operations and present organization-wide totals for each financial statement item in the balance sheet and statements of operations and cash flows. Organizations wishing to continue to use fund accounting may do so as long as they combine the funds and report organization-wide totals. The net asset balance will consist of unrestricted net assets, net assets restricted for endowment purposes, and net assets invested in capital assets. The organization's excess of revenue over expenses for the period represents the increase of resources that are not restricted to cover specific expenses of a future period.

Restricted Fund Method

The restricted fund method of accounting for contributions is a specialized type of fund accounting. Under the restricted fund method an organization must choose which restricted funds to report because all similar contributions must be treated in the same manner. Generally, it would not be practical to create and report a restricted fund for every different type of restricted contribution received. For example, an organization may receive many contributions restricted for research but few restricted for the purchase of capital assets. In this case, the organization may choose to present contributions restricted for research in a separate restricted research fund and the contributions restricted for the purchase of capital assets might be reported in the general fund.

What distinguishes the restricted fund method from the deferral method is that restricted contributions for which a corresponding restricted fund exists are recognized as revenue of that fund in the period the contributions are received, irrespective of whether the restrictions have been complied with by the reporting organization. The restricted fund balance represents the accumulation of resources subject to restrictions that have yet to be fulfilled. Restricted contributions for which no corresponding restricted fund is presented (such as the capital asset contribution referred to in the preceding paragraph), are recognized in the general fund in accordance with the deferral method. Alternatively, if an organization has a restricted capital asset fund, the contribution would be recognized as revenue in the restricted fund regardless of whether the capital asset has been acquired.

An endowment contribution is recognized as revenue in the endowment fund in the period the contribution is received.

Unrestricted contributions are recognized as revenue in the general fund when they are received.

Organizations following the restricted fund method are required to present totals in the balance sheet for each financial statement item for all funds reported. In the statements of operations and cash flows separate totals for each financial statement item are required for each of the general fund, the restricted funds, and the endowment funds.

In summary, the adoption of the new recommendations, and in particular the selection of the method of accounting for contributions, represents an opportunity to present financial statements that are easy to understand and more reflective of how the organization operates. Organizations should be encouraged to test the various methods and presentations and they should not be predisposed to selecting a method that is similar to what is currently being used.

Capital Asset

Organizations will now be required to record capital assets on the balance sheet at cost and amortize them over their useful life. Amortization should generally be recognized as an expense in the statement of operations. When an organization uses fund accounting, the expense would be recognized in the fund providing the most meaningful presentation.

When an asset no longer contributes to the organization's ability to provide services, it should be written down to its net residual value. The write-down should be recognized as an expense.

Financial statement disclosures should be made for each major category of capital asset, including cost, accumulated amortization (including the amount of any write-downs), and the amortization method used. In addition, the amount of amortization expense and any write-downs made during the period should be disclosed.

Contributed capital assets should be recorded at their fair value at the date of contribution. A nominal value is used if fair value cannot be reasonably determined. Financial statements should disclose the nature and amounts of contributed capital assets received during the period and a description of contributed capital assets recognized at nominal value.

Accounting for Collections

Collections are works of art, historical treasures or similar assets that meet three criteria. They are:

- held for public exhibition, education or research;
- protected, cared for and preserved; and
- subject to an organizational policy that requires any proceeds from their sale to be used either to maintain the existing collection or to acquire other items for the collection.

Collections are excluded from the definition of capital assets and are therefore not required to be capitalized and amortized. However, certain disclosures are required: a description of the collection; the accounting policies used; details of any significant changes to the collection in the year; the amount spend on collections during the year; and the amount and subsequent use of any proceeds received from the sale of items in the collection during the year.

Organizations which have not previously capitalized and amortized their capital assets should begin the process of assembling the necessary information. The availability of accounting records will determine the amount of effort required. In addition, consideration must be given to the current information system capabilities in view of the new recommendations.

Reporting Controlled and Related Entities

The recommendations provide guidance on how a not-for-profit organization should account for, and report, relationships with other not-for-profit organizations and for-profit entities.

The recommendations describe three different types of relationships between not-for-profit operations. The first two, control and significant influence, are consistent with the definitions used in the profit sector. Control is defined as the continuing power to determine the strategic operating, investing and financing policies of an entity without the co-operation of others. Significant influence is defined as the ability to affect the strategic operating, investing and financing policies of an entity. The general presumption is that control exists where a not-for-profit organization has the right to appoint the majority of the voting members of the other organization's board of directors. In the absence of this right, there may be other indicators of control such as provisions in the other organization's bylaws that cannot be changed without the reporting organization's consent and that limit the other organization to activities that provide future economic benefits to the reporting organization.

Organizations have a choice in accounting for controlled not-for-profit organizations. They may either present consolidated financial statements that include all controlled not-for-profit organizations, or provide information in the notes to the financial statements about the controlled entities' assets, liabilities, revenues, expenses and cash flows and details of any restrictions on the resources of the controlled organization. Similar recommendations exist for organizations that are able to exercise significant influence over another not-for-profit organization.

Some not-for-profit organizations have control over hundreds of individually immaterial organizations, e.g., a national organization with chapters. The expense and effort required to prepare consolidated financial statements or provide the disclosure information may far exceed any benefits from doing so. Accordingly, the recommendations provide relief from the disclosure requirements set out above for an organization that controls a group of organizations comprised of a large number of organizations that are individually immaterial.

The third type of relationship, unique to not-for-profit organizations, is an economic interest. An economic interest exists if another organization holds resources that must be used to produce revenue or provide services to the reporting organization or the reporting organization is responsible for the liabilities of another organization. An economic interest can lead to the presumption of control or significant influence, or at the other extreme may be much more limited. An economic interest might include one in which the other organization solicits funds in the name of, and with the approval of, the reporting organization and substantially all of the funds are transferred to the reporting organization. Alternatively, an economic interest might exist where the other organization performs significant functions on behalf of the first organization that are integral to the (first) reporting organization's objectives. If the economic interest does not lead to the presumption of control or significant influence, then the nature and extent of the interest should be disclosed.

Organizations with a controlling interest in for-profit entities could either consolidate or equity account for their investment. If the organization has significant influence over a for-profit entity the investment should be accounted for using the equity method.

The implementation challenge for most organizations will be to examine their relationships with other not-for-profit organizations to determine the nature of the relationship and the related disclosures that may be required.

Conclusion

Organizations should review the recommendations with an open mind and challenge themselves to present financial statements that are easy to understand and reflect how the organization operates. To ensure an efficient and effective transition leading to the adoption of the new recommendations, all affected areas of an organization including accounting, information systems, and, in many cases, the board of directors, should be involved.

FOOTNOTE

1. The CICA *Handbook* recommendations are set out in Section 4400, Financial Statement Presentation; 4410, Contributions; 4420, Contributions Receivable; 4430, Capital Assets; 4440, Collections; and 4450, Reporting Controlled and Related Entities.