1995

Not-for-profit organizations industry developments - 1995; Audit risk alerts

American Institute of Certified Public Accountants

AUDIT RISK ALERTS

Not-for-Profit Organizations Industry Developments—1995

Complement to AICPA Audit and Accounting Guide *Audits of Certain Nonprofit Organizations* and Industry Audit Guides *Audits of Colleges and Universities* and *Audits of Voluntary Health and Welfare Organizations*

AICPA
American Institute of Certified Public Accountants

NOTICE TO READERS

This audit risk alert is intended to provide auditors of financial statements of not-for-profit organizations with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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The staff of the AICPA is grateful to the members of the AICPA Not-for-Profit Organizations Committee for their contribution to this document.

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Industry and Economic Developments

Although the U.S. economy continues its steady recovery, the effects have not yet fully reached the not-for-profit sector. Consumer confidence is growing, but many individuals, still faced with financial concerns and skeptical about the efficiency of not-for-profit organizations, continue to reduce their levels of charitable giving. On the other hand, interest rates have risen, enabling not-for-profit organizations to realize modest increases in levels of return on their interest-earning investments. Similarly, funding received by not-for-profit organizations from private foundations has stabilized as foundations have adjusted their giving levels in response to favorable current earnings on their investment portfolios. Also, reductions in funding from state and local governments have slowed, but funds continue to go to not-for-profit organizations that have maintained positive public images and that are operationally effective and efficient.

The use of gifts, such as annuities, charitable-remainder trusts and unit trusts, pooled-income funds, and lead trusts that provide donors with tax deductions while retaining beneficial interests in property, has increased. Not-for-profit organizations that receive those gifts are faced with the challenge of maintaining the principal at sufficient levels to support the required payments to donors and beneficiaries. Also, because generally accepted accounting principles (GAAP), particularly revenue recognition principles, concerning how those gifts should be accounted for are inconsistent, auditors should consider whether organizations' accounting for those gifts is appropriate and consistently applied.

The media continue to focus attention on issues relating to not-for-profit organizations. First among these issues continues to be the reasonableness of compensation, fringe benefits, and perquisites afforded to the senior management personnel of some organizations. Others include the amounts of assets held by not-for-profit organizations, the portion of revenue earned from fees for goods or services, and the perception that expenditures for program services are a low portion of total expenditures. The adverse publicity concerning such issues continues to make many donors less willing to continue contributing at levels they maintained in the past. Furthermore, questions raised about the personal inurement of executives continue to threaten the tax-exempt status of the organizations they serve.

As a result of changes in not-for-profit funding and increased scrutiny, not-for-profit organizations continue to experience pressure to try to present financial statements that make their operations appear as efficient as possible and to maximize investment returns. Auditors should consider the effect that such pressures may have on audit risk, particularly those associated with areas such as (1) allocation of costs between program services and support services and (2) high-risk investments, such as derivatives.

Like many organizations, some not-for-profit organizations are restructuring their operations to become more efficient. Auditors should consider the effects of such restructuring on their consideration of internal controls, and should also consider whether restructuring charges are reported in conformity with GAAP.

Industry Conference

The AICPA will hold its third annual Not-for-Profit Organizations Industry Conference on July 10 and 11, 1995, in Washington, DC. The conference is designed to provide technical information to both practitioners and financial executives. For further information, call the AICPA CPE Division Hotline at (800) 862-4272.

Regulatory and Legislative Developments

State and Local Issues

State and local laws concerning not-for-profit organizations continue to change. Some states have enacted or are revising existing laws concerning registration or licensing requirements, reporting requirements, solicitation disclosure requirements, or limitations on fund-raising expenses. The American Association of Fund-Raising Councils, Inc. (AAFRC) publishes its *Annual Survey of State Laws Regulating Charitable Solicitations* (available for $10). Copies of this publication can be obtained by calling (212) 354-5799 or by writing to the AAFRC, Suite 820, 25 West 43d Street, New York, NY 10036.

IRS Activities

Auditors should be aware of relevant tax laws and regulations and their potential impact on not-for-profit organizations and their financial statements. An organization's failure to maintain its tax-exempt status could have serious tax consequences and affect both its financial statements and related disclosures, and it could possibly require modification of the auditor's report. Failure to comply with tax laws and regulations could be an illegal act that may have either a direct and material effect on the determination of financial statement amounts (for example, the result of an incorrect accrual for taxes on unrelated business income) or a material indirect effect on the financial statements that would require appropriate disclosures (for example, the result of a potential loss of tax-exempt status). Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards,* vol. 1, AU sec. 317), discusses the nature and extent of the consideration an auditor should give to the possibility of illegal acts and provides guidance on the auditor's responsibilities when a possible illegal act is detected.

This past year has been a busy year for the Internal Revenue Service (IRS). It has increased its examination activities and is in the process of implementing focused audit programs. The IRS's coordinated examination program has continued to focus on colleges and universities but has also covered tele-evangelists and other organizations. As a result of a coordinated examination audit, some organizations have paid significant taxes, penalties, and interest in order to close out their examinations. Organizations that are not in compliance face the possibility of having their exemptions revoked. Areas generating some of the largest assessments relate to classification of personnel as employees or independent contractors, improper use of FICA tax exclusions, improper payroll reporting, revenues from mailing list rentals, and associate member dues.

IRS compliance audit programs that are either being implemented currently or in the process of being developed include a tax-exempt bond compliance program and a 403(b) tax-sheltered annuity program.

The IRS is focusing particularly significant attention on taxation of associate member dues as unrelated business income. Associate member dues may be taxable if the associate members are not involved in the exempt organization's activities but join the organization to purchase services or products that do not have a direct causal relationship to the exempt activities of the organization. Audit guidelines on the taxation of associate member dues have been delayed pending the outcome of several tax court cases.

The IRS has issued the following publications concerning not-for-profit organizations:

1. Advance Announcement 94-112, which includes final examination guidelines concerning colleges and universities (available under the Freedom of Information Act)
2. A draft of a new publication, *Tax Guide for Churches and Other Religious Organizations* (IRS publication 1828)

3. *Charitable Contributions—Substantiation and Disclosure Requirements* (IRS publication 1771)
4. Notices indicating that political subdivisions (section 115 organizations), as well as religious organizations and their integrated auxiliaries, are not required to file Form 990
5. Advance Announcement 94-8, *Exempt Organizations Excepted from Reporting Lobbying Expenditures Under Section 6033(e)(3) and Regulation 1.162-29, Influencing Legislation* (discusses proposed regulations concerning political expenditures that allow the IRS to impose excise taxes on organizations, as well as on the responsible employee(s), for prohibited political activities of 501(c)(3) organizations)

As auditors test tax accruals, they should be aware of several significant cases. In *Southwest Texas Cooperative,* the Tax Court determined that the investment income of tax-exempt bond proceeds drawn by the exempt organization and invested were considered debt-financed income unrelated to the exempt purposes of the organization and, therefore, taxable as unrelated business income. Some believe the IRS may try to tax bond escrow funds too.

The IRS has taken, and continues to take, the position that any transaction that involves the provision of mailing lists is taxable in its entirety. It has opposed attempts to split compensation between mailing list rentals and royalties for the use of an organization's name and logo. In *Sierra Club Inc. v. Commissioner,* the most recent mailing list case, the Tax Court held not only that it is possible to split a revenue stream between taxable and nontaxable income, but that mailing list rentals are also nontaxable royalties. The IRS is appealing this decision.

OMB Circular A-133

Proposed Revisions. U.S. Office of Management and Budget (OMB) Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions,* establishes audit requirements that apply to not-for-profit organizations that receive federal awards. In March 1995, the OMB published proposed revisions to Circular A-133. The proposed revisions include the following:

- The threshold for when a not-for-profit organization would be required to have an audit under Circular A-133 would be raised from $25,000 to $300,000. (The OMB also is considering an additional approach whereby organizations meeting certain criteria categorizing them as low-risk would be permitted, with the approval of the cognizant or oversight agency, to undergo a full-scope audit in accordance with Circular A-133 on a triennial basis. In years in which a full-scope audit would not be required, those organizations would be required to have a financial statement audit in accordance with *Government Auditing Standards* [GAS or the Yellow Book], issued by the Comptroller General of the United States, and would be required to engage an auditor to perform certain other additional audit procedures.)

- Major programs, as defined in Circular A-133, would be determined on the basis of a risk assessment, considering prior audit experience, oversight performed by federal agencies and others, and the inherent risk of the program, rather than solely on the basis of federal expenditures, as currently required. Such determinations would be subject to requirements that programs be covered as major programs if program expenditures, as a percentage of total federal program expenditures, reach certain levels.
- The required level of testing of the internal control structure over major programs would be clarified as being based on the auditor's planning for a low assessed level of control risk.
- The minimum requirements for the Schedule of Federal Awards would be provided.
- Guidance would be provided on (1) reporting audit findings concerning federal awards in a single schedule of findings and questioned costs; (2) thresholds for determining which audit findings should be included in the audit report; (3) descriptions of what information the auditor should include in an audit finding; and (4) required follow-up on audit findings, including providing a corrective action plan for current audit findings and a summary schedule of prior audit findings.
- The definition of *non-profit organization* would be changed to include non-profit hospitals.
- Guidance would be provided on the assignment of cognizant agencies.
- Restrictions on auditor selection whereby an auditor who also prepares the indirect cost proposal, cost allocation plan, or the disclosure statement required by the Cost Accounting Standards Board (CASB) and OMB Circular A-21, *Cost Principles for Educational Institutions,* would be prohibited from being selected if the indirect costs charged are greater than five percent of expenditures of any Type A program, as defined in the Appendix to the proposed revised Circular.
- The due dates for submitting reports required by OMB Circular A-133 would be shortened from thirteen to nine months after the end of the recipient's fiscal year. (The provision for a cognizant or oversight agency to grant an extension would be retained.) Also, the report submission process would be streamlined.

In addition to the proposed revisions to Circular A-133, the OMB intends to seek modifications of the Single Audit Act of 1984 and OMB Circular A-128, *Audits of State and Local Governments,* consistent with the proposed revisions to Circular A-133 so that one law and one Circular can cover both nonprofit organizations and state and local governments.

The period for commenting on the proposal has expired.

PCIE Statistics. The President's Council on Integrity and Efficiency (PCIE) issues statistics concerning the results of Inspector General reviews of audits of federal activities performed by independent public accountants. The statistics based on reviews for the six months ended March 31, 1994, indicate that federal Inspectors General continue to find deficiencies that cause them to reject audit reports, though some improvement has been noted. Specifically, 26 percent of the OMB Circular A-133 audit reports submitted for federal review required major changes or were deemed significantly inadequate, as compared with 44 percent for the same period of the prior year.

Some of the more common deficiencies cited by reviewers include—

- Incomplete auditor's reports. Reports on the internal control structure or compliance with applicable laws and regulations were missing, or did not include all the required information, such as support for findings or the auditee's comments on the status of prior findings.
- Noncompliance with *Government Auditing Standards.* This includes failure to adequately test internal controls or compliance with applicable laws and regulations, inadequate documentation of substantive testing of significant compliance or provisions of laws and regulations, and failure to report all findings.
- Inadequate working papers. This includes failure to include adequate documentation to support the auditor's opinion.
- Lack of or incomplete financial statements.

Revisions to Government Auditing Standards

The U.S. General Accounting Office (GAO) issued a revision to *Government Auditing Standards* in June 1994 (1994 Revision). The standards for financial audits are effective for periods ending on or after January 1, 1995. The 1994 Revision provides *guidance,* rather than requirements, on the auditor's consideration of internal controls for control environment, safeguarding controls, controls over compliance with laws and regulations, and control risk assessment, and does not establish new responsibilities for testing controls. Further, the 1994 Revision—

- Adds a requirement for audit organizations to provide a copy of their most recent external quality control review report to parties seeking to contract for an audit.
- Sets a new benchmark for the sufficiency of working papers; they should enable an experienced auditor to ascertain from them the evidence that supports the significant conclusions and judgments. It explicitly requires the working papers to include descriptions of transactions and records examined so that an experienced auditor would be able to examine the same transactions and records.
- Adds a requirement for auditors to communicate their responsibilities for consideration of internal controls and compliance with laws and regulations to audit committees or the individuals with whom they have contracted for the audit.
- Adds a requirement to include a reference to *Government Auditing Standards* in audit reports when they are being submitted in accordance with a law or regulation calling for an audit in accordance with *Government Auditing Standards.*
- Adds a requirement that the report on the financial statements either (1) describe the results of the auditor's tests of internal controls and compliance or (2) refer to separate reports on controls and compliance.
- Clarifies a requirement that the auditor report irregularities and illegal acts directly to parties outside the client, in certain circumstances, even if he or she has resigned or been dismissed from the audit.
- Clarifies a requirement that auditors report all irregularities and illegal acts except for those that are clearly inconsequential.
- Adds a requirement to design the audit to provide reasonable assurance of detecting noncompliance with contract provisions and grant agreements that could have a direct and material effect on financial statement amounts.
- Deletes the requirement to describe categories of internal controls in reporting on internal controls.
- Deletes the requirement to express positive and negative assurance on compliance with laws and regulations.
- Incorporates relevant AICPA SASs, for example, SAS No. 62, *Special Reports* (AICPA, *Professional Standards,* vol. 1, AU sec. 623), and attestation standards into *Government Auditing Standards* for financial related audits.

Auditors should be mindful that *Government Auditing Standards* applies to OMB Circular A-133 audits and that it includes general standards, such as standards for (1) continuing professional education and (2) the auditor's participation in external quality control review programs.

AICPA Guidance on 1994 Revision. As noted on pages 10 and 11, the 1994 Revision changes the reporting requirements for financial audits performed in accordance with those standards. These and other general and fieldwork standards changes will be incorporated in Statement of Position (SOP) 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards,* through conforming changes to the AICPA's audit and accounting guides loose-leaf service. In the meantime, revised illustrative auditor's reports on a not-for-profit organization's financial statement audit that conform with the 1994 Revision may be obtained through the AICPA fax hotline by dialing (201) 938-3787 from a fax machine, following the voice cues, and selecting document no. 476.

OMB Circular A-122

In September 1994, the OMB published proposed revisions to OMB Circular A-122, *Cost Principles for Nonprofit Organizations.* The proposed revisions would apply to not-for-profit organizations other than colleges and universities, because interest and other financing costs are already allowable for colleges and universities under OMB Circular A-21, which is discussed below. The proposed revisions include a provision that interest on debt incurred through the purchase of certain assets would be an allowable cost if the purchase of the asset is considered necessary for the administration of a federal grant and is cheaper than renting such asset over the long term. Other proposed revisions include increasing the equipment capitalization threshold to $5,000 and changing allowable cost provisions to be consistent with OMB Circular A-87, *Cost Principles Applicable to State and Local Governments.*

OMB Circular A-21

During 1995, the OMB is expected to revise OMB Circular A-21, *Cost Principles for Educational Institutions,* to incorporate four standards promulgated by the CASB (Cost Accounting Standards 501, 502, 505, and 506) and a CASB Accounting Policies Disclosure Statement. These standards require educational institutions that receive a federal contract or subcontract in excess of $500,000 to adhere to mandated practices for consistently estimating, accounting, and reporting costs, among other things. Further, under certain circumstances, universities must disclose their cost accounting practices on a standard federal report when specific thresholds of federal contract activity are met. Once the four cost accounting standards are incorporated into OMB Circular A-21, they will be applicable to both contracts and other sponsored agreements. Auditors involved with audits of federal financial assistance for colleges and universities should be alert for the issuance of the revised circular.

CASB Standards

The CASB has issued a final rule, *Application of Cost Accounting Standards Board Regulations to Educational Institutions,* as published in the November 8, 1994, *Federal Register.* The rule applies to educational institutions receiving negotiated federal contract or subcontract awards in excess of $500,000 (excluding contracts awarded for the operation of federally funded research and development centers, which are already subject to CASB regulations). The rule is effective on January 9, 1995, and requires that organizations apply the following rules in connection with awards in excess of $500,000:

1. Consistently follow CASB cost accounting practices when estimating, accumulating, and reporting costs pursuant to contracts in connection with those awards.
2. Consistently allocate costs incurred in reporting in connection with those awards.
3. Identify unallowable costs and exclude them from billings, claims, and proposals.
4. Consistently use the same cost accounting period.
5. Disclose cost accounting practices of business units in certain circumstances.

Audit Issues and Developments

Internal Control Structure

Changes in financial accounting standards, changes in tax laws, increased attention to requirements to properly bill overhead costs to government agencies, restructuring, and expanded contractual audit requirements are resulting in the need for significant changes in the accounting systems and internal control structures of not-for-profit organizations. Auditors should ensure that they have a sufficient understanding of the organization's internal control structure in order to plan and perform the audit.

Access to Working Papers

Regulators and others may request auditors of not-for-profit organizations to provide access to working papers. Auditors who have been requested to provide such access should refer to Interpretation No. 1 of SAS No. 41, *Working Papers* (AICPA, *Professional Standards,* vol. 1, AU sec. 339), entitled *Providing Access to or Photocopies of Working Papers to a Regulator* (AICPA *Professional Standards,* vol. 1, AU sec. 9339). The Interpretation provides auditors with guidance on—

1. Advising management that a regulator has requested access to (and possibly photocopies of) the working papers and that the auditor intends to comply with the request.
2. Making appropriate arrangements with the regulator for review.
3. Maintaining control over the original working papers.
4. Considering submitting to the regulator a letter clarifying that an audit in accordance with generally accepted auditing standards (GAAS) is not intended to, and does not, satisfy a regulator's oversight responsibilities. (An example of such a letter is illustrated in paragraph 6 of the Interpretation.)

In addition, the Interpretation addresses situations in which an auditor has been requested by a regulator to provide access to working papers before the audit has been completed and the report released. Also, the Interpretation notes that when a regulator engages an independent party, such as another independent public accountant, to perform the working paper review on behalf of the regulatory agency, there are some precautions auditors should observe.

The complete text of this Interpretation was published in the "Official Releases" section of the July 1994 *Journal of Accountancy.*

Governmental Compliance Auditing Considerations

In February 1995, the AICPA's Auditing Standards Board (ASB) issued SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards,* vol. 1, AU sec. 801), to provide general guidance to practitioners engaged to perform compliance audits of recipients of governmental financial assistance. SAS No. 74 supersedes SAS No. 68, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance,* and is effective for audits of financial statements and of compliance with laws and regulations for fiscal periods ending after December 31, 1994. SAS No. 74 reduces the level of detail provided at the auditing standard level. The detailed audit and reporting guidance previously in SAS No. 68 is now provided in SOP 92-9 or will be included in the Audit and Accounting

Guide *Not-for-Profit Organizations,* the exposure draft of which is discussed on pages 21 to 24 of this Alert. Accordingly, these changes were intended to have no effect on the conduct of an audit.

SAS No. 74 continues to recognize three levels of audits—GAAS, *Government Auditing Standards,* and certain other federal requirements —of recipients of governmental financial assistance. SAS No. 74 is applicable when the auditor is engaged to perform an audit under GAAS, and under *Government Auditing Standards,* and in certain other circumstances involving governmental financial assistance, such as single or organization-wide audits or program-specific audits under certain federal or state audit regulations.

In 1993, the ASB issued a Statement on Standards for Attestation Engagements (SSAE) No. 3, *Compliance Attestation* (AICPA, *Professional Standards,* vol. 1, AT sec. 500). Audit regulations have been issued by federal agencies and departments requiring compliance attestation engagements in accordance with SSAE No. 3 (for example, the U.S. Department of Education relating to student financial assistance). SSAE No. 3 does not apply to audits performed in accordance with *Government Auditing Standards* and audits within the scope of SAS No. 68. However, there was confusion and a divergence of opinion as to when SAS No. 68 applied and when SSAE No. 3 applied. Thus, SAS No. 74 also clarifies the applicability of SSAE No. 3 to compliance audits of recipients of governmental financial assistance. SAS No. 74 states that SSAE No. 3 provides guidance for engagements related to management's assertion about an entity's compliance with the requirements of specified laws, regulations, rules, or contracts not involving governmental financial assistance. In addition, SAS No. 74 amends SSAE No. 3 to state that SSAE No. 3 does not apply to engagements for which the objective is to report in accordance with SAS No. 74, unless the terms of the engagement specify an attestation report under SSAE No. 3.

Investments in Derivatives

As interest rates, commodity prices, and numerous other market rates and indices from which derivative financial instruments derive their value have increased in volatility over the past several months, a number of organizations investing in derivatives have incurred significant losses. Not-for-profit organizations are increasingly using such instruments as risk management tools (hedges) or as speculative investment vehicles. The use of derivatives virtually always increases audit risk. Although the financial statement assertions about derivatives are generally similar to assertions about other transactions, the auditor's approach to achieving related audit objectives may differ because certain derivatives—such as futures contracts, forward contracts, swaps, options, and other contracts with similar characteristics—generally are not recognized in the financial statements. Many of the unique audit risk considerations presented by the use of derivatives are discussed in detail in *Audit Risk Alert—1994*.

Service Auditor's Reports

Not-for-profit organizations frequently use third-party service organizations to process transactions, such as payroll and student financial aid payments, as well as for other purposes. In April 1992, the ASB issued SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), which supersedes SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at Service Organizations*. SAS No. 70 provides guidance to auditors of entities, including not-for-profit organizations, that use service organizations, and is effective for service auditors' reports dated after March 31, 1993.

SAS No. 70 requires auditors to consider, in the planning stage of the audit, whether certain policies, procedures, and records of the service organization are relevant to the reporting entity's ability to record, process, summarize, and report financial data that is consistent with the assertions embodied in the entity's financial statements. Paragraph 8 of SAS No. 70 lists factors for auditors to consider in determining the significance of the service organization's policies, procedures, and records to planning the audit, including their effect on the not-for-profit organization's compliance with laws, regulations, and contractual agreements.

Using the Work of a Specialist

Auditors of not-for-profit organizations may consider using the work of a specialist (for example, with respect to the valuation of contributed assets, particularly contributed collection items that the organization capitalizes). In July 1994, the ASB issued SAS No. 73, *Using the Work of a Specialist* (AICPA *Professional Standards*, vol. 1, AU sec. 336). SAS No. 73 supersedes SAS No. 11 of the same title and is effective for audits of financial statements for periods ending on or after December 15, 1994. Among other things, SAS No. 73 requires auditors to evaluate the objectivity and professional qualifications of the specialist, including the specialist's experience in the type of work under consideration. SAS No. 73 also provides guidance for situations in which the specialist has a relationship with the client. Additional information is provided in *Audit Risk Alert—1994*.

Accounting Issues and Developments

Joint Costs

In 1987, the AICPA issued SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal.* SOP 87-2 provides guidance on reporting the costs of informational materials that include solicitations for financial support, and requires such costs to be reported as fund-raising expenses if it cannot be demonstrated that a bona fide program or a management and general function has been conducted in conjunction with the appeal for funds. If activities other than appeals for funds can be demonstrated, such costs should be allocated between fund-raising and the related program or management and general function. Certain financial statement disclosures concerning such allocations are also required.

Because of pressure to portray fund-raising expenses within certain percentages of revenue and expenses, there continues to be an increased risk that the cost of mailing materials or conducting other communications with the public may not be properly allocated between program expenses and fund-raising or management and general expenses in conformity with SOP 87-2.

Some state attorneys general continue to criticize the manner in which some organizations allocate joint costs. They believe some organizations have been too liberal in their allocation of costs to program expenses, especially those costs incurred to educate the public.

Not-for-profit organizations and auditors should carefully review the requirements of SOP 87-2 and consider the sufficiency of evidence that exists to support any allocations of such joint costs.

An AICPA exposure draft of a proposed SOP on this subject is discussed on page 21 of this Alert.

Restructuring

Like many organizations, some not-for-profit organizations are restructuring their operations to become more efficient. Some organizations are recording restructuring charges in the face of workforce reductions, facility closings, and the discontinuance of certain operations. Auditors should consider the consensus reached by the Emerging Issues Task Force (EITF) of the Financial Accounting Standards Board (FASB) in its discussion of EITF Issue No. 94-3, *Liability Recognition for Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring),* which provides guidance on whether certain costs (such as employee severance and termination costs) should be accrued and classified as part of restructuring charges, or whether such costs would be more appropriately considered a recurring operational cost of the organization. EITF

Issue No. 94-3 provides guidance concerning the appropriate timing of recognition of restructuring charges and prescribes disclosures that should be included in the financial statements. The EITF is expected to continue its discussion of this issue.

Auditors whose clients record restructuring charges should monitor the EITF's discussion of this issue.

Accounting Pronouncements and Projects

FASB Not-for-Profit Organizations Project. The FASB is continuing its consideration of the specialized accounting principles and practices included in four AICPA Industry Audit Guides and Audit and Accounting Guides (Guides) relevant to not-for-profit organizations. The FASB added this project to its agenda in March 1986, initially to address accounting for contributions and the recognition of depreciation by not-for-profit organizations. The portion of the project dealing with depreciation was completed in September 1988 and resulted in FASB Statement No. 93, *Recognition of Depreciation by Not-for-Profit Organizations.* The portion of the project dealing with contributions was completed in June 1993 and resulted in FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made.* The portion of the project dealing with financial statement display was completed in June 1993 and resulted in FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations.*

FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* which was issued in May 1993, exempts not-for-profit organizations from its scope. FASB Statement No. 117 defines not-for-profit organizations as follows:

> An entity that possesses the following characteristics that distinguish it from a business enterprise: (*a*) contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return, (*b*) operating purposes other than to provide goods or services at a profit, and (*c*) absence of ownership interests like those of business enterprises. Not-for-profit organizations have those characteristics in varying degrees (Concepts Statement 4, paragraph 6). Organizations that clearly fall outside this definition include all investor-owned enterprises and entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance companies, credit unions, farm and rural electric cooperatives, and employee benefit plans (Concepts Statement 4, paragraph 7).

Some organizations that have traditionally been considered to be not-for-profit organizations and that have been covered by the AICPA Guides do not meet the definition of a not-for-profit organization in

FASB Statement No. 116. Beginning with financial statements issued for fiscal years beginning after December 15, 1994 (the effective date of FASB Statement No. 116 for entities other than not-for-profit organizations), entities that do not meet the FASB Statement No. 116 definition of a not-for-profit organization, regardless of whether they follow the AICPA not-for-profit Guides, should follow the guidance on accounting and reporting for investments included in FASB Statement No. 115 rather than the guidance included in the AICPA Guides to the extent that the guidance in the Guides conflicts with the guidance in FASB Statement No. 115.

Derivatives. In October 1994, the FASB issued Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments.* FASB Statement No. 119 requires disclosures about derivative financial instruments—futures, forward, swap, and option contracts—and other financial instruments with similar characteristics.

More specifically, FASB Statement No. 119 requires disclosures about amounts, the nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk,* because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading.

FASB Statement No. 119 is effective for financial statements issued for fiscal years ending after December 15, 1994, except for organizations with less than $150 million in total assets. For those organizations, FASB Statement No. 119 is effective for financial statements issued for fiscal years ending after December 15, 1995.

Investments. In March 1995, the FASB released an exposure draft of a proposed Statement of Financial Accounting Standards, *Accounting for Certain Investments Held by Not-for-Profit Organizations.* The Statement would require the following:

1. 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 included in a statement of activities.
2. A not-for-profit organization should disclose certain information about its investments and return on its investments.
3. In the absence of donor stipulations or laws to the contrary, losses of an endowment fund that is created by a donor stipulation

requiring investment of the gift in perpetuity or for a specified term should reduce temporarily restricted net assets to the extent that donor-imposed restrictions on net appreciation of the fund have not been met before the loss occurs. Any remaining loss would reduce unrestricted net assets.

The proposed Statement would be effective for annual financial statements issued for years beginning after December 31, 1995, with earlier application encouraged. Comments are due June 30, 1995.

AcSEC Projects. The AICPA Accounting Standards Executive Committee (AcSEC) has issued two SOPs and released two exposure drafts that provide, or propose, guidance for 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,* requires that such pronouncements be applied by not-for-profit organizations unless the pronouncements specifically exclude them, are not relevant to the kinds of transactions entered into by not-for-profit organizations, or pertain to topics also addressed in the AICPA Audit and Accounting Guides *Audits of Colleges and Universities, Audits of Providers of Health Care Services, Audits of Voluntary Health and Welfare Organizations,* or *Audits of Certain Nonprofit Organizations.* SOP 94-2 is effective for financial statements issued for fiscal years beginning after December 15, 1994, except for not-for-profit organizations that have less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date is for fiscal years beginning after December 15, 1995. Earlier application is permitted.

SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations,* amends and makes uniform the guidance on reporting of related entities in the AICPA Audit and Accounting Guides *Audits of Colleges and Universities* and *Audits of Voluntary Health and Welfare Organizations* and in SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations.* SOP 94-3 provides that the decision about whether the financial statements of a reporting not-for-profit organization and those of one or several other entities (either not-for-profit organizations or business entities) should be consolidated should be based on the entities' relationship to each other. That relationship also governs the disclosures that the reporting organization is required to make. The guidance in SOP 94-3 focuses on investments in majority-owned for-profit subsidiaries and financially interrelated not-for-profit organizations. SOP 94-3 is effective for financial statements issued for fiscal years beginning after December 15, 1994, except for not-for-profit organizations that have less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date is for fiscal years beginning after December 15, 1995. Earlier application is permitted. For organizations that adopt FASB Statement No. 117 before its effective date, earlier application of the SOP is encouraged.

Accounting for the Costs of Joint Activities. In September 1993, the AICPA Not-for-Profit Organizations Committee released an exposure draft of a proposed SOP, *Accounting for Costs of Materials and Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include a Fund-Raising Appeal,* that would clarify and revise SOP 87-2. The proposed SOP would be applied by not-for-profit organizations and state and local governmental entities in determining fund-raising costs. It would require reporting the costs of all materials and activities that include a fund-raising appeal as fund-raising costs, including costs that are otherwise clearly identifiable with program or management and general functions, unless a bona fide program or management and general function has been conducted in conjunction with the appeal for funds. If a bona fide program or management and general function has been conducted in conjunction with an appeal for funds, the joint costs of those activities would be allocated. Costs that are clearly identifiable with fund-raising, program, or management and general functions would be charged to that cost objective. The period for commenting on the exposure draft has expired and the committee is considering the comments received. AcSEC expects to issue a final SOP in the fourth quarter of 1995.

AICPA Guide Project. In April 1995, the AICPA Not-for-Profit Organizations Committee released an exposure draft of a proposed Audit and Accounting Guide that is a comprehensive revision and consolidation of the AICPA Industry Audit Guides *Audits of Colleges and Universities* and *Audits of Voluntary Health and Welfare Organizations,* the AICPA Audit and Accounting Guide *Audits of Certain Nonprofit Organizations,* SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities,* and SOP 78-10. The objective of the project is to make the Guides consistent with FASB Statements No. 116 and No. 117 and to provide further guidance. The proposed Guide would provide the following, among other things:

- Entities covered by the existing not-for-profit Guides that are not covered by FASB Statements No. 116 and No. 117 because they do not meet the definition of a not-for-profit organization in Statement No. 116, such as certain country clubs, would be required to follow the guidance in Statements No. 116 and No. 117. However, those entities would be required to report expenses by function only if they receive significant contributions from the general public. (The general public would exclude governments.)

- The existing not-for-profit Guides include diverse guidance concerning investments. As discussed on pages 19 and 20 of this Alert, the FASB currently has on its agenda a project on not-for-profit organizations' investments, which resulted in an exposure draft of a Statement that proposes reporting marketable equity securities and all debt securities at fair value. The proposed Guide refers to the FASB project and states that, in conformity with that project, investments in equity securities with a readily determinable fair value and debt securities should be reported at fair value. Other investments would be required to be reported using the methods available under the existing not-for-profit Guides, with not-for-profit organizations continuing to follow the guidance that was included in the not-for-profit Guide they were required to follow before the issuance of the revised not-for-profit Guide.
- For split-interest agreements, if the not-for-profit organization is the trustee, it would recognize contribution revenue at the fair value of the assets received and would recognize the assets. A liability would be reported for the present value of the expected future cash payments to be made to other beneficiaries, if any. If the not-for-profit organization is not the trustee, it would be required to recognize contribution revenue and an asset representing its right to receive future cash flows.
- Contributions of perpetual trusts held by third parties would be required to be reported as permanently restricted support, rather than as temporarily restricted support.
- Solicitations that explicitly allow the resource providers to rescind their indication that they will give are intentions and would be prohibited from being reported as contributions.
- Paragraph 156 of FASB Statement No. 117 permits cash received with donor-imposed restrictions limiting its use to the acquisition of long-lived assets to be reported as "assets restricted to investment in land, buildings, and equipment," rather than being aggregated with cash that is available for current use. Paragraph 30d of FASB Statement No. 117 requires those cash inflows to be classified as financing activities on the statement of cash flows. Because those amounts are not included in the balance-sheet accounts for cash and cash equivalents, they would be required to be classified as outflows from investment activities in the year received, in order for the statement of cash flows to articulate with the balance sheet. If the assets are acquired in a subsequent year, that activity would be reported as an inflow and outflow from investing activities.
- If a contribution is transferred to the ultimate recipient through an agent acting as an intermediary, the ultimate recipient should report

the contribution when adequate evidence that the agent has received the promise to give or the contribution becomes available.

- Total fund-raising expense would be required to be disclosed.
- Total general and administrative expense would be required to be disclosed.
- Cost of sales may be a functional classification. However, the components of that cost, such as direct labor and materials, would be required to be displayed separately on the statement of functional expenses, if such a statement is presented.
- Funds received by federated fundraisers that are designated for other not-for-profit organizations, even organizations that are part of the federated fundraiser's network, would be reported as agency funds rather than as contributions revenue because the not-for-profit organization has no discretion in distributing the funds.
- Federated fund-raisers would be permitted to report the agency transactions on the statement of activity, but the funds received under agency transactions would not be classified as revenue.
- All costs of soliciting funds, whether solicited for the not-for-profit organization itself or for other organizations, would be required to be reported as fund-raising costs.
- Agency funds held would be required to be reported in the balance sheet as assets and liabilities and reflected in the statement of cash flows as operating cash flows. If the statement of cash flows is presented using the indirect method, cash received and paid in such transactions would be permitted to be reported either gross or net.
- Not-for-profit organizations would be required to disclose certain information in the notes to the financial statements, including—

  —The nature of the organization's operations.

  —A description of each program activity that is separately identified or displayed on the statement of activity.

  —A description of the nature of prior-year information by using appropriate titles on the face of the financial statements and in a note to the financial statements, if the prior-year information, such as summarized comparative information, is presented but does not include the minimum information required by FASB Statement No. 117 and the proposed Guide (for example, if the statement of activities does not present revenues, expenses, gains, and losses by net asset class). Such a note to the financial statements is not considered part of the current-period financial statements. If the required disclosures about the nature of that information are omitted or are incomplete, the auditor ordinarily should add a paragraph to his or her report calling the omitted or incomplete disclosure to the readers' attention.

Comments on the proposed Guide are due August 14, 1995.

The AICPA expects to issue a final Guide in the second quarter of 1996.

GASB Governmental Not-for-Profit Project. In March 1995, the Governmental Accounting Standards Board (GASB) released an exposure draft of a proposed Statement, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities.* The proposed Statement would provide that governmental entities that have applied not-for-profit accounting and financial reporting principles by following SOP 78-10 or *Audits of Voluntary Health and Welfare Organizations* should apply the governmental model or the AICPA not-for-profit model. The proposed Statement would define the AICPA not-for-profit model to consist of the accounting and reporting principles contained in SOP 78-10 and *Audits of Voluntary Health and Welfare Organizations,* as amended by SOP 87-2 and as modified by all applicable FASB pronouncements issued through November 30, 1989, and as modified by most applicable GASB pronouncements.

The proposed Statement also would provide guidance for proprietary activities—that is, proprietary funds and other governmental entities that use proprietary-fund accounting—that apply the provisions of paragraph 7 of GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting.* It would provide that the only FASB Statements and Interpretations issued after November 30, 1989, that these activities should apply are those developed for business enterprises, rather than those whose provisions are limited to not-for-profit organizations or that address issues concerning primarily such organizations (such as FASB Statements No. 116 and No. 117).

The provisions of the Statement generally would be effective for financial statements for periods beginning after December 15, 1994; the modifications of the AICPA not-for-profit model for certain GASB pronouncements would be effective for entities that previously have not applied those pronouncements for periods beginning after December 15, 1995. Earlier application would be encouraged.

Comments were due by May 1, 1995.

GASB Reporting Entity Project

In December 1994, the GASB released an exposure draft of a proposed Statement, *The Financial Reporting Entity—Affiliated Organizations,* that would establish (1) standards to determine whether an organization should be classified as an affiliated organization and (2) criteria to determine whether an affiliated organization is a component unit of a primary government's reporting entity. The proposed Statement also would establish financial reporting guidance for those organizations. It would apply to financial reporting by primary governments and other stand-alone governments, as well as to the separately issued financial statements of governmental component units as defined in GASB Statement No. 14, *The Financial Reporting Entity.* The GASB expects to issue a final Statement in mid-1995. The Statement would be effective for financial statements for periods beginning after December 15, 1995, with early application encouraged.

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This Audit Risk Alert supersedes *Not-for-Profit Organizations Industry Developments—1994.*

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Auditors should also be aware of the economic, regulatory, and professional developments in *Audit Risk Alert—1994,* which may be obtained by calling the AICPA Order Department at the number below and requesting product number 022141.

Copies of AICPA publications referred to in this document can be obtained by calling the AICPA Order Department at (800) TO-AICPA. Copies of FASB and GASB publications referred to in this document can be obtained directly from the FASB or GASB by calling the FASB/GASB Order Department at (203) 847-0700, ext. 10.

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