TAX AND BUSINESS SERVICES

Misconceptions in Not-For-Profit Accounting

Understanding the Reality Behind the Standards

BY JOHN D'AMICO AND XIXI DONG

Certain accounting standards are specific to donations, contributions, and grants from governments and foundations and are uniquely applicable to not-for-profit organizations. Not-for-profits do not exist to generate profits for their owners; they exist to fulfill a social mission. While they are not profit-oriented, they must consistently generate sufficient revenue to cover their expenditures. The standards unique to not-for-profit accounting are based on the idea that not-for-profits should be accountable to their donors by responsibly utilizing funds to achieve their mission. Therefore, they need to report their expenses by both natural category and by function, specifically program services, management and general, and fundraising.

Because of the various differences between for-profit commercial entities and not-for-profit entities, FASB uses Accounting Standards Codification (ASC) Topic 958, Not-for-Profit Entities, to cover the standards unique to not-for-profits. The ASC is updated through the issuance of Accounting Standards Updates (ASU).

The unique accounting standards applicable to not-for-profits, combined with the routine issuance of various ASUs, have led to occasional misunderstandings by both not-for-profit managers and auditors alike.

This article presents a wide range of actual misconceptions that the authors have encountered with some of their clients while performing audit procedures. The authors have also encountered these misconceptions with auditors not familiar with not-for-profit accounting during quality control reviews of not-for-profit engagements. The authors will state the actual misconception they encountered and then explain why it does not align with reality.

While these items might be familiar to experienced not-for-profit accountants, the authors believe they are worth keeping in mind when working with clients who may be less informed, less experienced, or approach the topic with a different mindset.

Conditional Contributions Misconceptions

The treatment of conditional contributions was clarified by FASB with the issuance of ASU 2018-08, *Clarify the Scope and Accounting Guidance for Contributions*, which updated ASC 958-605, Not-for-Profit Entities–Revenue Recognition. This ASU clarified that government and foundation grants to NFPs should be considered conditional contributions if the government or foundation is not directly receiving something of equal value. Government or foundation grants are not considered exchange transactions simply because society benefits directly from the grant. If the grant provides goods or services that directly benefit the government or foundation, this would be considered an exchange transaction, and ASC Topic 606, Revenue from Contracts with Customers, would apply.

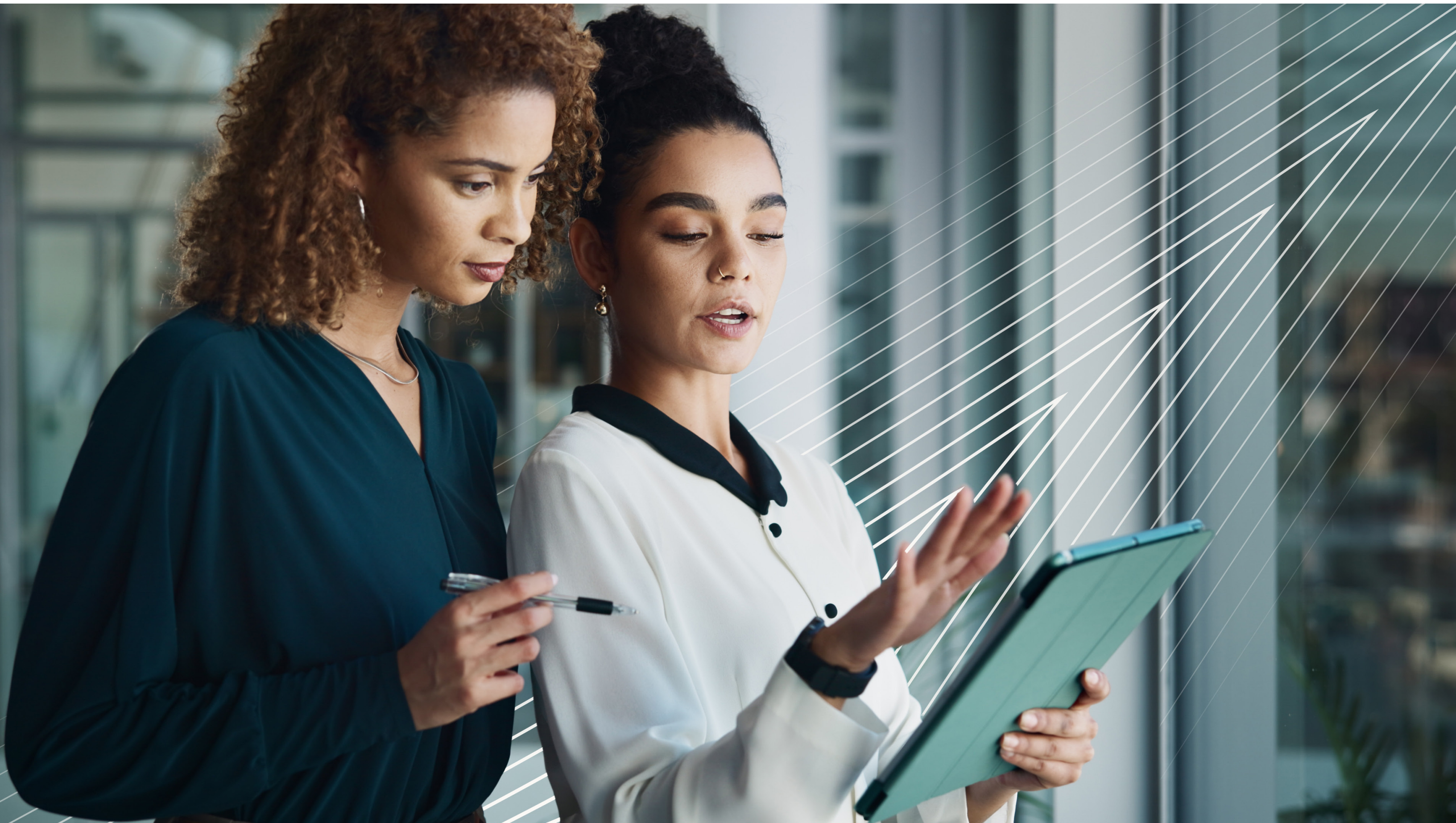
Grants are conditional contributions if they contain a barrier to overcome, such as providing specific services, and a right of return that is linked to the barrier. Restrictions on the use of the funds are not conditions. Also, grants that contain a matching requirement are considered conditional and should not be recorded until the not-for-profit makes the match.

Misconception	***Reality***
A contribution cannot be both unconditional and conditional at the same time.	It can. One example would be if the not-for-profit does not receive the second payment until they take a measurable action, but there is no right of return on the first payment.
A promise to give a $100,000 matching contribution for a specific purpose if the organization raises $100,000 should be recorded as both revenue and a receivable.	This is a conditional contribution and should only be recorded when the organization actually raises the $100,000 for that same purpose. Only unconditional promises to give should be recorded.
If a not-for-profit receives a restricted contribution for one of the organization's programs that also has a right of return, the not-for-profit must consider it a conditional contribution.	This is not the case. Because there is no barrier to be overcome, it is not considered a conditional contribution. It should be recorded as a contribution with donor restrictions.
When an organization receives a signed government or foundation grant (e.g., to provide specific services to those in need of housing), the organization should record a receivable and a restricted contribution that increases net assets with donor restrictions. As services are provided, net assets are released from restrictions.	This is an example of a conditional grant. No entry is recorded when an NFP receives the signed grant document. A receivable and grant revenue (without donor restrictions) must be recorded when the services are provided, as that is when the conditions are met.
For conditional grants, organizations only need to disclose the amounts of grants that have not yet been recognized, as they have not yet met the conditions.	Organizations must disclose the total number of conditional grants for which they have not yet met the conditions and grants for which they received funds in advance.

Other Revenue-Related Misconceptions

Accounting standards for not-for-profits can be found in ASC 958-605 and ASC 958- 606. ASC 958-605 is a set of accounting standards for not-for-profits to recognize and measure contributions. ASC 958-606 is a set of accounting standards that govern how not-for-profit organizations recognize revenue from contracts with customers. It provides a standardized framework for revenue recognition, ensuring consistency and comparability across not-for-profit organizations and commercial entities.

Misconception	*Reality*
If an organization has previously adopted ASC Topic 606 for exchange transactions, there is no requirement to disclose the opening balances of receivables, contract assets, and contract liabilities. This disclosure is not required because there was only an immaterial difference in the allowance for credit losses.	ASC Topic 606 requires disclosure of the opening balances of receivables, contract assets, and contract liabilities each year, per ASC 606-10-50-11.
An organization should only record a beneficial interest in a trust from an estate when it starts receiving distributions from the trust.	An organization should record the beneficial interest in a trust when it has cleared probate, not when it starts receiving distributions.
When a donor reports to a not-for-profit that they donated to a donor-advised fund (DAF), the not-for-profit should record a receivable and contribution revenue for the amount of the contribution to the DAF.	Unless there is specific language to the contrary, a DAF typically holds a variance power, which allows it to decline requests from the original donor. A not-for-profit should not record anything until the DAF itself advises them of the gift.



Misconceptions Regarding Presentations on Financial Statements

Not-for-profit financial statements summarize an organization's financial health and activities over a specific period. They are important for demonstrating accountability and transparency to stakeholders, making informed financial decisions, using resources effectively, and complying with legal and regulatory requirements.

Misconception	*Reality*
All cash accounts should be presented on the first line of the statement of financial position (SOFP).	Only cash that is available to pay expenditures should be on the first line. Cash accounts held for an endowment, for the purpose of acquiring long-lived assets, and restricted cash must be shown separately, further down on the SOFP, in order of liquidity.
On the SOFP, the assets (cash and investments) corresponding to board designations can be included on the same lines with cash and investments available for operations.	The assets related to board designations should be presented separately in the asset section of the SOFP and further down in the asset section, as they are not available to pay general expenditures. This is needed to place the assets on the SOFP in order of liquidity.
The statement of functional expenses (SOFE) total must agree with the total expenses on the statement of activities (SOA) and does not need to include non-operating expenses and expenses that were netted against revenue.	All expenses must be included on the SOFE regardless of whether they were considered as non-operating or netted on the SOA, except for investment fees.
Gain or loss on the disposition of long-lived assets must be included as non-operating on the SOA if the organization has an operating measure.	Under ASC 360-10-45-4, gains or losses on the disposition of long-lived assets must be included in the subtotal for the change in net assets from operations.
For the liquidity and availability footnote, it is not necessary to back out the assets related to the board-designated fund, as the board can undesignate those funds at any given time.	Because the board-designated fund is not available for general expenditures, it must be backed out of this disclosure. For additional information, see ASU 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-For-Profit Entities.*
For financial statements prepared in accordance with GAAP, prepaid expenses and accounts payable should be recorded for a special event occurring after their fiscal year-end. (This misconception stemmed from the fact that the not-for-profit received a contract from the vendor for the special event and recorded it in their accounts payable system.)	Prepaid expenses should only be recorded when actually paid.
An organization can net advances on its SOFP from government agencies against the receivables from the same government agency if it discloses this in its summary of accounting policies.	Government advances received should only be shown gross and not net of any receivables due.
For the allowance for credit losses (current expected credit losses, or CECL), it is okay not to disclose the roll-forward of the allowance if the change in the allowance is not significant from the prior year.	The disclosure of the roll forward of the allowance is required for all entities when they adopt ASU 2016-13, per ASC 326-20-50-13.
When a board-designated endowment appropriates funds to operations and has negative cumulative investment earnings, it can result in the board-designated endowment being underwater.	This is not the case. Only donor-restricted endowments can be considered underwater. Board-designated endowments cannot have a negative amount.

Restricted Cash Misconceptions

FASB issued ASU 2016-08, which amends ASC 230, Statement of Cash Flows, to add or clarify guidance on the classification and presentation of restricted cash in the statement of cash flows to address the diversity in practice related to the classification of restricted cash. An entity should include in its cash and cash-equivalent balances in the statement of cash flows those amounts that are deemed to be restricted cash and restricted cash equivalents. Changes in restricted cash and restricted cash equivalents that result from transfers between cash, cash equivalents, and restricted cash and restricted cash equivalents should not be presented as cash flow activities in the statement of cash flows.

Misconception	***Reality***
A cash account restricted for the personal needs allowances of participants in the organization's programs should be included in the statement of cash flows as restricted cash.	A cash account held on behalf of others is not the organization's cash and therefore should be included on the SOFP as "custodial account held for others" and not included as restricted cash.
Tenants' security deposits held in a bank account in an organization's name should be included as restricted cash for purposes of the statement of cash flows.	Restricted cash for purposes of the statement of cash flows should only be the organization's cash that is restricted by an outside entity, such as a bank or a governmental agency, such as HUD. Tenant security deposits are not the organization's cash.

Right to Use Assets/Leases Misconceptions

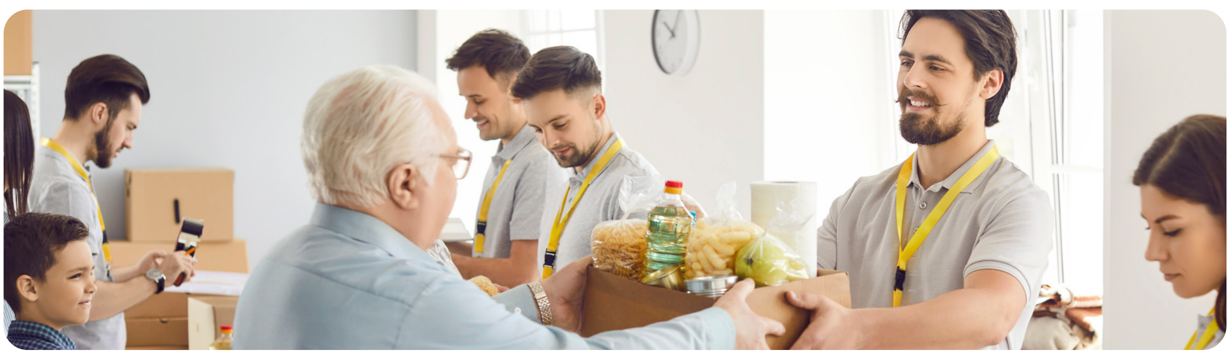
ASC 842, Leases, requires lessees to recognize right-of-use assets and lease liabilities for all leases other than those for which the lessee has elected the short-term lease accounting policy. The requirements for a lessor are similar to those of a lessee, with an additional requirement to assess collectability to support a direct financing lease. Leases are defined as an arrangement in which it conveys the right to "control" the use of an "identified asset" to a customer and the customer obtains substantially all of the economic benefits from its use. ASU 2016-02 replaces previous guidance in ASC 840, Leases.

Misconception	***Reality***
All leases as defined in ASC Topic 842, including in-kind signed lease agreements, must be included in the calculation to determine the right-to-use assets and liabilities.	In-kind lease agreements should not be included as right-to-use assets, and liabilities as leases under ASC Topic 842 must have consideration paid by the lessee. In addition, leases that are below the fair market value of the leased asset should only include the consideration used to calculate the right-to-use assets and liabilities, rather than the fair market value of the lease itself. In-kind lease agreements are recorded under ASC 958-605 as "donated non-financial assets."
In a classified balance sheet, the current portion of the liability for right-of-use assets is included with current assets. (This misconception occurred as the not-for-profit had to record the current portion for the operating right-of-use liability and believed it was appropriate to include the corresponding amount in their current assets so that their current ratio would not be affected.)	All right-of-use assets must be presented as non-current assets.
When calculating the value of right-of-use assets and liabilities, prepaid rent, deferred rent credits, and all other offsets are recorded against the asset.	Prepaid rent should be recorded against the liability. Deferred rent credits and all other offsets are recorded against the asset.

Net Assets with Donor Restrictions: Misconceptions

Net assets may include contributions received or promised to the organization that carry a donor-imposed restriction as to when (time restriction) or for what purpose (purpose restriction) the gift can be used. These contributions increase the not-for-profit's net assets with donor restrictions. When the restriction is met, an organization will record a release from restriction, which is basically a transfer between net assets with donor restrictions to net assets without donor restrictions. ASC 958-605 is the guidance that applies to contributions with donor restrictions.

Misconception	***Reality***
An organization can utilize its net assets without donor restrictions for expenditures even though it has restricted net assets for that same purpose, if it chooses to do so, and disclose it in its summary of significant accounting policies.	Net assets with donor restrictions must be utilized first when the restriction is met, per ASC 958- 205 45 (expirations of donor-imposed restrictions). Not-for-profits are not permitted to keep their donor-restricted contributions for a "rainy day." Simply stating their accounting policy in their summary of significant accounting polices does not make it correct.
An organization can elect to record a restricted gift as an increase in net assets without donor restrictions if the restriction is met in the same year for all of their contributions, but not for their restricted investment return, provided they disclose this as their accounting policy.	If an organization elects to record an increase in net assets without donor restrictions for restricted gifts met in the same year, it must do so for its restricted investment return as well.
An organization can impose a time restriction on the gift of a long-lived asset, such as a building, and release the restriction over the useful life of the building to correspond to the annual depreciation expense if it discloses this as its accounting policy.	Imposing a time restriction is no longer allowed per ASU 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-For-Profit Entities.*



Facing Reality

Understanding these misconceptions can help organizations properly record transactions and prepare their financial statements. This can help reduce or eliminate deficiencies and management letter comments from their auditors. Clearing up misconceptions early in the audit process improves the accuracy of a not-for-profit's financial reporting, ultimately streamlining the audit process.

Have questions? Connect with a CBIZ not-for-profit professional for one-on-one guidance today.

This article first appeared in *The CPA Journal*—to read it there, click here.

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