2012

# Not-for-profit entities industry developments - 2012; Audit risk alerts

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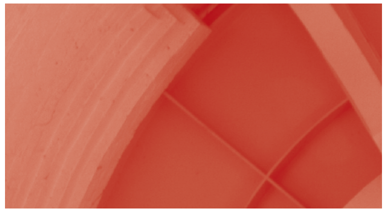

# 2012 Not-for-Profit Entities Industry Developments

AUDIT RISK ALERT

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STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

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# Notice to Readers

This Audit Risk Alert replaces *Not-for-Profit Entities Industry Developments—2011*.

This Audit Risk Alert is intended to provide auditors of financial statements of not-for-profit entities with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform. This Audit Risk Alert also can be used by an entity's internal management to address areas of audit concern.

This publication is an *other auditing publication*, as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an other auditing publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

**Recognition**

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**Feedback**

The Audit Risk Alert *Not-for-Profit Entities Industry Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert also would be appreciated. You may e-mail these comments to A&APublications@aicpa.org.

# TABLE OF CONTENTS

# How This Alert Helps You

**.01** This Audit Risk Alert helps you plan and perform your audits of not-for-profit entities (NFPs) and also can be used by an entity's internal management to address areas of audit concern. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environments in which your clients operate. This alert is an important tool to help you identify the significant risks that may result in the material misstatement of financial statements and delivers information about emerging practice issues and current accounting, auditing, and regulatory developments. You should refer to the full text of accounting and auditing pronouncements, as well as the full text of any rules or publications that are discussed in this alert. Additionally, the Audit Risk Alert *General Accounting and Auditing Developments—2011/12* (product no. 0223311) explains important issues that affect all entities in all industries in the current economic climate.

**.02** It is essential that the auditor understand the meaning of audit risk and the interaction of audit risk with the objective of obtaining sufficient appropriate audit evidence. In AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*), *audit risk* is broadly defined as the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. Further, paragraph .04 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), explains that the auditor should use professional judgment to determine the extent of the understanding required of the entity and its environment. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to assess risks of material misstatement of the financial statements and to design and perform further audit procedures.

# Economic and Industry Developments

## The Current Economy

**.03** When planning and performing audit engagements, an auditor should understand both the general and specific economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, availability of credit, consumer confidence, overall economic expansion or contraction, inflation, real estate values, and labor market conditions are likely to have an effect on an entity's business and, therefore, its financial statements.

### *Key General Economic Indicators*

**.04** The following key economic indicators illustrate the state of the economy of the United States during 2011 as we entered into 2012.

**.05** The gross domestic product (GDP) measures output of goods and services by labor and property within the United States. It increases as the economy grows or decreases as it slows. According to the Bureau of Economic Analysis, real GDP increased at an annual rate of 3.0 percent in the fourth quarter of 2011 (second estimate), which results in an estimated overall increase in GDP of 1.9 percent for 2011, compared with an increase of 3.0 percent in 2010. From December 2010 to December 2011, the unemployment rate fluctuated between 9.1 percent and 8.5 percent. The annual average rate of unemployment increased from 4.6 percent in 2007 to 9.3 percent in 2009 and stands at 8.9 percent for 2011. An unemployment rate of 10.0 percent represents approximately 15.3 million people. Additionally, one reason for the continued high unemployment rate is that more Americans are resuming their search for work.

**.06** The Federal Reserve decreased the target for the federal funds rate more than 5.0 percentage points, from its high of 5.25 percent prior to the financial crisis to less than 0.25 percent, where it remains through December 2011. The Federal Reserve described the current economic recovery in its January 25, 2012, press release as follows:

- Household spending has continued to advance, but growth in business fixed investment has slowed, and the housing sector remains depressed.
- Inflation has been subdued in recent months, and longer-term inflation expectations have remained stable.
- The unemployment rate will decline only gradually in the near term.
- The pace of economic recovery is likely to be modest in the near term.

**.07** The Federal Reserve also noted in the press release that "economic conditions—including low rates of resource utilization and a subdued outlook for inflation over the medium run—are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014." The Federal Reserve also decided to continue its program to extend the average maturity of its holdings of securities as announced in September 2011. The Federal Reserve is maintaining its existing policies of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction and will regularly review the size and composition of its securities holdings and is prepared to adjust those holdings, as appropriate, to promote a stronger economic recovery in a context of price stability. Further, the Federal Reserve will continue to monitor the economy and employ other policy tools as necessary.

## The State of NFPs

**.08** The NFP sector continues to play a large role in the world economy. Currently, 1.4 million NFPs are registered with the IRS. Contributions to these entities in 2010 exceeded $290 billion, whereas total revenues in the sector approached $2 trillion, and assets topped $4.3 trillion. According to U.S. Department of Labor statistics, 26.3 percent of the population of the United States, or 62.7 million people, did volunteer work for NFPs during 2010, putting in a total of more than 14.8 million hours of their time.

**.09** Although contributions to NFPs have been flat or, in some cases, declining, demand for the services they provide is increasing. Although the overall economic situation has been improving recently, the value of endowments, which some entities rely on for support, may have decreased substantially (in some cases, to a point below historic cost), thereby reducing or eliminating much needed funding. As a result, some NFPs have been forced to reduce their workforce or cut back programs and services. Of particular concern is a lack of availability of affordable lines of credit; increased competition for a smaller pool of contributions; maintaining effective internal controls with a reduced staff; and an increase in the number of delayed or uncollectible promises to give, grants, or accounts receivable.

## *Governance and Accountability*

**.10** For many NFPs, the organization's reputation is its most valuable asset and most important marketing tool. NFPs spend years doing good work, helping people, investing in the community, and promoting causes. That work is reflected in the reputation that the NFP maintains. As a marketing tool, the positive image associated with the NFP's name is a major reason that donors give and keep giving. As a member of the community, that same positive image can open doors and influence decision makers, not only to the benefit of the NFP but to assist in the achievement of its mission.

**.11** In this electronic, "37 seconds ago" era, an NFP's reputation can be tarnished with the click of a mouse. Facebook, Twitter, blogs, Internet newsletters, and e-mail can turn a disgruntled employee rant or volunteer comment taken out of context into front-page news. Allegations about, or investigations into, areas such as financial or sexual misconduct can have a significant and long-term impact on an NFP's reputation. This can result in a drastic reduction in the demand for the NFP's services, as well as individual and corporate donations and grant funding. It can also impede the ability of the NFP to recruit volunteers and focus on its mission.

**.12** Although no policy or set of policies can be put in place that will eliminate the risk to the reputation of an NFP, properly implemented policies and tools can help mitigate that risk. To protect their reputational investment, NFPs should be aware of employee and volunteer sentiment and have proper policies and systems, such as conflict of interest policies or whistle-blower hotlines, in place to detect and correct issues before they become problems.

## *Cause-Related Marketing*

### Consumer Donations

**.13** Businesses and NFPs have collaborated in a variety of ways to increase both the sales of the business and the revenues of the NFP. In general, these alliances are convenient because the NFP benefits from the existing spending patterns of the donor-consumer. These arrangements are common both on the Internet and with brick and mortar retail stores.

**.14** Brick and mortar retail stores often support NFPs in the surrounding areas because it adds value to the community and is both visible and important to those who shop at those stores. One way that brick and mortar businesses connect with NFPs and, often, local schools is through affinity cards. These affinity cards are provided to customers by the business and, when presented at checkout, entitle the customer to discounts or other benefits. Some businesses allow customers to link the affinity card to a local NFP or school that will receive a donation based on that customer's purchasing activity.

**.15** A popular tool for NFPs to reach out to potential and current donors is through the use of click-through donations. NFPs will typically structure online fund-raising arrangements with businesses in one of two ways:

- Donor-consumers can be directed to click a link in an e-mail from the NFP or on the NFP's website that will take them to the website of the business where they can purchase merchandise at the same price as the general public, and a portion of that sale is sent to the NFP by the business.
- A business states on its website that a portion of all sales will be donated either to a specific charity designated by the business or one identified by the donor-consumer.

**.16** It is important to note that, although donor-customers believe that they are supporting the NFP, these contributions are made by the business, not the donor-consumer because the donor-consumers receive the same goods or services for their payment without regard to whether a donation is made to the NFP. It is difficult for the NFP to monitor whether it is receiving all the promised contributions from these affiliations because a donation is conditional upon the business making a sale.

### *Joint Marketing Arrangements*

**.17** Another form of NFP-to-business partnership focuses on using the assets, reputation, and influence of both the NFP and corporate partner to support an event or a cause. These arrangements can include

- fund-raising with licensing component. The NFP allows the corporate partner to use its branding in conjunction with a variety of marketing arrangements aimed at engaging the partner's customers (but not selling a product) while increasing awareness and raising funds for the NFP. In some arrangements, the partner will provide guaranteed amounts to the NFP, typically either guaranteed minimums or a "not to exceed" amount. The licensing component of these agreements is ancillary, not core, to the transaction. An example of such an arrangement would be a licensing arrangement with a retail store whereby an NFP-branded scannable card is sold for a fixed dollar amount. Proceeds from the sale are given to the NFP. Another example would be when a beverage company provides a specific dollar amount for each Facebook "Share" generated for a specific soft drink brand during a specified time period.
- sponsorship with licensing component. The NFP and corporate partner mutually agree to the ability to use the corporate brand in conjunction with the NFP brand. In exchange for the licensing, the NFP receives a contracted sponsorship payment. The NFP agrees to utilize the partner's branding in various manners and markets as an official sponsor. For example, an NFP whose mission is to promote cardiovascular fitness holds a walk or run event with the corporate partner named as the sponsor.
- licensing with royalty payments. The NFP allows the corporate partner to use its branding on a particular product or service for a certain period of time in exchange for a fee, typically a fixed amount. For example, an NFP whose mission is to promote healthy eating has a licensing arrangement with a breakfast cereal company in which the NFP's "Eat Healthy" brand is placed on certain whole grain cereal products in exchange for a fixed royalty.

- hybrid arrangements. These arrangements typically involve pure licensing but may also include sponsorships, fund-raising, third-party sales promotions, or a combination. For example, a housewares company has a long-standing cause marketing relationship with an NFP built on a certain project that includes multiple components: royalty payments for usage of the NFP's logo on certain products sold; third-party sales promotions on specially created products available for specific periods, as well as sales promotions on other specific items year round; and individual fund-raising by the corporate partner's sales associates.

**.18** For each cause program, the NFP should carefully examine the implications for unrelated business income, as well as whether they qualify as professional fund-raising relationships. The NFP should make appropriate business decisions to ensure the success of the program and the continued compliance with any and all regulations.

## *The State of Higher Education*

**.19** Higher education, it seems, is being hit from all sides these days. From government scrutiny to internal scandals to diminished resources, colleges and universities must work hard to maintain a focus on their academic missions. Competition for students, donations, government funding, and other resources is keener than ever, making it imperative that those resources obtained by an institution enhance its reputation. These pressures are likely to create increased risk from an audit perspective.

**.20** Endowment returns improved in fiscal year 2011, returning, on average, 19.2 percent, according to the 2011 National Association of College and University Business Officers (NACUBO) Commonfund Study of Endowments (NCSE), but they have not recovered from the losses (-18.7 percent) incurred in 2008–09. In fact, 3 year average returns were just 3.1 percent, and 10 year returns were 5.6 percent. Of particular concern is the fact that longer-term returns still lag behind the amount needed to cover annual spending rates adjusted for inflation and investment management costs. The NCSE reported an average spending rate of 4.6 percent, which, after adding an additional 3 percent to 4 percent for inflation and costs, would require an average return of 7 percent to 8 percent to maintain current endowment balances. Although approximately half (49 percent) of the institutions participating in the NCSE reported that they decreased their effective spending rate in fiscal year 2011, 25 percent reported an increase, and 24 percent reported no change to their spending rates.

**.21** In January, Moody's gave a mixed outlook for higher education in 2012. Although market-leading colleges and universities have a stable outlook, the bulk of higher education institutions, especially those heavily dependent on tuition or state appropriations, have a negative outlook. The rating agency noted pressures to improve quality and limit tuition increases. That sentiment was echoed by President Obama in his fiscal year 2013 budget request that would tie the distribution of federal campus-based aid to three principles: setting responsible tuition policies, providing good value to students, and serving low income students.

**.22** The NACUBO Tuition Discounting Survey (TDS) measures tuition discount rates and other indicators of institutional grant aid awards provided by four-year private, nonprofit (independent) colleges and universities to undergraduate students. Preliminary indications from the 2011 TDS revealed one of the lowest average tuition increases in over one decade. Although tuition increases were modest, fortunately, institutional grants kept pace. In support of Moody's outlook, the survey also notes a decline in freshman enrollment and some general losses in total undergraduate enrollment.

**.23** Given these internal and external pressures, management may be inclined to be more aggressive in the recognition of gift and net tuition revenue. They may also fail to reasonably assess the long-term rate of return on their endowments when determining their current spending rate. Another risk is that management may not have appropriately accounted for endowments whose value has decreased below the amount of the restricted principle, commonly known as underwater endowments. Auditors should be alert to these issues and should consider them when assessing overall engagement risk.

### *The State of Religious Entities*

**.24** Many central religious organizations have strong structure, a large number of employees, and good systems and processes. However, some of their activities are outside the central structure and operate autonomously from the central office. It has been found that controls tend to be weaker at these outlying offices and locations, and there is more risk and less structure and process.

**.25** Economic uncertainty continues to increase the inherent risk of embezzlement and theft, particularly among religious entities. Religious institutions often do not have strong internal controls because it may be perceived as counterintuitive to their mission and direction from governing bodies. Therefore, it is critical that auditors continue to address this inherent risk when assessing controls, performing risk assessment procedures, and assessing the internal control structure.

**.26** Another timely issue relates to potential asset impairment. The Catholic Church, for example, has a tremendous shortage of priests and, as such, is consolidating parishes throughout the United States. As a result, many buildings are left unused or being closed. Auditors may need to consider the potential impairment of these long-lived assets.

# Legislative and Regulatory Developments

## Payments in Lieu of Taxes

**.27** Payments in lieu of taxes (PILOT) are amounts paid to a state or local government in place of some or all of the tax revenue lost because of the nature of the ownership or use of a particular piece of real property. Usually, it relates to the foregone property tax revenue.

**.28** PILOT payments can arise in several different ways for NFPs. In some states, real estate owned by colleges and universities is not subject to local property taxes. The state government reimburses the local governments for part of the tax revenue it would otherwise have collected had the property been held by an individual or a for-profit entity. In other cases, the institution may be asked to make a direct payment to the local government to help the local government offset the costs of providing services to the institution. Similarly, when an NFP may be exempt from equipment taxes and sales taxes, its mission may permit payment of an agreed PILOT to the local tax authorities to offset the impact on local services funded by town residents.

**.29** PILOT for NFPs is voluntary; however, with the recent recession that began in 2007, some cities want this to change. At issue are the vast amounts of land owned by universities, hospitals, churches, and other NFPs. The tax-exempt status granted to these entities by the IRS means that property taxes that would have been paid to municipalities had this land been owned by private individuals or companies are not collected.

**.30** PILOT payments and arrangements vary widely. For example, two neighboring universities were approached by their municipality for PILOT payments. The two universities teamed up and hired a consultant to perform an economic impact study on the benefits the municipalities received from having the universities as residents of the city. The results of the study presented to the city showed that the revenue generated for the city and the overall positive economic impact of the universities on the city far outweighed the costs of the services provided by the city. The study concluded that the universities provided a greater benefit to, rather than a burden on, the city.

**.31** In a another instance, a university acknowledges that there is no requirement to pay any amounts to the city, yet the university leaders felt that paying nothing is not the appropriate position for them to take, and in the spirit of sharing responsibilities, they are not opposed to such payments. They have chosen, however, to address each of the city's requests individually and to try to respond to the requests by focusing on the positive impact to the city and being creative in doing so. In one such case, the city addressed a specific water line repair that benefited the university, which, in turn, provided a police squad car to the city.

**.32** According to a survey conducted by Grant Thornton LLP in fall 2011, NFPs throughout the United States are receiving requests from various municipal governments to pay taxes, to make PILOT, or to pay fees to cover local government services (such as water and sewer service and police and fire protection) that were previously provided at no charge.

**.33** Thirty-one percent of the NFPs responding to this survey indicated that they are paying taxes outright to their municipal governments, and 8 percent are making PILOT. Another 33 percent of respondents are paying service fees to their local government, and 6 percent anticipate that they will be approached to make payments sometime in the future.

## Matters Affecting Religious Organizations

**.34** Among the most significant developments affecting religious organizations are

- challenges to the ministerial housing allowance tax law and regulations.
- challenges to religious hiring practices.
- concerns about political activities.
- the Commission on Accountability and Policy for Religious Organizations.

### Ministerial Housing Allowances

**.35** Challenges have been raised about the constitutionality of the ministers' housing allowance. In 2009, the atheist group Freedom From Religion Foundation filed a lawsuit challenging the constitutionality of Internal Revenue Code (IRC) Section 107 that relates to ministers of the gospel receiving a housing allowance and IRC Section 265(1)(6) that allows ministers of the gospel to deduct their mortgage interest and real estate taxes on Schedule A, in addition to using those expenses as housing allowance expenses. The group's argument stated that the unique benefit set aside for ministers of the gospel is a violation of the separation of church and state.

**.36** In June 2011, this legal challenge to the clergy housing allowance was voluntarily dismissed by the Federal District Court for the Eastern District of California. The reason the lawsuit was dropped was due to the fact that the atheist group was not directly affected by IRC Sections 107 and 265(1)(6); therefore, they did not have the standing to challenge it.

**.37** In another case, a federal appeals court reversed a decision that allowed ministers to use their housing allowances on more than one home. A three-judge panel from the U.S. 11th Circuit Court of Appeals issued a ruling overturning a 2010 ruling made in the Driscoll case by the U.S. Tax Court allowing the application of the ministerial housing allowance to more than one home. Any church or ministry providing for the application of a housing allowance to more than one home should consider this decision and its tax implications to the minister and employer.

**.38** Housing allowances are a decades-old tax benefit used by churches, ministries, and other employers to help offset expenses associated with the home a minister lives in while serving the respective church or ministry. It is especially helpful for small and rural congregations or those in high-cost areas who are not able to pay high enough salaries to recruit and retain pastors.

### Religious Hiring Practices

**.39** On January 12, 2012, the U.S. Supreme Court handed down a unanimous decision upholding the freedom of religious organizations to decide who will be their leaders and teachers. The case *Hosanna-Tabor Evangelical Lutheran Church and School v. Equal Employment Opportunity Commission*, 113 S. Ct. 1783 (2011), was about the validity of a ministerial exception: a concept created by lower federal courts in response to the First Amendment's religion clauses. Those clauses say that the government must respect religious exercise while not establishing religion. The Supreme Court upheld the reality of the ministerial exception while sharply chastising the federal government for denying its existence.

**.40** The extent and application of religious hiring practices could be considered part of a religious organization's employment practices and compliance with laws and regulations.

### Concerns About Political Activities

**.41** The ban on political campaign activity by charities and churches was created by Congress more than one-half century ago. In 1954, Congress approved an amendment prohibiting 501(c)(3) organizations, which includes charities and churches, from engaging in any political campaign activity. To the extent Congress has revisited the ban over the years, it has in fact strengthened the ban. The most recent change came in 1987 when Congress amended the language to clarify that the prohibition also applies to statements opposing candidates.

**.42** Currently, the law (*Charitable and Similar Gifts*, *U.S. Code* 26, Section 2522) prohibits political campaign activity by charities and churches by defining a 501(c)(3) organization as one that "does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office."

**.43** IRS Revenue Ruling 2007-41 outlines how churches and all 501(c)(3) organizations can stay within the law regarding the ban on political activity. Also, the ban by Congress is on political campaign activity regarding a candidate. Churches and other 501(c)(3) organizations can engage in a limited amount of lobbying (including ballot measures) and advocate for or against issues that are in the political arena. The IRS has provided guidance regarding the difference between advocating for a candidate and advocating for legislation.

### *Commission on Accountability and Policy for Religious Organizations*

**.44** Following efforts initiated in 2007 by Senator Charles Grassley, a member of the United States Senate Committee on Finance, to obtain information from six media-based ministries, Senator Grassley asked the Evangelical Council for Financial Accountability to lead an independent, national effort to review and provide input on major accountability and policy issues affecting such organizations. In response, the Commission on Accountability and Policy for Religious Organizations (the commission) was created. The commission includes a panel of legal experts, religious sector representatives, and nonprofit sector representatives.

**.45** Some of the issues being addressed include

- a proposal that the IRS establish an advisory committee for churches and religious organizations.
- whether churches should file the same annual information form as other nonprofits (Form 990).
- whether the income tax exclusion for housing allowances paid to clergy should be limited in some manner.
- whether the current prohibition against political campaign intervention by churches and other 501(c)(3) charities should be repealed or modified.
- whether the law should impose an excise tax (penalty) on nonprofit organizations that engage in excess benefit transactions.
- whether the current IRS audit protection for church leaders should be repealed.
- whether the rebuttable presumption of reasonableness for transactions between nonprofit organizations and their leaders should be eliminated.
- whether legislation is needed to remove uncertainty about the taxability of "love offerings" paid by church attendees to ministers through a church.

**.46** More information about the commission and these issues can be found at http://religiouspolicycommission.org.

## IRS Activities

### *Unrelated Business Income Taxes on Alternative Investments*

**.47** In the years since the stock market routinely provided double-digit annual growth, the return of low interest rates and slow investment appreciation has resulted in a proliferation of alternative investments promising better results. These investments, which can include hedge funds; real estate investment trusts; private equity funds; and timber, oil, and gas partnerships, often deliver above-average returns. The reporting requirements for tax-exempt organizations involved in alternative investments can be extremely challenging to understand. Tax-exempt organizations should be aware of the tax-reporting implications involved with alternative investments at the federal and state levels, including both unrelated business income tax (UBIT) and additional reporting disclosures.

**.48** Many of the alternative investment partnerships, limited liability companies (LLCs), and fund managers provide the necessary information to complete these reporting requirements. Unrelated business income from alternative investments is reportable on Form 990-T and state income tax returns. Most states are facing substantial budget deficits and are struggling to balance budgets. Looking to NFPs as a potential revenue source, state governments are focusing on entities involved in alternative investments to raise additional revenue.

**.49** Frequently, an alternative investment fund will turn to international investments to increase the rate of return for investors. Investments in foreign partnerships and foreign corporations may give rise to additional filings with the IRS. Failure to file carries a substantial penalty for each form not filed on time. Additional filing requirements could include the following forms:

- Form 926 for foreign corporations
- Form 5471 for controlled foreign corporations
- Form 8621 for passive foreign investment companies
- Form 8858 for foreign disregarded entities
- Form 8865 for foreign partnerships
- TD F 90-22.1 for foreign bank account reports
- Form 8886 for reportable transactions

**.50** If Schedule K-1 received by an NFP from an alternative investment makes no reference to unrelated business income or investments in foreign corporations or partnerships, the NFP should contact the manager of the investment directly to confirm that there is no information to report or unrelated business income subject to tax.

### *IRS Exempt Organizations Division 2012 Work Plan*

**.51** This year, the Exempt Organizations Division (EOD) of the IRS will support several overarching focus areas that are included in its 2012 Work Plan. These areas include, among others, the following:

- *Auto revocation for nonfilers*. The Pension Protection Act of 2006 (PPA) required that almost all tax-exempt organizations file an annual return or notice with the IRS every year and provided that any organization that does not file a required return or notice for 3 consecutive years would automatically lose its tax-exempt status. The PPA required the IRS to publish and maintain a list of revoked organizations. As of November 2011, the list totaled approximately 380,000 organizations. In early January 2012, the EOD incorporated the revocation list into Select Check (http://apps.irs.gov/app/eos/), a new online application that consolidates 3 separate search pages into a single entry point.

Through Select Check, users can find out whether an organization

— is eligible to receive tax deductible charitable contributions.

— has had its tax exempt status automatically revoked.

— has filed a Form 990-N annual electronic notice.

Notice 2011-44 provides general rules for applying for reinstatement of tax-exempt status (including requests for retroactive reinstatement) until regulations under the new PPA provisions are enacted. Notice 2011-43 and Revenue Procedure 2011-36 provide transition relief for certain small tax-exempt organizations by allowing them to pay a reduced application fee of $100 and regain their tax-exempt status retroactive to the date of revocation.

- *Redesign of Form 990 to promote transparency and compliance*. The new form that was effective in tax year 2008 has provided the EOD with a wealth of information on exempt organizations. The EOD has used this information to develop risk models to assess the likelihood of noncompliance by organizations, allowing more effective use of examination resources. In fiscal year 2012, the EOD will incorporate information from the revised Form 990 into the following activities:

  — *Section 501(c)(4), (5), and (6) self-declarers*. These groups (social welfare organizations; labor, agricultural, and horticultural groups; and business leagues, such as a chamber of commerce) can declare themselves tax exempt without seeking a determination from the IRS. The EOD will review organizations to ensure that they have classified themselves correctly and that they are complying with applicable rules. In fiscal year 2012, the EOD will send a comprehensive questionnaire to organizations based on Form 990 filings to assess compliance in this area.

  — *Political activity*. As in any election year, the IRS will continue its work to enforce the rules relating to political campaigns and campaign expenditures. In fiscal year 2012, the IRS will combine what it has learned from past projects on political activities with new information gleaned from the redesigned Form 990 to focus its examination resources on serious allegations of impermissible political intervention.

— *Form 990-T and UBIT*. In fiscal year 2012, the IRS will be looking at organizations that report unrelated business activities on Form 990 but have not filed Form 990-T. In addition, the IRS will analyze Form 990-T data to develop risk models that will help identify organizations that consistently report significant gross receipts from unrelated business activities but declare no tax due. The IRS will use this work in connection with a coming UBIT project.

— *Governance*. The new Form 990 has given the IRS a great deal of information about organizational governance practices. In fiscal year 2012, the IRS will be using this data to look at connections between certain governance practices and tax compliance.

- *International*. Globalization affects all parts of our economy, including the exempt sector. Many tax-exempt organizations, in order to accomplish their charitable purposes, are moving money, people, and goods across U.S. borders. The IRS's focus is whether assets of exempt organizations that are dedicated for charitable purposes internationally are being diverted for noncharitable purposes.

  In fiscal year 2012, the IRS will continue to examine exempt organizations that operate internationally to ensure that those activities are consistent with their charitable purposes. This will include a number of large private foundations that have international activities with assets or total annual revenue greater than $500 million. The IRS will be looking at compliance issues unique to private foundations, such as self-dealing, failure to distribute income, excess business holdings, jeopardy investments, and taxable expenditures.

  In addition, the IRS will continue to look at organizations that report ownership of a foreign bank account to determine

  — whether the organization maintains adequate books and records to ensure assets are used for charitable purposes.

  — whether the organization has maintained proper discretion and control over funds that have left the United States.

  — whether the organization has met all filing requirements.

  — how foreign operations or grant making furthers the organization's exempt purpose.

- *National Research Program*. The IRS-wide National Research Program (NRP) looks at employment tax matters involving taxable and tax-exempt organizations, large and small businesses, and the government sector. The results of this project will direct improvements to IRS procedures for auditing, processing, and resolving employment tax return cases. The project applies to exempt organizations through the examination of the employment tax returns of 1,500 organizations, with 500 selected randomly each year over a 3 year period. Fiscal year 2012 is the third and final year of the project, focusing on completing all remaining exams and providing data for the overall IRS report.

- *Colleges and universities*. The IRS is completing a wide-ranging review of this important part of the tax-exempt sector. Information from a compliance questionnaire sent to 400 colleges and universities was summarized for the public in an interim report in May 2010. The IRS is working to further analyze questionnaire data and to complete examinations of selected colleges and universities. A final report will highlight the findings drawn from the questionnaire data and exam results.
- *Disaster relief communications*. Disasters in the United States and abroad often prompt an immediate effort from the exempt community to raise and distribute funds for relief. Unfortunately, disasters also present opportunities for organizations to abuse the tax law. In fiscal year 2012, the IRS will work to identify specific compliance issues that are most commonly associated with disaster relief efforts and will develop a communications plan to help educate new and existing organizations about the rules and responsibilities in this area. The IRS wants to offer guidance for those groups that provide relief to those in need without engaging in activities that may cause them to be penalized or jeopardize their exemption.
- *Group rulings*. The Advisory Committee on Tax Exempt and Government Entities (ACT) issued a report on group exemptions in June 2011. The IRS will continue the analysis of the group exemption issue begun by ACT through development of a questionnaire to be sent to a cross-section of group ruling holders. The questionnaire will explore the practices used by the central or parent organization to meet the requirements of Revenue Procedure 80-27 and will include questions about the methods used to satisfy annual filing requirements. In addition, based on experience with the autorevocation process, the IRS plans to expand educational efforts for group ruling members.
- *Mortgage foreclosure assistance*. As residential foreclosures have mounted, the IRS has seen the number of exempt organizations involved in foreclosure assistance activities rise, as well. In fiscal year 2012, the IRS will focus on the activities of these organizations to determine whether they are fulfilling their exempt purpose and complying with the requirements of IRC Section 501(q).
- *State-sponsored workers compensation organizations—501(c)(27)*. In fiscal year 2012, the IRS will review the activities of a number of state-sponsored groups that provide workers compensation insurance and claim exempt status under IRC Section 501(c)(27). The IRS will contact these organizations to determine whether they are meeting the criteria for exemption, correctly classified as exempt, and paying any employment taxes due.
- *Private foundations*. Many private foundations hold substantial assets and generally are subject to more restrictive rules than other charities. Based on information reported on Form 990-PF, the IRS is examining a selection of the largest private foundations to evaluate compliance with tax law.

**.52** Additional information on these and other topics, as well as the complete EOD 2012 Work Plan, is available at www.irs.gov/charities.

### *Department of the Treasury and the IRS Issue Priority Guidance Plan for 2011–12*

**.53** The joint Department of the Treasury and IRS priority guidance plan for 2011–12 contains the following items of interest to tax-exempt organizations:

- Final regulations to implement Form 990 revisions and modify the public support test
- Guidance updating grantor and contributor reliance criteria under IRC Sections 170 and 509
- Final regulations on new requirements for supporting organizations, as added by the PPA
- Additional guidance on 509(a)(3) supporting organizations.
- Final regulations under IRC Section 7611 relating to church tax inquiries and examinations
- Guidance on excess business holdings rules in IRC Section 4943, as amended by the PPA
- Guidance on program-related investments under IRC Section 4944
- Regulations on new excise taxes on donor-advised funds and fund management under IRC Section 4966, as added by the PPA
- Regulations on group returns

**.54** Additional information on these and other topics is available at www.irs.gov/foia/article/0,,id=181687,00.html.

### *Listing of Published Guidance—2011*

**.55** Readers should be aware that the IRS website contains a digest of published guidance for tax-exempt entities issued in 2011 at www.irs.gov/charities/content/0,,id=232774,00.html. The published guidance includes Treasury regulations, revenue rulings, revenue procedures and notices, and announcements of recently published issues of interest to tax-exempt entities.

**.56** The IRS website also contains an archive that presents digests of IRS-published guidance of interest to tax-exempt entities for the years 1954–2010. The archived guidance can be found at www.irs.gov/charities/article/0,,id=151053,00.html. Additionally, the IRS has a useful tool for NFPs to assist them in maintaining their tax-exempt status through compliance with IRS requirements. The publication *Compliance Guide for 501(c)(3) Public Charities* is available at www.irs.gov/pub/irs-pdf/p4221pc.pdf.

# Audit and Attestation Issues and Developments

## Audit Risks for NFPs

**.57** As noted in paragraph .17 of AU section 312, some possible audit responses to significant risks of material misstatement include increasing the extent of audit procedures, performing procedures closer to year-end, or modifying audit procedures to obtain more persuasive evidence. Additionally, given constantly changing economic conditions that could affect your NFP client, auditors may consider changes in the environment throughout the audit and potentially modify audit procedures to ensure that risks are adequately addressed.

**.58** Although it is impossible to predict and include all accounting, auditing, and attestation issues that may affect your NFP engagements, this alert covers the primary areas of concern. As you perform your engagements, continue to remain alert to economic, legislative, and regulatory developments, as well as the associated accounting, auditing, and attestation issues.

## Supplementary and Other Information Related to Financial Statements

**.59** In February 2010, the AICPA Auditing Standards Board (ASB) issued a trio of auditing standards related to the auditor's responsibility for other information, supplementary information, and required supplementary information (RSI). These three standards supersede AU sections 550A, *Other Information in Documents Containing Audited Financial Statements*; 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*; and 558A, *Required Supplementary Information*. All three standards are effective for audits of financial statements for periods beginning on or after December 15, 2010. Early application is permitted.

### *Other Information in Documents Containing Audited Financial Statements*

**.60** Statement on Auditing Standards (SAS) No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 550), addresses the auditor's responsibility relative to other information in documents containing audited financial statements and the auditor's report thereon. Typically, for an NFP organization, this includes the client's annual report and those reports issued to governmental agencies. This SAS establishes the requirement for the auditor to read the other information of which the auditor is aware because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information.

### *Supplementary Information in Relation to the Financial Statements as a Whole*

**.61** SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*, AU sec. 551), addresses the auditor's responsibility when engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. For NFPs, this typically includes consolidating schedules and those that may have an organizational purpose but excludes RSI that is considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. An example of supplementary information that would be included under SAS No. 119 would be the "Schedule of Expenditures of Federal Awards" in the financial statements of an NFP that falls under U.S Office of Management and Budget Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations*. Such information may be presented in a document containing the audited financial statements or separate from the financial statements.

**.62** The auditor may report on supplementary information within an explanatory paragraph following the opinion paragraph or in a separate report. Generally, the date of the auditor's report on the supplementary information should not be earlier than the report date on the audited financial statements.

**.63** During 2011, the AICPA issued Technical Questions and Answers (TIS) section 9170.01, "Consolidating Information Presented on the Face of the Financial Statements" (AICPA, *Technical Practice Aids*), that applies the guidance in SAS No. 119 to consolidating information presented on the face of the financial statements. TIS section 9170.01 clarifies that such consolidating information is supplementary information and should be reported on in accordance with the guidance in SAS No. 119.

### RSI

**.64** SAS No. 120, *Required Supplementary Information* (AICPA, *Professional Standards*, AU sec. 558), addresses the auditor's responsibility with respect to RSI. The SAS defines *RSI* as information that a designated accounting standard setter requires to accompany an entity's basic financial statements. For an NFP, this would include the information that a designated accounting standard setter considers to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context.

**.65** SAS No. 120 modified the auditor's reporting responsibilities. Previously, the auditor was only required to report on RSI in certain circumstances. Under SAS No. 120, the auditor should always report on RSI in an explanatory paragraph following the opinion paragraph.

**.66** SAS No. 120 requires the auditor to perform specified procedures in order to

- describe in the auditor's report whether RSI is presented.
- communicate therein when some or all of the RSI has not been presented in accordance with guidelines established by a designated accounting standard setter or when the auditor has identified material modifications that should be made to the RSI for it to be in accordance with guidelines established by the designated accounting standard setter.

## Going Concern Risks for NFPs

**.67** Recently, there has been an increase in the number of bankruptcies of NFPs, especially in the social services sector. One of the more recent high-profile failures was the closure of Hull House in Chicago, IL.

**.68** Started in 1889 by Nobel laureate Jane Addams, Hull House existed to help Chicago's immigrants build responsible, self-sufficient lives. Hull House continued Jane Addams's legacy by offering foster-care services, job training, counseling, and literacy and other education programs at more than 40 sites throughout Chicago. In January 2012, its 300 employees received their final paychecks.

**.69** It was almost the perfect storm: (*a*) an increased demand for social services because of the difficult economic times, (*b*) excess dependence on state contracts to fund its mission, (*c*) late payments from the state of Illinois on its contracts as a result of the state's own fiscal difficulties, and (*d*) a lack of reserves to weather the difficult economic times. The combination of these factors made it difficult to withstand any further degradation in its financial performance.

**.70** The following indicators suggest a risk that an NFP cannot continue as a going concern and may signal the existence of a precursor to a possible bankruptcy filing:

- Continued losses from operations
- Borrowing of temporarily restricted net assets to fund unrestricted operations
- Transfers of investments to fund operating deficits above and beyond budgeted amounts
- Declining fund-raising dollars available for operations
- Unrealistic budget assumptions
- Lack of liquid unrestricted net assets
- Past due receivable amounts from government contracts
- Lack of borrowing capacity on current lines of credit
- Significant unfunded defined benefit plans
- Difficult union negotiations
- Excess debt leverage
- Debt covenant violations

## Related-Party Transactions

**.71** As described in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 850, *Related Party Disclosures*, parties are considered to be related when one has the power through ownership, contractual right, family relationship, or otherwise to directly or indirectly control or significantly influence the other. Parties are also related when they are under the common control or significant influence of a third party. Certain disclosures are required for related-party transactions and when related-party relationships exist.

**.72** Per FASB ASC 850-10-20, related parties include

- affiliates of the entity.
- entities for which investments in their equity securities would be required, absent the election of the fair value option under the "Fair Value Option" subsection of FASB ASC 825-10-15, to be accounted for by the equity method by the investing entity.
- trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management.
- principal owners of the entity and members of their immediate families.
- management of the entity and members of their immediate families.

- other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests.
- other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

**.73** For NFPs, one of the more common related-party relationships is that of its board members. Through their personal affiliations and professional job responsibilities, NFP board members often operate in the same circles as the NFP they serve. This arrangement can lead to conflicts of interest. Conflicts of interest are usually viewed negatively but can sometimes be beneficial to an organization. The fact that a conflict exists does not prevent the NFP from entering into a transaction if it is determined that the transaction is appropriate for the NFP and its constituents. An example may include an NFP that receives free or below market rent from an entity whose CEO is a member of the governing board of the NFP. Although this is a related-party transaction requiring disclosure, saving the cost of rent during times of funding reductions may provide the NFP with resources that can be directed toward its programmatic mission and could be considered a prudent operating decision.

**.74** Auditors should review related-party transactions with their clients and understand the process that is used to evaluate whether a transaction or relationship that involves a member of the governing board or management is in the best interests of the NFP. Additionally, auditors should understand and document the policy and actions that the NFP has adopted when such a conflict is identified.

**.75** Accordingly, material transactions with *related parties*, as defined under FASB ASC 850, including those NFP relationships with unconsolidated supporting organizations, brother-sister organizations, and certain national and local affiliates, as well as entities whose officers or directors are members of the NFP's governing board, may have to be disclosed. In addition, the auditor should ensure that the NFP discloses significant concentrations of revenues and receivables and obligations associated with contributions, such as gift annuities payable to related parties or environmental remediation liabilities associated with real estate donated by related parties.

## Higher Education Audit Issues

**.76** As the fiscal year 2012 not-for-profit audit season approaches, there are a few areas to consider when planning audits of higher education institutions. Key among them is the overall engagement risk stemming from increasing competition and diminishing resources, as discussed in "The State of NFPs" section of this alert. Despite improving endowment returns in the last couple years, long-term returns still lag behind the average annual payout. In addition, private institutions have seen a decline in enrollment during the last year as students look to public institutions for more economical options. Add to this the public and private scrutiny that colleges and universities are under, and the likelihood of more aggressive accounting must be considered in the audit planning process.

**.77** As the pressure for revenue growth increases, more and more colleges and universities are expanding their international operations, and although some institutions are doing so as part of a larger strategic initiative, more likely, activities are being addressed on a case-by-case basis. For example, a faculty member may decide to research crop production in Zimbabwe. If an institution does not have controls in place to identify such international activity, it may be months or years before the financial and legal offices are made aware of it. As an institution's global presence increases, so does its administrative burden and the risk that it will run afoul of the laws in a foreign country. Such violations can result in fines, halt operations in a given country, and negatively affect the institution's reputation. Auditors should obtain an understanding of the institution's controls around identifying and overseeing international activities. Depending on the sophistication of the institution's global activities, additional work may be required to ensure that activity is properly recorded and that no unrecorded liabilities are related to regulatory violations.

**.78** Finally, for colleges and universities that do not have publicly traded debt and are, therefore, considered nonpublic by FASB, additional disclosures under Accounting Standards Update (ASU) No. 2010-20, *Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and Allowance for Credit Losses*, will be required in fiscal year 2012. See the "Accounting Issues and Developments" section of this alert for additional information about this ASU. Auditors should ensure that their clients are prepared to implement this guidance. For additional information on this topic, as it relates to higher education, see the discussion and sample disclosures published by NACUBO in the August 25, 2011, article "NACUBO Issues Guidance on Credit Quality Disclosures," which can be found at www.nacubo.org.

## New Markets Tax Credit Program

**.79** NFPs that serve low-income communities may be the recipients of funding from the New Markets Tax Credit (NMTC) Program. Auditors of NFPs that receive NMTC Program funding should be familiar with the program and should plan and perform the audit to respond to the risks of material misstatements to the financial statements related to accounting for the funding.

**.80** The NMTC Program was established by Congress in 2000 to spur new or increased investments into operating businesses and real estate projects located in low-income communities. The NMTC Program attracts investment capital to low-income communities by permitting individual and corporate investors to receive a tax credit against their federal income tax return in exchange for making equity investments in specialized financial institutions called community development entities (CDEs). The credit provided to the investor totals 39 percent of the investment in a CDE and is claimed over a 7 year credit allowance period. The investment in the CDE cannot be redeemed before the end of the 7 year period.

**.81** Since the NMTC Program's inception, the U.S. Department of the Treasury's Community Development Financial Institutions (CDFI) Fund has made almost 700 awards, allocating a total of $33 billion in tax credit authority to CDEs through a competitive application process.

**.82** CDEs are required to invest the proceeds of the equity investments in low-income communities. NMTC Program investments by CDEs may be used to finance a wide variety of activities, including loans to, or equity investments in, businesses; loans to, or equity investments in, real estate projects; and capitalization of other CDEs.

**.83** Funding from CDEs is often in the form of loans or equity investments in NFPs' real estate projects. The transactions are usually complex and have specific audit risks that should be considered by the auditor of the NFP.

### *Accounting Issues*

**.84** NMTC Program funding arrangements that NFPs enter into are not all structured in the exact same way. However, they often include the following elements:

- Several separate legal entities are created to facilitate the transaction. Often, an LLC or a limited partnership (investment fund) is created to receive funds from the individual or corporate investor, a CDE is created as a separate legal entity, and the NFP is often required to establish a separate legal entity to own the real estate project.
- The NFP is obligated to indirectly invest its own funds in the real estate project via a loan (note receivable) or equity investment in the investment fund.
- The investment fund pools the funding from the individual or corporate investor and the NFP and invests those funds in the CDE.
- The CDE invests the funds it receives into the real estate project. The investment from the CDE is in the form of a loan (note payable) or an equity investment. If the funds from the CDE are in the form of a loan, often, financial and nonfinancial covenants must be complied with.
- Usually, a put and call option agreement exists that allows the NFP to obtain control or ownership, or both, of the investment fund or CDE entity at the end of the seven-year compliance period, provided that certain conditions are met. If the conditions are met, and the NFP obtains control, it would be allowed to cancel the loan (note payable) or equity investment from the CDE, as well as the loan (note receivable) or equity investment by the NFP in the investment fund, with little or no cash outlay.

**.85** The NMTC Program funding received by the NFP usually does not fund the full amount needed for the real estate project. Therefore, the NFP usually funds the remainder via a combination of debt, grants, contributions, or NFP funds, which further adds to the complexity of the project.

### *Audit Risks*

**.86** Auditors of NFPs that receive NMTC Program funding may wish to consider the following risks that are common to NMTC Program funding:

- Risk that the NFP will not properly account for its interests in the investment fund or separate legal entity created to own the real estate project

- Risk that the NFP will not properly account for the loan (note receivable) or equity investment it makes to the investment fund
- Risk that the NFP will not properly account for the loan (note payable) or equity investment it receives from the CDE
- Risk that the NFP will not include appropriate disclosures related to the NMTC Program funding

**.87** When required, auditors should design further audit procedures related to the NMTC Program funding to address the risks previously described, as well as any additional risks that are unique to the NFP under audit.

**.88** More information about the NMTC Program can be found on the CDFI website at www.cdfifund.gov/what_we_do/programs_id.asp?programID=5.

## Auditing Fair Value Measurements

**.89** Auditors should continue to be aware of audit issues involving fair value measurements. Particular assets, liabilities, and components of net assets are measured or disclosed at fair value in the financial statements, and it is management's responsibility to develop the fair value measurements and disclosures. This includes alternative investments, gifts in kind (GIK), and defined benefit pension plan assets and liabilities, as well as investments in split-interest agreements.

**.90** The strongest audit evidence to support a fair value is an observable price in an active market (level 1). If that is not available, a valuation method should incorporate market-based assumptions that market participants would use in their estimates when that information is available without undue cost and effort. If information about market participant assumptions is not available, management may use its own assumptions, as long as no contrary data indicate that market participants would use different assumptions (level 3).

**.91** The auditor should obtain an understanding of the entity's process for determining fair values, as well as whether the fair value measurements and disclosures are in accordance with U.S. generally accepted accounting principles (GAAP).

**.92** According to paragraph .23 of AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*), substantive tests of the fair value measurements may involve (*a*) testing management's significant assumptions, the valuation model, and the underlying data; (*b*) developing independent fair value estimates for corroborative purposes; or (*c*) reviewing subsequent events and transactions. Paragraph .26 also notes that when testing the fair value measurements and disclosures, the auditor should evaluate whether management's assumptions are reasonable and reflect, or are not inconsistent with, market information.

## Audit Issues for Pension Plan Reporting

### *Projected Benefit Obligations and Discount Rates*

**.93** The discount rate is integral to the determination of a plan's projected benefit obligations (PBO); the lower the discount rate, the higher the benefit obligation. The discount rate should reflect the expected benefit payments, as well as other demographics of the plan's participants (such as trends and nature of benefit distributions, gradual plan population shifts, plan mergers or acquisitions, and changes to plan benefit formulas or plan freezes).

**.94** Management of the plan sponsor is required to determine the appropriate discount rate on an annual basis. This means that, at each measurement date, management should use discount rates that reflect the then current level of interest rates. In the United States, the discount rate is generally based on the yields of fixed-income debt securities, such as bonds rated AA or higher by a recognized rating agency.

**.95** Interest rates have generally declined in 2011 from 2010, as have discount rates. The decrease in this year's interest and discount rates will likely have a negative effect on plan funding levels, significantly affecting the plan sponsor's 2011 year-end financial position. As the PBO increases, the unfunded amount (the excess of the plan's PBO over its assets) included in the plan sponsor's statement of financial position also increases. In consideration of recent trends, auditors should pay particular attention to the discount rates used by management. Management should be using interest rates as of the balance sheet date to determine the appropriate discount rate.

**.96** Auditors should review and analyze their client's discount rates used to calculate their PBO and document the assumptions used in the calculations, including current market conditions that support the estimate.

### *Plan Assets and Rates of Return*

**.97** The discount rate for a plan's benefit obligations should not be confused with the expected long-term rate of return on plan assets. The expected return on plan assets is a long-term actuarial measure and does not necessarily change due to short-term market conditions but would change if there is a change in the composition of investments. Given recent economic conditions, some plan sponsors are changing the mix of investments that have been used historically. This makes the historic rate of return less relevant as compared with expectations for future returns based on the new allocation of investments.

**.98** Auditors should understand and document how the expected rate of return on plan assets was determined by management, including whether such rate took into consideration any changes in the mix of the plan's investments. Auditors should also evaluate the plan sponsor's disclosures to determine whether they appropriately include the following information for major asset classes:

- A description of the basis used to determine the overall expected rate of return
- The extent to which the overall expected rate of return was based on historical returns
- The extent to which adjustments were made to historical returns to reflect expectations of future returns and how those adjustments were determined

## Service Organizations

**.99** Many NFPs use service organizations (such as bank trustees, payroll processing companies, or benefit plan administrators) to process transactions. Often, SAS No. 70 type 2 reports were obtained and used by the auditor to reduce the amount of substantive testing required. These reports were prepared by service auditors based on guidance in SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, AU sec. 324). The guidance for service auditors previously included in AU section 324 has been moved to the attestation standards in AT section 801, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*). Effective for periods ending on or after June 15, 2011, reports issued by service auditors are now prepared in accordance with Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801).

**.100** Similar to SAS No. 70 reports, SSAE No. 16 reports (also referred to as service organization control [SOC 1] reports) are specifically intended to meet the needs of the entities that use service organizations (user entities) and the CPAs who audit the user entities' financial statements (user auditors) in evaluating the effect of the controls at the service organization on the user entities' financial statements. User auditors use these reports to plan and perform audits of the user entities' financial statements. There are two types of reports for these engagements:

- *Type 1*. Report on the fairness of the presentation of management's description of the service organization's system and the suitability of the design of the controls to achieve the related control objectives included in the description as of a specified date.
- *Type 2*. Report on the fairness of the presentation of management's description of the service organization's system and the suitability of the design and operating effectiveness of the controls to achieve the related control objectives included in the description throughout a specified period.

**.101** Use of these reports is restricted to management of the service organization, user entities, and user auditors.

**.102** A new requirement in SSAE No. 16 that was not included in SAS No. 70 is the requirement for the service auditor to obtain a written assertion from management of the service organization about the fairness of the presentation of the description of the service organization's system and the suitability of the design. In a type 2 engagement, the assertions must also address the operating effectiveness of the controls. Those assertions will either accompany the service auditor's report or be included in the description of the service organization's system.

**.103** The guidance in AU section 324 for user auditors continues to be effective until AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization* (AICPA, *Professional Standards*), becomes effective for audits of financial statements for periods ending on or after December 15, 2012. See the "On the Horizon" section of this alert for more information on the ASB's Clarity Project.

### *Timing Considerations*

**.104** If the user auditor plans to use a type 2 SOC 1 report as audit evidence that controls at the service organization are operating effectively, the amount of time elapsed since the tests of controls needs to be considered. The SOC 1 report may be for a period that precedes or is subsequent to the period under audit or may overlap a portion of the period under audit. If the portion of the audit period that is not covered by the service auditor's tests of operating effectiveness (the gap period) is significant, the less audit evidence the tests of operating effectiveness may provide. When there is overlap of the two periods, an additional type 2 SOC 1 report covering the preceding or subsequent period may provide additional audit evidence. In other cases, when there is little or no overlap, and another SOC 1 report is not available, the user auditor may consider the need to perform or use another auditor to perform tests of controls at the service organization. If the period covered by the testing in the SOC 1 report is completely outside the period under audit, the user auditor should not rely on such tests as support for control risk reduction because they do not provide evidence of the operating effectiveness of controls during the period under audit. The user auditor should consider the following relevant factors when determining the nature and extent of the additional evidence that is needed to update a type 2 SOC 1 report:

- The significance of the assessed risks of material misstatement at the assertion level
- The specific controls that were tested during the period covered by the type 2 SOC 1 report and significant changes to them since they were tested, including changes in the information systems, processes, and personnel
- The degree to which audit evidence about the operating effectiveness of those controls was obtained
- The length of the remaining period
- The extent to which the user auditor intends to reduce further substantive procedures based on the reliance on controls
- The effectiveness of the control environment and related monitoring controls at the user entity

**.105** If testing controls is not an effective or efficient approach for the user auditor, management of the user entity may consider requesting that the service organization have the service auditor perform the necessary update testing. Basically, the user auditor can only rely on the results of tests of the operating effectiveness of controls when he or she believes that there has been sufficient testing to achieve the necessary audit evidence for the entire period under audit.

### Compilation and Review Engagements

**.106** The AICPA Guide *Compilation and Review Engagements* provides additional information on implementing Statement on Standards for Accounting and Review Services No. 19, *Compilation and Review Engagements* (AICPA, *Professional Standards*). It also includes illustrative engagement and representation letters, sample compilation and review reports, detailed illustrations, and case studies. This guide is now available electronically and in paperback on www.cpa2biz.com.

## Accounting Issues and Developments

**.107** Given the current economic climate, auditors should consider a number of accounting and financial reporting issues, such as the following:

- Reporting of related entities

- Fair value measurements
- Disclosures about credit quality and allowance for credit losses

## Reporting of Related Entities, Including Consolidation

**.108** FASB ASC 810-10-10-1 states that the purpose of consolidated financial statements is to present, primarily for the benefit of the shareholders and creditors of the parent entity, the results of operations and the financial position of a parent entity and its subsidiaries essentially as if the group were a single entity with one or more branches or divisions. There is a presumption that consolidated financial statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the entities in the group directly or indirectly has a controlling financial interest in the other entities. Pursuant to FASB ASC 810-10-15-17, NFPs do not apply the guidance for variable interest entities in FASB ASC 810, *Consolidation*, to their relationships with other entities. Exhibit 1, "Relationships of a Not-for-Profit Reporting Entity," describes some common relationships with other entities and identifies where these relationships are discussed in FASB ASC. The guidance in this table applies to relationships with entities that provide goods or services that accomplish the purpose or mission for which the NFP exists or that serve the NFP's administrative purposes, but the guidance does not apply to interests in for-profit entities in which the objective is to invest in the entity for total return (including an objective to realize investment income, gains upon sale, or both). Exhibit 1 summarizes certain guidance in FASB ASC but is not intended as a substitute for reading the guidance itself.

**Exhibit 1—Relationships of a Not-for-Profit Reporting Entity**

| ***Relationship*** | ***Financial Accounting Standards Board* Accounting Standards Codification™ *Reference*** |
|---|---|
| *Relationships With Not-for-Profit Entities* | |
| The reporting entity is the sole corporate member of a not-for-profit entity (NFP). | Use the guidance in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 958-810-25-2 and 954-810-45-3A. |
| The reporting entity has a controlling financial interest through direct or indirect ownership of a majority voting interest in the other NFP. | Use the guidance in FASB ASC 958-810-25-2. |
| The reporting entity controls another NFP through a majority voting interest in its board and has an economic interest in that other entity. | Use the guidance in FASB ASC 958-810-25-3. |

*(continued)*

| *Relationship* | ***Financial Accounting Standards Board* Accounting Standards Codification™ *Reference*** |
|---|---|
| The reporting entity controls an NFP through a form other than majority ownership, sole corporate membership, or majority voting interest in the board of the other entity and has an economic interest in that other entity. | Use the guidance in FASB ASC 958-810-25-4. |
| The reporting entity has control over another NFP or an economic interest in the other but not both. | Use the guidance in FASB ASC 958-810-25-5. |
| The reporting entity receives distributions from a related fund-raising foundation, but it does not control that foundation. | Use the guidance in the "Transfers of Assets to a Not-for-Profit Entity or Charitable Trust that Raises or Holds Contributions for Others" sections of FASB ASC 958-605. |
| *Relationships With For-Profit Entities* | |
| The reporting entity owns a majority of a for-profit entity's common voting stock. | Use the guidance in the "General" sections of FASB ASC 810-10 to determine whether that interest constitutes a controlling financial interest. |
| The reporting entity owns 50 percent or less of the common voting stock of an investee and can exercise significant influence over the investee's operating and financial policies. | Except when the reporting entity elects to report such interests at fair value, in accordance with the "Fair Value Option" sections of FASB 825-10, use the equity method of accounting, in accordance with FASB ASC 323-10. |
| The reporting entity owns 50 percent or less of the common voting stock of an investee, and the reporting entity neither controls nor can exercise significant influence over the investee's operating and financial policies. | Use the guidance in FASB ASC 958-320-35-1 or 958-325-35. |

| ***Relationship*** | ***Financial Accounting Standards Board* Accounting Standards Codification™ *Reference*** |
|---|---|
| The reporting entity is the general partner of a for-profit limited partnership or similar entity, such as a limited liability company (LLC) that has governing provisions that are the functional equivalent of a limited partnership. | Use the guidance in FASB ASC 810-20 to determine whether the general partner within the group controls and, therefore, should consolidate the limited partnership or similar entity. If not required to consolidate, use the equity method, unless that partnership interest is reported at fair value in conformity with the "Fair Value Option" sections of FASB 825-10. |
| The reporting entity is a limited partner of a for-profit limited partnership or similar entity that is engaged in activities other than real estate activities. | Entities typically use by analogy the guidance in FASB ASC 970-323. |
| The reporting entity has an interest in an LLC. | Use the guidance in FASB ASC 323-30-35-3, if the functional equivalent of a limited partnership, or FASB ASC 810-10-25-3, if the functional equivalent of a regular corporation. Unless required to consolidate, the reporting entity may elect to report its interest at fair value in accordance with the "Fair Value Option" sections of FASB 825-10. |
| The reporting entity has a noncontrolling interest that constitutes more than a minor interest in a for-profit partnership, limited liability entity, or similar entity engaged in real estate activities. | Except when the reporting entity elects to report such interests at fair value, in accordance with the "Fair Value Option" sections of FASB 825-10, use the equity method of accounting, in accordance with the guidance in FASB ASC 970-323. |
| The reporting entity holds over 50 percent of the total partnership interest in a limited partnership engaged in real estate activities. | Entities might apply by analogy the guidance in FASB ASC 970-323 and 970-810. |
| The reporting entity has a noncontrolling interest that constitutes a minor interest in a for-profit partnership, limited liability entity, or similar entity engaged in real estate activities. | Entities typically apply the guidance in FASB ASC 958-325. |

*(continued)*

| ***Relationship*** | ***Financial Accounting Standards Board* Accounting Standards Codification™ *Reference*** |
|---|---|
| The reporting entity has an interest in a general partnership. | Except when the reporting entity elects to report such interests at fair value, in accordance with the "Fair Value Option" sections of FASB 825-10, entities typically use by analogy the guidance in FASB ASC 970-810. |
| The reporting entity has a contractual management relationship with another entity in which it does not have a financial interest. | Use the guidance in the "Consolidation of Entities Controlled by Contract" sections of FASB ASC 810-10 to determine whether the arrangement constitutes a controlling financial interest. |
| *Relationships With Special Entities* | |
| The reporting entity has a relationship with a variable interest entity (VIE), as described in the "Variable Interest Entities" sections of FASB ASC 810-10. | Pursuant to FASB ASC 810-10-15-17, NFP entities are not subject to the "Variable Interest Entities" sections of FASB ASC 810-10 unless the NFP is used by a business entity in a manner similar to a VIE in an effort to circumvent the provisions of those standards. |
| The reporting entity is engaged in a leasing transaction with a special-purpose entity lessor. | Use the guidance in paragraphs 8–10 of FASB ASC 958-810-25 and paragraphs 7–16 of FASB ASC 958-810-55 to determine whether to consolidate the lessor. |
| The reporting entity has entered into a joint operating agreement with another entity. They agree to jointly conduct an activity while sharing the operating results and a residual interest upon dissolution. | If housed in a separate legal entity, use the equity method of accounting for that entity type; otherwise, use the guidance in FASB ASC 808, *Collaborative Arrangements*. |
| The reporting entity is a sponsor in a research and development arrangement. | Use the guidance in FASB ASC 810-30. |
| The reporting entity has another type of relationship with a special-purpose entity. | In practice, entities analogize to the guidance in paragraphs 8–10 of FASB ASC 958-810-25 and paragraphs 7–16 of FASB ASC 958-810-55. |

## Fair Value

**.109** FASB ASC 820-10-20 defines fair value and establishes a framework for measuring fair value; however, it does not dictate when an entity must measure something at fair value nor does it expand the use of fair value in any way. The need to understand fair value accounting has increased in importance as alternative investments have increased in popularity and complexity. Fair value is defined as the "price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

**.110** The disclosure requirements for fair value measurements have changed frequently in recent years. NFPs should ensure that their fair value measurement disclosures meet all the latest disclosure requirements. Recent new disclosure requirements include the following:

- FASB Staff Position (FSP) FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, as codified in FASB ASC 820-10-50-2, was issued and is effective for periods ending after June 15, 2009. This FSP requires that equity and debt securities be broken out by major security types, as described in FASB ASC 320-10-50-1B.
- ASU No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*, requires additional disclosures about fair value measurements. It has staggered effective dates for the various newly required disclosures, as follows:
  - — For years beginning after December 15, 2009, the following new disclosures are required:
    - *Transfers in and out of levels 1 and 2*. A reporting entity should disclose separately the amounts of significant transfers in and out of level 1 and level 2 fair value measurements and describe the reasons for the transfers.
    - *Level of disaggregation*. A reporting entity should provide fair value measurement disclosures for each class of assets and liabilities. A class is often a subset of assets or liabilities within a line item in the statement of financial position. A reporting entity needs to use judgment in determining the appropriate classes of assets and liabilities.
    - *Disclosures about inputs and valuation techniques*. A reporting entity should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements. Those disclosures are required for fair value measurements that fall into either levels 2 or 3.
- For years beginning after December 15, 2010, the following new disclosure is required:

- — *Activity in level 3 fair value measurements*. In the reconciliation for fair value measurements using significant unobservable inputs (level 3), a reporting entity should present separately information about purchases, sales, issuances, and settlements (that is, on a gross basis rather than as one net number).

- ASU No. 2009-12, *Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*, requires the following additional disclosures about fair value measurements for investments in entities that calculate net asset value:

  - — These disclosure requirements were effective for periods ending after December 15, 2009.
  - — Disclosures are only required for investments that are within the scope of the ASU (that is, investments that calculate a net asset value).
  - — Required disclosures include attributes of the investments, such as the nature of any restrictions on the investor's ability to redeem its investments at the measurement date, any unfunded commitments, and the investment strategies of the investees.
  - — An example of the required disclosures is in FASB ASC 820-10-55-64A.

## *Accounting for GIK*

**.111** A large number of NFPs receive significant noncash GIK that is critical in sustaining their mission. Because these transactions typically result in the NFP recording substantial amounts of revenue and a corresponding program service expense, particular attention should be paid to whether the GIK should be recorded as contribution revenue and how the fair value of the GIK has been calculated.

**.112** The GIK can take a variety of forms, such as property, equipment, medical supplies, food, clothes, and household items. When donors contribute resources to NFPs, it is generally beneficial to both the NFP and donor. The NFP is able to operate its programs and activities without having to purchase these items, and donors, such as corporations, have an opportunity to give back to their communities by putting excess inventory to good use. For some NFPs, GIK donations represent a significant portion of their total revenue and program expense.

**.113** NFPs that receive GIK should consider the following issues when determining how to account for the GIK received:

- FASB ASC 958-605-30-11 indicates that the GIK that can be used or sold shall be measured at fair value. If the GIK received has no value, as might be the case for certain items that cannot be (*a*) used internally by the NFP for program or supporting service activities or (*b*) sold by the NFP, the GIK received should not be recognized as contribution revenue.

- FASB ASC 958-605 provides guidance for agency transactions. The NFP should determine if the GIK received should be accounted for as a contribution or an agency transaction.
- FASB ASC 958-605 provides guidance for differentiating between contributions and exchange transactions. Exchange transactions are transfers of assets that are, in substance, purchases of goods or services in which each party receives and sacrifices commensurate value. However, if a donor voluntarily transfers assets to the NFP or performs services for the NFP in exchange for assets of substantially lower value, and no unstated rights or privileges are involved, the contribution received that is inherent in that transaction may be recorded as contribution revenue. When obtaining GIK in which a fee is paid by the NFP to the resource provider, the NFP must determine if the fee is an indicator of an exchange transaction based on the value of the GIK relative to the fee paid.
- FASB ASC 958-605-30 provides guidance on the initial measurement of contributions, including GIK, at fair value. Some donations of GIK are relatively easy to measure at fair value because observable inputs often are readily available, such as donations of marketable securities, automobiles, or real estate. Other donations of GIK, such as certain pharmaceuticals, are more difficult to measure at fair value due to a lack of readily available observable inputs.

**.114** NFPs that receive an amount of GIK that is significant to their financial statements should develop appropriate policies and procedures to address the following:

- The process for determining whether it has received a contribution that should be recorded in its financial records.
- A gift acceptance policy that specifies the types of GIK the entity will accept that are critical to fulfilling its mission. The entity should also determine the quantity of the GIK that it will be able to use, so that it does not accept more than it can utilize.
- A process for establishing obsolescence reserves (if applicable).
- A process to inventory and track the use of the GIK received.
- A process for determining the fair value of the GIK received.

## *AICPA Issues White Paper on Fair Value Measurements and Disclosures for Certain Issues Pertaining to NFPs*

**.115** NFPs face various challenges in applying the provisions of FASB ASC 820, *Fair Value Measurement*, which codifies FASB Statement No. 157, *Fair Value Measurements*. To assist practitioners, in October 2011, the AICPA issued a white paper, *Measurement of Fair Value for Certain Transactions of Not-for-Profit Entities*. The white paper discusses fair value measurement for the following types of transactions:

- Unconditional promises to give cash or other financial assets
- Beneficial interests in trusts
- Split interest agreements

**.116** Many of the challenges that NFPs encounter result from the fact that markets do not exist for these assets and liabilities. The white paper addresses, among other things, the following:

- Valuation approaches and techniques, including variations of the income approach using probability-weighted cash flows or a single set of cash flows model that uses a risk-adjusted discount rate
- Considerations for determining an appropriate valuation technique based on facts and circumstances, as well as considerations for the related inputs to the valuation model
- Determination of an appropriate discount rate when using present value techniques
- Use of market inputs when valuing split-interest obligations, including use of actuarial data and prices for annuity contracts
- The unit of account for unconditional promises to give that are expected to be collected in one year or more and for beneficial interests in a trust
- Disclosure considerations

**.117** As a benefit of AICPA membership, all members can access the white paper at no cost by logging in to the Financial Reporting Center of the AICPA website at www.aicpa.org/FRC/. Nonmembers can purchase a PDF of the paper (product number FRC1201PDF) at a cost of $15.25 at www.cpa2biz.com.

## Disclosures About Credit Quality and Allowance for Credit Losses

**.118** In July 2010, FASB issued ASU No. 2010-20 that requires an entity to provide a greater level of disaggregated information about the credit quality of its financing receivables and its allowance for credit losses. The amendments in this ASU apply to all entities with financing receivables. Examples of financing receivables include loans; trade receivables; notes receivable; and receivables relating to a lessor's leveraged, direct financing, and sales-type leases. Examples of financing receivables for NFPs include church mortgages held by church development funds, student loans issued by colleges and universities, microfinance loans advanced by exempt organizations, and program-related investments issued by foundations. See the "Pending Content" in paragraphs 13–15 of FASB ASC 310-10-55 for more information on the definition of *financing receivable*, including a list of items that are excluded from the definition (for example, debt securities). In addition, the "Pending Content" in paragraphs 7–12 of FASB ASC 310-10-55 illustrates certain disclosures required by this ASU.

**.119** The ASU amends the existing disclosures to require an entity to provide the following disclosures about its financing receivables on a disaggregated basis:

- A rollforward schedule of the allowance for credit losses from the beginning of the reporting period to the end of the reporting period on a portfolio segment basis, with the ending balance further disaggregated on the basis of the impairment method. For each disaggregated ending balance, the related recorded investment in financing receivables should also be disclosed.

- The nonaccrual status of financing receivables by class of financing receivables.
- Impaired financing receivables by class of financing receivables

**.120** The amendments in this ASU require an entity to provide the following additional disclosures about its financing receivables:

- Credit quality indicators of financing receivables at the end of the reporting period by class of financing receivables (see FASB ASC 310-10-55-19 for examples of credit quality indicators)
- The aging of past due financing receivables at the end of the reporting period by class of financing receivables
- The nature and extent of troubled debt restructurings that occurred during the period by class of financing receivables and their effect on the allowance for credit losses
- The nature and extent of financing receivables modified as troubled debt restructurings within the previous 12 months that defaulted during the reporting period by class of financing receivables and their effect on the allowance for credit losses
- Significant purchases and sales of financing receivables during the reporting period disaggregated by portfolio segment

**.121** An entity must also describe, by portfolio segment, its accounting policies and methodology used to estimate its allowance for credit losses, including the identification of any changes to the entity's accounting policies or methodology from the prior period and the entity's rationale for the change.

**.122** For public entities, the disclosures as of the end of a reporting period are effective for interim and annual reporting periods ending on or after December 15, 2010. The disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010. For nonpublic entities, the disclosures are effective for annual reporting periods ending on or after December 15, 2011.

## Disclosures About Multiemployer Pension Plans

**.123** In September 2011, FASB issued ASU No. 2011-09, *Compensation—Retirement Benefits—Multiemployer Plans (Subtopic 715-80): Disclosures about an Employer's Participation in a Multiemployer Plan*, to address concerns from various users of financial statements on the lack of transparency about an employer's participation in a multiemployer pension plan. A unique characteristic of a multiemployer plan is that assets contributed by one employer may be used to provide benefits to employees of other participating employers. If a participating employer fails to make its required contributions, the unfunded obligations of the plan may be borne by the remaining participating employers. The amendments in this ASU will require additional disclosures about an employer's participation in a multiemployer pension plan.

**.124** For public entities, the amendments in this ASU are effective for annual periods for fiscal years ending after December 15, 2011, with early adoption permitted. For nonpublic entities, the amendments are effective for annual periods for fiscal years ending after December 15, 2012, with early adoption permitted. The amendments should be applied retrospectively for all prior periods presented.

## Convergence With International Financial Reporting Standards

**.125** Since the signing of the Norwalk Agreement by FASB and the International Accounting Standards Board (IASB), the bodies have had a common goal: one set of accounting standards for international use. *International convergence of accounting standards* refers to both the goal of this project and the path taken to reach it. The path toward reaching this goal will both improve GAAP and International Financial Reporting Standards (IFRSs) and eliminate the differences between them. In the Norwalk Agreement, each body acknowledged its commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. FASB and the IASB have undertaken several joint projects that are being conducted simultaneously in a coordinated manner to further the goal of convergence of GAAP and IFRSs. The "On the Horizon" section of this alert discusses these joint projects. For more information, visit www.fasb.org and www.iasb.org.

### *FASB Not-for-Profit Advisory Committee*

**.126** The FASB Not-for-Profit Advisory Committee (NAC) was established in October 2009 to serve as a standing resource for FASB in obtaining input from the NFP sector on existing guidance, current and proposed technical agenda projects, and longer-term issues affecting those organizations.

**.127** The primary functions of NAC are as follows:

- Provide focused input and feedback to FASB's board and staff on existing guidance, current and proposed technical agenda projects, and longer-term issues (for example, the alternatives and recommended course for the financial reporting for NFPs if the Securities and Exchange Commission [SEC] mandates IFRSs for public business entities).
- Assist FASB's board and staff in its communication and outreach activities to the NFP sector about recent and other existing guidance, current and proposed projects, and longer-term issues.

**.128** At its September 2011 meeting, NAC recommended changes to accounting rules that would enable NFPs to better report and explain their finances to donors and other interested parties. Key recommendations advanced by NAC include

- revisiting current net asset classifications and how they may be relabeled or redefined in conjunction with improving how liquidity is portrayed in a not for profit's statement of financial position and related notes.
- improving the statements of activities and cash flows to more clearly communicate financial performance.
- creating a framework for not-for-profit directors and managers to provide commentary and analysis about the organization's financial health and operations, somewhat similar to the management discussion and analysis provided by publicly traded companies in their annual reports, to help them bring context to their financial story.
- streamlining, when possible, existing not-for-profit-specific disclosure requirements to improve their relevance and clarity.

**.129** As a result of these recommendations, in November 2011, FASB added two projects to its agenda. The first is a standard-setting project that will focus on the financial statements and related notes that are unique to NFPs. It will reexamine existing standards for financial statement presentation by NFPs, with a focus on improving the current net asset classification scheme and information provided in financial statements and notes about an organization's liquidity, financial performance, and cash flows. The second is a research project that will study other means of communication that NFPs currently use in telling their financial story, including a review of best practices followed by NFPs in this area, and how such communications enhance the understanding of donors, creditors, and other stakeholders about the financial health and performance of the organization.

**.130** More information about NAC and other FASB advisory groups is available at www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176154493483.

## Private Company Financial Reporting

**.131** A new council with the authority to identify, propose, and vote on specific improvements to U.S. accounting standards for private companies is the centerpiece of a new private company plan released in October 2011 for public comment by the board of trustees of the Financial Accounting Foundation (FAF). The comment period ended in January 2012.

**.132** Under the FAF plan, a new Private Company Standards Improvement Council (PCSIC) would identify, propose, deliberate, and formally vote on specific exceptions or modifications to GAAP for private companies. Changes approved by a two-thirds majority would be forwarded to FASB for ratification. The changes would become final following public comment, further deliberation by the PCSIC, and final ratification by FASB. The PCSIC would replace the Private Company Financial Reporting Committee, a FASB advisory-only body established in 2006. FAF decided to exclude NFPs from the scope of the new committee.

**.133** The new private company council would comprise between 11 and 15 members appointed by the FAF trustees and would represent investors, lenders, auditors, accountants, and others with broad experience in using and preparing private company financial statements. The chairman of the group would be a member of FASB and also would be appointed by the FAF trustees.

**.134** The complete plan is available on the FAF website at www.accountingfoundation.org.

## Recent Pronouncements

**.135** AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers. The Public Company Accounting Oversight Board (PCAOB) establishes auditing and attestation standards for audits of issuers. For information on pronouncements issued subsequent to the writing of this alert, please refer to the AICPA website at www.aicpa.org, the FASB website at www.fasb.org, and the PCAOB website at www.pcaob.org. You also may look for announcements of newly issued accounting standards in the *CPA Letter Daily* and the *Journal of Accountancy*.

## Recent Auditing and Attestation Pronouncements and Related Guidance

**.136** The following table presents a list of recently issued audit and attestation pronouncements and related guidance.

| ***Recent Auditing and Attestation Pronouncements and Related Guidance*** | |
|---|---|
| Statement on Auditing Standards (SAS) No. 125, *Alert That Restricts the Use of the Auditor's Written Communication* (AICPA, *Professional Standards*, AU-C sec. 905)<br>Issue Date: December 2011 | This SAS supersedes SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, AU sec. 532). This statement includes a requirement to include language that restricts the use of the auditor's written communication when the subject matter is based on (*a*) measurement or disclosure criteria that are determined by the auditor to be suitable for limited users who have understanding of criteria, (*b*) measurement or disclosure criteria that are available only to specified parties, or (*c*) identification of matters that are not the primary objective of the engagement (by-product report).<br>This SAS has specific requirements for audit engagements issued under *Government Auditing Standards*. The statement modifies guidance pertaining to single combined reports in that language is only required for restricted use reports, not those for general use. Lastly, this SAS does not require an auditor to consider informing a client that restricted use reports are not intended for distribution to nonspecified parties. |
| SAS No. 124, *Financial Statements Prepared in Accordance With a Financial Reporting Framework Generally Accepted in Another Country* (AICPA, *Professional Standards*, AU-C sec. 910)<br>Issue Date: October 2011 | This SAS supersedes the requirements and guidance in SAS No. 51, *Reporting on Financial Statements Prepared for Use in Other Countries* (AICPA, *Professional Standards*, AU sec. 534). This statement requires the auditor, in instances when a report that is to be used in the United States was prepared in accordance with a financial reporting framework generally accepted in another country, to include an emphasis-of-matter paragraph to highlight the foreign financial reporting framework but permits the auditor to express an unqualified opinion. |

| *Recent Auditing and Attestation Pronouncements and Related Guidance* | |
|---|---|
| SAS No. 123, *Omnibus Statement on Auditing Standards—2011* (AICPA, *Professional Standards*)<br>Issue Date: October 2011 | This SAS contains amendments to SAS Nos. 117–118 and the following AU-C sections within SAS No. 122: 200, 230, 260, 705, and 915 (AICPA, *Professional Standards*). |
| SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification* (AICPA, *Professional Standards*)<br>Issue Date: October 2011 | This SAS contains 39 clarified SASs and recodifies the AU section numbers (using the new AU-C designation), as designated by SAS Nos. 1–121. |

## Recent ASUs

**.137** The following table presents, by codification area, a list of recently issued ASUs, through the issuance of ASU No. 2011-12, *Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*. However, this table does not include ASUs that are SEC updates (such as ASU No. 2010-19, *Foreign Currency [Topic 830]: Foreign Currency Issues: Multiple Foreign Currency Exchange Rates [SEC Update]*) or ASUs that are technical corrections to various topics. FASB ASC does include SEC content to improve the usefulness of FASB ASC for public companies, but the content labeled as SEC staff guidance does not constitute rules or interpretations of the SEC nor does such guidance bear official SEC approval.

| *Recent Accounting Standards Updates* | |
|---|---|
| **Presentation Area of Financial Accounting Standards Board (FASB)** ***Accounting Standards Codification*** **(ASC)™** | |
| Accounting Standards Update (ASU) No. 2011-12<br>(December 2011) | *Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05* |
| ASU No. 2011-11<br>(December 2011) | *Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities* |
| ASU No. 2011-05<br>(June 2010) | *Comprehensive Income (Topic 220): Presentation of Comprehensive Income* |

*(continued)*

| *Recent Accounting Standards Updates* | |
|---|---|
| **Assets Area of FASB ASC** | |
| ASU No. 2011-10 (December 2011) | *Property, Plant, and Equipment (Topic 360): Derecognition of in Substance Real Estate—a Scope Clarification (a consensus of the FASB Emerging Issues Task Force)* |
| ASU No. 2011-08 (September 2011) | *Intangibles—Goodwill and Other (Topic 350): Testing Goodwill for Impairment* |
| ASU No. 2011-02 (April 2011) | *Receivables (Topic 310): A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring* |
| **Expenses Area of FASB ASC** | |
| ASU No. 2011-09 (September 2011) | *Compensation—Retirement Benefits—Multiemployer Plans (Subtopic 715-80): Disclosures about an Employer's Participation in a Multiemployer Plan* |
| ASU No. 2011-06 (July 2011) | *Other Expenses (Topic 720): Fees Paid to the Federal Government by Health Insurers (a consensus of the FASB Emerging Issues Task Force)* |
| **Broad Transactions Area of FASB ASC** | |
| ASU No. 2011-04 (May 2011) | *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs* |
| ASU No. 2011-03 (April 2011) | *Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements* |
| **Industry Area of FASB ASC** | |
| ASU No. 2011-07 (July 2011) | *Health Care Entities (Topic 954): Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities (a consensus of the FASB Emerging Issues Task Force)* |

## Recently Issued Technical Questions and Answers

**.138** AICPA nonauthoritative accounting and audit and attest technical questions and answers address a variety of practice issues encountered by practitioners. Recently issued questions and answers can be accessed at www.aicpa.org/InterestAreas/FRC/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

## Recent AICPA Independence and Ethics Developments

**.139** The Audit Risk Alert *Independence and Ethics Developments—2011/12* (product no. 0224711) contains a complete update on new independence and ethics pronouncements. This alert will heighten your awareness of independence and ethics matters likely to affect your practice. Obtain this alert by calling the AICPA at 888.777.7077 or visiting www.cpa2biz.com.

### *Revisions to Ethics Ruling No. 2 and New Definition of Confidential Client Information*

**.140** In August 2011, the Professional Ethics Executive Committee (PEEC) adopted revisions to Ethics Ruling No. 2, "Disclosure of Client Information to Third Parties," of ET section 391, *Ethics Rulings on Responsibilities to Clients* (AICPA, *Professional Standards*, ET sec. 391 par. .003–.004). The revisions clarify a member's obligations when the member provides confidential client information to another person, without disclosing the name of the client, who then uses that information for benchmarking, research, or similar purposes.

**.141** The revisions to Ethics Ruling No. 2 require members to

- obtain the client's specific consent, preferably in writing, to disclose confidential client information to a third party or to use that information for the member's own purposes when the information results in disclosure to others.
- when a third party is involved, consider whether to execute a contractual agreement with the third party to maintain the confidentiality or limit the use of the information.

**.142** PEEC also adopted a new definition of *confidential client information* that generally includes any information obtained from the client that is not available to the public. Information that is in the public domain or available to the public includes, but is not limited to, information that is

- in a book, periodical, newspaper, or similar publication.
- obtained from commercially available databases.
- in a client document that the client has released to the public or that has otherwise become a matter of public knowledge.
- on client websites and available to persons accessing those websites without restrictions imposed by the client concerning use or access.
- released or disclosed by the client or other third parties in media interviews, speeches, testimony in a public forum, presentations made at seminars or trade association meetings, panel discussions, earnings press release calls, investor calls, analyst sessions, investor conference presentations, or a similar public forum.
- maintained by, or filed with, regulatory or governmental bodies and available to the public.
- obtained from other public sources.

**.143** In conjunction with the revisions to Ethics Ruling No. 2, PEEC also adopted related nonauthoritative guidance that can be found on the AICPA's website at www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Categories-of-Information.pdf.

**.144** The revisions to Ethics Ruling No. 2 and the new definition of *confidential client information* became effective on November 30, 2011.

### Proposed Revisions to Interpretation No. 101-3

**.145** In February 2011, the AICPA Professional Ethics Division released an omnibus proposal that contained important clarifying language regarding CPAs' provision of nonattest services. Among them, it made clear that certain bookkeeping and other nonattest services that help clients produce more reliable financial information are permitted under the interpretation, even though they may be viewed as maintaining an internal control for the client. For example, it clarified that a practitioner is allowed to prepare and maintain monthly account reconciliations for an attest client, provided that the client accepts responsibility for the services and that other general requirements of Interpretation No. 101-3, "Performance of Nonattest Services," under Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101 par. .05), are met, such as ensuring that the client reviews and approves the account reconciliations and sufficiently understands the services performed to oversee them. This clarification was made because some have interpreted the current standard as prohibiting these activities, and the change reinforces that they are permissible.

**.146** The exposure draft also proposed that *management functions* be changed to *management responsibilities* and provided additional examples of the types of activities that would be considered to be responsibilities of management and, therefore, impair independence.

**.147** Comments on the exposure draft were due by May 31, 2011. During the August 2011 PEEC meeting, adoption of the proposed revisions to Interpretation No. 101-3 was deferred until several of the observations made in the comment letters were evaluated further by the Interpretation No. 101-3 study group. The Interpretation No. 101-3 study group reported its updated recommendations at the November 2011 PEEC meeting. Although progress was made on proposed revisions to Interpretation No. 101-3 at the January 2012 PEEC meeting, PEEC is expected to continue discussing the proposed revisions to Interpretation No. 101-3 at its April 2012 meeting.

**.148** PEEC meeting information, including meeting agendas, discussion materials, and minutes of prior meetings, can be found at www.aicpa.org/InterestAreas/ProfessionalEthics/Community/MeetingMinutesandAgendas/Pages/MeetingInfo.aspx.

**.149** Exposure drafts, including the previously mentioned omnibus exposure draft, issued by PEEC can be found at www.aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/Pages/ExposureDrafts.aspx.

## On the Horizon

**.150** Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance to NFPs or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

**.151** Information on, and copies of, outstanding exposure drafts may be obtained from the various standard-setters' websites. These websites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. Readers should refer to documents provided by the various standard-setting bodies for further information.

## Overhaul Project—AICPA Audit and Accounting Guide Not-for-Profit Entities

**.152** The Financial Reporting Executive Committee, the Not-for-Profit Entities Expert Panel, and the Not-for-Profit Guide Task Force are expected to release for review by the public a new comprehensive revision of the Audit and Accounting Guide *Not-for-Profit Entities* late in 2012. Enhancements have been made to improve user understanding and minimize diversity in practice, including the following:

- A greatly expanded section in chapter 3, "Basic Financial Statements and General Financial Reporting Matters," about reporting relationships with other entities. The guide will provide guidance and examples for reporting relationships with not-for-profit and for-profit corporations, limited liability partnerships, general partnerships, and financially interrelated entities.
- New sections in chapter 5, "Contributions Received and Agency Transactions," about reporting and measuring noncash gifts, including GIK; contributions of fund-raising materials, informational materials, advertising, and media time or space; below-market interest rate loans; and bargain purchases.
- A new chapter on program-related investments and microfinance loans.
- A greatly expanded section in chapter 10, "Debt and Other Liabilities," about municipal bond debt, including IRS considerations, third-party credit enhancements, capitalization of interest, extinguishments and debt modifications, and the effects of terms (such as subjective acceleration clauses) on the classification of debt.
- New guidance in chapter 11, "Net Assests," for reporting the expiration of donor-imposed restrictions.
- Greatly expanded discussion in chapter 15, "Tax Considerations," about the legal and regulatory environment in which NFPs operate.
- For assets and liabilities that are unique to NFPs, suggestions for audit procedures an auditor might consider as a supplement to the risk assessment procedures.

## Auditing and Attestation Pipeline—Nonissuers

### *The Clarity Project*

**.153** With the release of SAS Nos. 122–125, the ASB has substantially completed its project to redraft all the auditing sections in *Codification of Statements on Auditing Standards* (contained in AICPA *Professional Standards*). The issuance of the clarified standards reflects the ASB's established clarity drafting conventions designed to make the standards easier to read, understand, and apply. Among other improvements, generally accepted auditing standards (GAAS) now specify more clearly the objectives of the auditor and the requirements with which the auditor has to comply when conducting an audit in accordance with GAAS.

**.154** As the ASB redrafted the standards for clarity, it also converged the standards with the International Standards on Auditing issued by the International Auditing and Assurance Standards Board.

**.155** Although the purpose of redrafting the auditing standards is for clarity and convergence, not to create additional requirements, auditors will need to make some adjustments to their practices as a result of this project.

**.156** The clarified standards generally will be effective for audits of financial statements for periods ending on or after December 15, 2012. Thus, the clarified standards will be effective for calendar year 2012 audits.

### *Impact of the Clarity Project*

**.157** The revisions to GAAS, although extensive, do not create many substantial requirements or change many existing requirements. Most are consistent with existing GAAS. Some, however, do contain significant changes from the extant[1] standards and require auditors to prepare accordingly. Now is the time for all auditors to start preparing for the transition to the clarified standards that are effective for calendar year 2012 audits. A smooth transition requires information, education, and training.

**.158** To assist you in the transition, the following paragraphs highlight some important steps you can take to start preparing for the clarified standards and to minimize the impact of the transition on your firm and clients.

**.159** First, familiarize yourself with the clarified standards, including the application material, appendixes, and exhibits. The ASB has redrafted its Statements on Quality Control Standards and SASs using a drafting convention called the clarity format. This new format is clear, consistent, and easy to understand.[2]

**.160** The clarity format presents each standard in these categories:

- *Introduction*. The introduction explains the purpose and scope of the standard.
- *Objective*. The objective defines the context in which the requirements are set.
- *Definitions*. The "Definitions" section, included when relevant, explains specific meanings of terms in the standard.
- *Requirements*. The requirements set out what the auditor is required to do to achieve the objective of the standard. Requirements are expressed using the words *the auditor should* or *the auditor must*.
- *Application and other explanatory material*. "Application and Other Explanatory Material" paragraphs are cross-referenced to

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[1] The term *extant* is used throughout this Audit Risk Alert in reference to the standards that are superseded by the clarified standards.

[2] The Auditing Standards Board is also clarifying the attestation standards, and the Accounting and Review Standards Committee is clarifying the compilation and review standards following this format.

the requirements and provide further explanation of, and guidance for, carrying out the requirements of the standard. These paragraphs are an integral part of the standard, and the auditor is required to read and understand the entire text of the standard, including these paragraphs, in order to understand the objectives of the standard and apply its requirements properly.

**.161** Other clarity drafting conventions include the following:

- When appropriate, special considerations relevant to audits of smaller, less complex entities within the text of the standard
- When appropriate, special considerations relevant to audits of governmental entities within the text of the standard
- Formatting techniques, such as bullet lists, to enhance readability

**.162** After reviewing the standards and becoming familiar with the changes, identify the timing for transitioning the clarified standards for each engagement. For example, several new requirements may involve planning discussions with the client early in 2012, some may affect interim testing and other fieldwork, and some may require changes to the report. Steps your firm can take to implement the standards may include the following:

- Appoint a person or team to be in charge of the transition
- Consider establishing small task forces of staff at different levels to develop revisions to the firm's audit methodologies
- Provide training for all audit staff
- Review your client base to determine those clients that will be affected first
- Provide an overview of how the audit engagement may change for key client personnel

**.163** In addition to determining any changes necessary to audit procedures and training in accordance with your firm's quality control procedures, you will need to revise firm guidance and audit methodology to refer to the clarified standards. The effort required for these revisions will depend on the level of detail of such references in your firm's methodology.

**.164** The Audit Risk Alert *Understanding the Clarified Auditing Standards* (product no. ARACLA12P) identifies the substantive and clarifying changes in requirements from the Clarity Project and includes a mapping schedule tracking the extant standards to the clarified standards.

## *What Are Group Audits?*

**.165** As part of the Clarity Project, certain concepts have been aligned with International Accounting Standards (IAS). One key change relates to group audits. Group audits involve the audit of group financial statements. AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* (AICPA, *Professional Standards*), expands previous guidance related to using the work of other auditors to encompass audits of group financial statements. The new standard introduces a number of new terms, concepts, and requirements related to group audits that will significantly affect current practice. Because the new standard is much broader than previous guidance and is effective for audits of group financial statements for periods ending on or after December 15, 2012, it is important for auditors to fully understand the requirements of the new standard well in advance of its effective date.

**.166** The following questions and answers point out some of the major changes in the new standard that may assist auditors in recognizing when they are involved in an audit of group financial statements:

- *What are group financial statements?* Group financial statements include the financial information of more than one component. The concept of group financial statements is broader than consolidated or combined financial statements.
- *What is a component?* A *component* is an entity or a business activity for which group or component management prepares financial information that is required to be included in the group financial statements. It is a broader concept than in previous guidance and may include, but is not limited to, subsidiaries, geographical locations, divisions, investments, products or services, functions, or processes.
- *Does an other auditor audit components, and does the principal auditor audit the group financial statements?* The auditor who performs work on the financial statements or financial information of a component is now referred to as the component auditor, rather than an other auditor. The auditor of the group financial statements, which encompasses the firm and group engagement team, including the group engagement partner, replaces the concept of the principal auditor. A member of the group engagement team may perform work on the financial information of a component for the group audit at the request of the group engagement team. When this is the case, such a member of the group engagement team is also a component auditor.
- *Do the requirements change for making reference to the work of other auditors?* The new standard better articulates the degree of involvement required when reference is made to component auditors in the auditor's report on the group financial statements. It establishes three explicit conditions that are necessary for the group engagement partner to make reference to a component auditor in the auditor's report on the group financial statements. Additionally, the new standard establishes requirements that apply to all group audits, regardless of whether reference is made to the work of the component auditor.
- *Are new procedures required when assuming responsibility for the work of other auditors?* Provisions of the new standard apply to all group audits, regardless of whether reference is made to the work of the component auditor. The new standard specifically articulates the procedures necessary for the group engagement team to perform in order to be involved with component auditors to the extent necessary for an effective audit. Additional specific procedures are applicable when the auditor of the group financial statements assumes responsibility for the work of a component auditor.

**.167** The new Audit Risk Alert *Understanding the Responsibilities of Auditors for Audits of Group Financial Statements* (product no. ARAGRP12P) summarizes the new standard and provides implementation guidance for the auditor of the group financial statements. However, auditors will need to read the new standard and the application material in their entirety to fully understand the new standard and its effect on current practice.

## Joint FASB and IASB Accounting Pipeline

### *FASB and IASB Memorandum of Understanding*

**.168** In April 2011, FASB and the IASB jointly published an update to their 2006 Memorandum of Understanding (MoU) to report the progress they have made in their continued commitment to developing common, high-quality standards. The MoU identifies 12 convergence topics:

- Business combinations
- Derecognition
- Consolidated financial statements
- Fair value measurement
- Postemployment benefits
- Financial statement presentation—other comprehensive income
- Insurance contracts
- Financial instruments with characteristics of equity
- Intangible assets
- Financial instruments
- Leases
- Revenue recognition

**.169** During 2011, the boards regularly updated project completion dates as difficulties in completing projects arose. Some projects (for example, income taxes) were removed from the convergence schedules when the boards agreed that convergence was unlikely to be achieved in the short time available, whereas other projects have reached the exposure draft milestone initially set. Each board believes that these standards, when completed, would improve the quality, consistency, and comparability of financial information for investors and capital markets around the world.

**.170** A progress report for the quarter ended March 31, 2011, highlighted the following topics:

- Completion of five projects, including the IASB's issuance of new standards on consolidated financial statements, joint arrangements, and postemployment benefits, and both boards will issue new requirements in relation to fair value measurement and the presentation of other comprehensive income
- Priority given to the three remaining MoU projects covering financial instruments accounting, leasing, and revenue recognition, as well as insurance accounting, and the boards' joint project to improve and align U.S. and international insurance accounting standards
- Agreement to extend the timetable for the remaining priority convergence projects beyond June 2011 to permit further work and consultation with stakeholders in a manner consistent with an open and inclusive due process

**.171** The convergence projects are targeted for completion in the second half of 2011; however, the U.S. insurance standard that has not yet been exposed is targeted for the first half of 2012.

**.172** The priority joint projects are financial instruments, revenue recognition, and leases. The following text is a discussion of each of these projects:

- *Financial instruments*. The boards' efforts to reach a common solution have been complicated by differing imperatives that pushed their respective timetables out of alignment. The IASB has been replacing its financial instrument requirements in a phased approach, whereas FASB developed a single proposal. Differing development timetables and other factors have impeded the ability of the boards to publish joint proposals on a number of important technical issues, including classification and measurement, impairment, hedge accounting, and balance sheet netting of derivatives and other financial instruments. In January 2012, the boards agreed to work together to seek to reduce differences in their respective classification and measurement models for financial instruments.
- *Revenue recognition*. In June 2011, the IASB and FASB agreed to reexpose their revised proposals for a common revenue recognition standard. This provided interested parties with an opportunity to comment on revisions the boards have undertaken since the publication of an exposure draft on revenue recognition in June 2010. In November 2011, the boards issued a revised exposure draft. The comment period ended in March 2012.
- *Leases*. The IASB and FASB announced in July 2011 their intention to reexpose their revised proposals for a common leasing standard. Reexposing the revised proposals will provide interested parties with an opportunity to comment on revisions the boards have undertaken since the publication of an exposure draft on leasing in August 2010. The boards intend to issue a revised exposure draft during the second quarter of 2012.

## Recent FASB Exposure Drafts

### *Accounting for Investment Property Entities*

**.173** In October 2011, FASB issued a proposed ASU intended to develop accounting guidance for investment property entities. This proposed ASU would require an entity that meets certain criteria to measure its investment properties at fair value, rather than apply lease accounting to each individual lease. The proposed amendments also would introduce additional presentation and disclosure requirements for an investment property entity.

**.174** This proposed ASU is a result of FASB's efforts to align the scope of entities that would apply the proposed lessor accounting model under GAAP and IFRSs and to address the diversity in practice about the accounting by real estate entities.

**.175** As part of the FASB and IASB joint project on accounting for leases, the IASB decided that a lessor of an investment property would not be required to apply the proposed lessor accounting requirements in the IASB's August 2010 exposure draft, *Leases*, if the lessor measures its investment properties at fair value by electing the fair value model under IAS 40, *Investment Property*. Unlike IFRSs, GAAP does not contain specific accounting requirements for investment properties. As a result, an entity that invests in real estate properties but is not an investment company is required to measure its real estate properties at cost under FASB ASC 360, *Property, Plant, and Equipment*, and account for the leases separately. In response to consistent investor input, FASB decided to prescribe the circumstances when fair value would be required, rather than introduce an optional accounting practice into GAAP. The extended comment period ended in February 2012.

### Defining Investment Companies

**.176** In October 2011, FASB issued a proposed ASU intended to improve and converge financial reporting by setting forth consistent criteria for determining whether an entity is an investment company.

**.177** This proposed ASU is a result of the efforts of FASB and the IASB to develop consistent criteria for determining whether an entity is an investment company. Under long-standing GAAP, investment companies carry all their investments at fair value, even if they hold a controlling interest in another company. The primary changes being proposed by FASB relate to which entities would be considered investment companies, as well as certain disclosure and presentation requirements. These changes are being proposed for the first time under IFRSs. Therefore, the proposed ASU would improve the comparability between entities that meet the criteria to be investment companies under GAAP and those that meet the criteria to be investment entities under the proposed amendments to IFRSs.

**.178** In addition to the changes to the criteria for determining whether an entity is an investment company, FASB also proposes that an investment company consolidate another investment company if it holds a controlling financial interest in the entity. The extended comment period ended in February 2012.

### Consolidations

**.179** In October 2011, FASB issued a proposed ASU intended to increase transparency and consistency of financial reporting about consolidations. The proposed amendments in this ASU would affect all companies that are required to evaluate whether they should consolidate another entity. It provides criteria for a reporting entity to evaluate whether a decision maker is using its power as a principal or an agent. These criteria would affect the evaluation of whether an entity is a variable interest entity and, if so, whether the reporting entity should consolidate the entity being evaluated. The determination of whether the decision maker is using its power as a principal or an agent would be based on the rights held by other parties, the compensation the decision maker is entitled to in accordance with the compensation agreement, and the decision maker's exposure to variability of returns from other interests that it holds in the entity.

**.180** The proposed ASU also would amend the evaluation of kick-out and participating rights held by noncontrolling shareholders in a consolidation analysis. For example, the assessment of whether the participating rights of a noncontrolling shareholder would overcome the presumption of control by the majority shareholder would focus on whether such rights allow the noncontrolling shareholders to participate in the activities that most significantly affect the investee's economic performance.

**.181** In addition, the proposed amendments would change the requirements for determining whether a general partner controls a limited partnership and, therefore, could affect reporting entities that are involved with partnerships and similar entities. For example, the general partner in a limited partnership would evaluate whether it uses its decision-making authority in a principal or an agent capacity, rather than focusing on whether a simple majority of the limited partners hold substantive kick-out rights or participating rights.

**.182** The amendments in this proposed ASU would rescind the indefinite deferral provided for an investment manager and other similar entities by previous guidance. The extended comment period ended in February 2012.

### *Revenue Recognition*

**.183** In November 2011, FASB issued a revised proposed ASU to improve and converge the financial reporting requirements of IFRSs and GAAP for revenue and some related costs from contracts with customers. The boards decided to reexpose the proposals because of the importance of the financial reporting of revenue to all entities and the boards' desire to avoid unintended consequences arising from the final standard. The proposed standard would improve IFRSs and GAAP by

- providing a more robust framework for addressing revenue recognition issues.
- removing inconsistencies from existing requirements.
- improving comparability across companies, industries, and capital markets.
- providing more useful information to users of financial statements through improved disclosure requirements.
- simplifying the preparation of financial statements by streamlining the volume of accounting guidance.

**.184** The core principle of this revised proposed standard is the same as that of the 2010 exposure draft: an entity would recognize revenue from contracts with customers when it transfers promised goods or services to the customer. The amount of revenue recognized would be the amount of consideration promised by the customer in exchange for the transferred goods or services. However, in response to feedback received from nearly 1,000 comment letters on the 2010 exposure draft and extensive outreach activities, the boards further refined their original proposals. In particular, they

- added guidance on how to determine when a good or service is transferred over time.
- simplified the proposals on warranties.
- simplified how an entity would determine a transaction price (including collectability, time value of money, and variable consideration).
- modified the scope of the onerous test to apply to long-term services only.
- added a practical expedient that permits an entity to recognize as an expense costs of obtaining a contract (if one year or less).
- provided exemption from some disclosures for nonpublic entities that apply GAAP.

**.185** The comment period on the proposed ASU ended in March 2012.

### *Intangible Assets With Indefinite Lives*

**.186** In January 2012, FASB issued for public comment a proposed ASU on indefinite-lived intangible asset impairment testing that is intended to simplify impairment assessment and reduce the recurring costs to comply with existing guidance while improving the consistency of testing methods among long-lived asset categories for preparers. Examples of intangible assets subject to the proposal would include indefinite-lived trademarks, licenses, and distribution rights. The standard would apply to all public, private, and NFPs.

**.187** The amendments would allow an organization the option to first assess qualitative factors to determine whether it is necessary to perform the quantitative impairment test. An organization electing to perform a qualitative assessment no longer would be required to calculate the fair value of an indefinite-lived intangible asset, unless the organization determines, based on a qualitative assessment, that it is more likely than not that the asset's fair value is less than its carrying amount.

**.188** Under the current guidance, an organization is required to test an indefinite-lived intangible asset for impairment on at least an annual basis by comparing the fair value of the asset with its carrying amount. If the carrying amount of an indefinite-lived intangible asset exceeds its fair value, an impairment loss is recognized in an amount equal to the difference.

**.189** The comment period for this proposed ASU ended in April 2012.

## Resource Central

**.190** The following are various resources that practitioners engaged in the not-for-profit industry may find beneficial.

### Publications

**.191** Practitioners may find the following publications useful. Choose the format best for you: online or print.

- Audit and Accounting Guide *Not-for-Profit Entities* (2012) (product no. AAGNFP12P [paperback], WNP-XX [online with the associated Audit Risk Alert], or DNP-XX [CD-ROM])
- Audit and Accounting Guide Government Auditing Standards *and Circular A-133 Audits* (2012) (product no. AAGGAS12P [paperback] or WRF-XX [online with the associated Audit Risk Alert])
- Audit and Accounting Guide *Health Care Entities* (2011) (product no. 0126111 [paperback] or WHC-XX [online with the associated Audit Risk Alert])
- Audit and Accounting Guide *Employee Benefit Plans* (2012) (product no. AAGEBP12P [paperback] or WEB-XX [online])
- Audit Guide *Analytical Procedures* (2008) (product no. 012558 [paperback] or WAN-XX [online])
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2009) (product no. 012459 [paperback] or WRA-XX [online])

- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2010) (product no. 0125210 [paperback] or WDI-XX [online])
- Guide *Compilation and Review Engagements* (2011) (product no. 0128111 [paperback] or WRC-XX [online])
- Audit Guide *Audit Sampling* (2008) (product no. 012538 [paperback] or WAS-XX [online])
- Audit Risk Alert *Compilation and Review Developments—2011/12* (product no. 0223011 [paperback])
- Audit Risk Alert *General Accounting and Auditing Developments—2011/12* (product no. 0223311 [paperback] or WGE-XX [online])
- Audit Risk Alert *Independence and Ethics Developments—2011/12* (product no. 0224711 [paperback] or WIA-XX [online])
- Audit Risk Alert *Employee Benefit Plans Industry Developments—2012* (product no. ARAEBP12P [paperback])
- Checklists and Illustrative Financial Statements *Not-for-Profit Entities* (product no. CHKNFP12P [paperback] or WNP-CL [online])
- *Accounting Trends & Techniques, 65th Edition* (product no. 0099011 [paperback] or WAT-XX [online])
- *IFRS Accounting Trends & Techniques* (product no. 0099111 [paperback] or WIF-XX [online])
- *Not-for-Profit Entities Accounting Trends and Techniques* (product no. 0066110 [paperback] or WNT-XX [online])
- *Audit and Accounting Manual* (2011) (product no. 0051311 [paperback] or WAM-XX [online])

**.192** Additional resources for accountants in business and industry are the *Financial Reporting Alert* series, designed to be used by members of an entity's financial management and audit committee to identify and understand current accounting and regulatory developments affecting the entity's financial reporting:

- Financial Reporting Alert *Current Economic Instability: Accounting Issues and Risks for Financial Management and Reporting—2011* (product no. 0292011 [paperback])
- Financial Reporting Alert *Not-for-Profit Entities Accounting Issues and Risks 2011: Strengthening Financial Management and Reporting* (product no. 0292211 [paperback])

## AICPA Online Professional Library: Accounting and Auditing Literature

**.193** The AICPA has created your core accounting and auditing library online. The AICPA Online Professional Library is now customizable to suit your preferences or your firm's needs, or you can sign up for access to the entire library. Get access—anytime, anywhere—to FASB ASC; the AICPA's latest *Professional Standards*, *Technical Practice Aids*, Audit and Accounting Guides, Audit Risk Alerts, *Accounting Trends & Techniques*; and more. One option is the *AICPA Audit and Accounting Guides with FASB Accounting Standards Codification*™ that contains all audit and accounting guides, all audit risk alerts, and FASB ASC in the Online Professional Library (product no. WFA-XX [online]). To subscribe to this essential online service for accounting professionals, visit www.cpa2biz.com.

## Continuing Professional Education

**.194** The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *Annual Update for Accountants and Auditors (2011–2012 Edition)* (product no. 730097 [text], 180097 [DVD and manual], or 350097 [additional manual for DVD]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.
- *Internal Control Essentials for Financial Managers, Accountants and Auditors* (product no. 731858 [text], 181857 [DVD and manual], or 351857 [additional manual for DVD]). This course will provide you with a solid understanding of systems and control documentation at the significant process level.
- *International Versus U.S. Accounting: What in the World is the Difference?* (product no. 731669 [text], 181662 [DVD and manual], or 351662 [additional manual for DVD]). Understanding the differences between IFRSs and GAAP is becoming more important for businesses of all sizes. This course outlines the major differences between IFRSs and GAAP.

**.195** Among the many courses, the following are specifically related to the NFP industry:

- *Not-For-Profit Accounting & Reporting: From Start to Finish* (product no. 732985 [text]). This course trains you to clear the key hurdles in NFP accounting and reporting in an efficient and effective manner. Avoid the potholes of confusion and finish first by providing a financial picture that end users can truly understand.
- *Nonprofit Auditing and Accounting Update (2011–2012 Edition)* (product no. 732097 [text], 182078 [DVD and manual], or 352078 [additional manual for DVD]). Covering all the latest auditing and accounting developments affecting NFPs, this course will give you a complete understanding of changes in the NFP environment. For 2011–12, the course will include recent FASB pronouncements relating to not for profits (including mergers and acquisitions; endowments subject to the Uniform Prudent Management of Institutional Funds Act; FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*; and not for profits); developments in the Circular A-133 area; recent AICPA pronouncements related to communicating internal control-related matters identified in an audit; compliance auditing; RSI; and more.
- *Accounting and Reporting Practices of Not-for-Profit Organizations* (product no. 743279 [text]). Understand and apply the requirements of FASB and AICPA pronouncements to your NFP

clients. Consider real world financial statements, cases, and problems faced by CPAs with NFP clients and executives of NFPs.

- *Frequent Frauds Found in Governments and Not-For-Profits* (product no. 733314 [text]). Through an informative case study approach, this course illustrates common frauds that make headlines and damage the reputations of governments and NFPs.

**.196** Visit www.cpa2biz.com for a complete list of CPE courses.

### *Online CPE*

**.197** AICPA CPExpress, offered exclusively through CPA2Biz, is the AICPA's flagship online learning product. AICPA members pay $209 for a new subscription. Nonmembers pay $435 for a new subscription. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. Some topics of special interest to NFPs include the following:

- *Nonprofit Auditing: Unique Auditing for a Unique Entity*
- *Fraud in Exempt Organizations: The Governmental and Not-for-Profit Environments*
- *Nonprofit Accounting: Financial Reporting*

**.198** To register or learn more, visit www.cpa2biz.com.

## Webcasts

**.199** Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM. For additional details on available webcasts, please visit www.cpa2biz.com/AST/AICPA_CPA2BIZ_Browse/Store/Webcasts.jsp.

## Member Service Center

**.200** To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at 888.777.7077.

## Hotlines

### *Accounting and Auditing Technical Hotline*

**.201** Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. The hotline is available from 9 a.m. to 8 p.m. EST on weekdays. You can reach the Technical Hotline at 877.242.7212 or online at www.aicpa.org/Research/TechnicalHotline/Pages/TechnicalHotline.aspx. Members can also e-mail questions to aahotline@aicpa.org. Additionally, members can submit questions by completing a Technical Inquiry form found on the same website.

### *Ethics Hotline*

**.202** In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at 888.777.7077 or by e-mail at ethics@aicpa.org.

## Industry Conference

**.203** The AICPA offers its annual NFP conference in June in Washington, DC. The National Not-for-Profit Industry Conference is a comprehensive forum that deals with the challenges facing NFP practitioners and financial executives today. It's where you'll find out the latest information on the effect of tax, management, auditing, and accounting issues pertaining to NFPs. You'll also receive training in operational strategies that are crucial to the well-being of an NFP. For additional information about the conference, call 888.777.7077 or visit www.cpa2biz.com.

**.204** In October, the AICPA offers its Not-for-Profit Financial Executive Forum in San Francisco, CA. This conference is a unique educational offering focusing on the issues faced by financial executives in NFPs. The objective of the forum is to provide a solutions-based conference that will address a wide variety of relevant topics encountered by the NFP financial executive. The sessions offered will enable increased interaction and the exchange of ideas among the participants and will seek to provide clarification on the tough subjects. For additional information about the conference, call 888.777.7077 or visit www.cpa2biz.com.

## AICPA Government Audit Quality Center

**.205** The Government Audit Quality Center (GAQC) is a voluntary membership center for CPA firms and state audit organizations designed to improve the quality and value of governmental audits. Governmental audits are performed under *Government Auditing Standards* and are audits and attestation engagements of federal, state, or local governments; NFPs; and certain for-profit organizations, such as housing projects and colleges and universities that participate in governmental programs or receive governmental financial assistance. The GAQC keeps its members informed about the latest developments and provides them with tools and information to help them better manage their audit practice. CPA firms and state audit organizations that join demonstrate their commitment to audit quality by agreeing to adhere to certain membership requirements.

**.206** The GAQC has been in existence since September 2004. Since its launch, center membership has grown to 1,675 firms from 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, and 17 state audit organizations. The CPA firm portion of the GAQC membership accounts for approximately 90 percent of the total federal expenditures covered in single audits performed by CPA firms in the Federal Audit Clearinghouse database (http://harvester.census.gov/sac/) for the year 2008 (the latest year with complete submission data).

**.207** The GAQC's focus is to promote the highest quality audits and to save members time by providing a centralized place to find information that they need, when they need it, to maximize quality and practice success. Center resources include the following:

- E-mail alerts with the latest audit and regulatory developments, including information on the American Recovery and Reinvestment Act of 2009 and its effect on your audits
- Exclusive Internet seminars, webcasts, and teleconferences on compliance auditing and timely topics relevant to governmental and not-for-profit financial statement audits (optional CPE is available for a small fee, and events are archived online)
- Dedicated GAQC website at www.aicpa.org/GAQC with resources, community, events, products, and a complete listing of GAQC member firms in each state
- Online member discussion forums for sharing best practices and discussing issues members are facing
- Savings on professional liability insurance

**.208** For more information about the GAQC, visit www.aicpa.org/GAQC.

## AICPA Industry Expert Panel—Not-for-Profit Entities

**.209** For information about the activities of the AICPA Not-for-Profit Entities Industry Expert Panel, visit the panel's Internet page at www.aicpa.org/InterestAreas/FRC/IndustryInsights/Pages/Expert_Panel_Not_for_Profit_Entities.aspx.

## Industry Websites

**.210** The Internet covers a vast amount of information that may be valuable to auditors of NFPs, including current industry trends and developments. Some of the more relevant sites for auditors with NFP clients include those shown in the appendix of this alert.

**.211** The NFP industry practices of some of the larger CPA firms also may contain industry-specific auditing and accounting information that is helpful to auditors.

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# Appendix—Additional Internet Resources

Here are some useful websites that may provide valuable information to accountants.

| *Website Name* | *Content* | *Website* |
|---|---|---|
| AICPA | Summaries of recent auditing and other professional standards, as well as other AICPA activities | www.aicpa.org<br>www.cpa2biz.com<br>www.ifrs.com |
| AICPA Accounting and Review Services Committee | Summaries of review and compilation standards and interpretations | www.aicpa.org/Research/Standards/CompilationReview/ARSC/Pages/ARSC.aspx |
| AICPA Financial Reporting Executive Committee (formerly known as the Accounting Standards Executive Committee) | Summaries of recently issued guides, technical questions and answers, and practice bulletins containing financial, accounting, and reporting recommendations, among other things | www.aicpa.org/InterestAreas/FRC/AccountingFinancialReporting/Pages/FinREC.aspx |
| Better Business Bureau | Information about not-for-profit entities (NFPs) and donors | www.give.org |
| Board Source | Resources to help strengthen NFPs' boards of directors | www.boardsource.org |
| The *Chronicle of Philanthropy* | Articles from the *Chronicle of Philanthropy* newspaper and links to other sites | www.philanthropy.com |
| CompassPoint Nonprofit Services | Workshops, consulting, publications, and other information and resources of interest to managers of NFPs | www.compasspoint.org |
| CPAnet | Links to other websites of interest to CPAs | www.cpanet.com |

*(continued)*

| *Website Name* | *Content* | *Website* |
|---|---|---|
| Economy.com | Source for analyses, data, forecasts, and information on the U.S. and world economies | www.economy.com |
| The Federal Reserve Board | Source of key interest rates | www.federalreserve.gov |
| Financial Accounting Standards Board (FASB) | Summaries of recent accounting pronouncements and other FASB activities | www.fasb.org |
| Government Accountability Office | Policy and guidance materials and reports on federal agency major rules | www.gao.gov |
| Governmental Accounting Standards Board (GASB) | Summaries of recent accounting pronouncements and other GASB activities | www.gasb.org |
| Guidestar | Information, news, and resources for NFPs and donors | www.guidestar.org |
| Independent Sector | A forum to encourage giving, volunteering, NFP initiatives, and citizen action | www.independentsector.org |
| Information for Tax-Exempt Organizations (an IRS site) | A Treasury Department site providing information and answers to frequently asked questions regarding tax-exempt entities | www.irs.gov/charities/index.html |
| International Accounting Standards Board | Summaries of International Financial Reporting Standards and International Accounting Standards | www.iasb.org |
| International Auditing and Assurance Standards Board | Summaries of International Standards on Auditing | www.iaasb.org |

| ***Website Name*** | ***Content*** | ***Website*** |
|---|---|---|
| International Federation of Accountants | Information on standards-setting activities in the international arena | www.ifac.org |
| National Association of College and University Business Officers | Provides information geared to colleges and universities, including accounting tutorials on specific situations encountered in higher education accounting | www.nacubo.org |
| National Center for Charitable Statistics | Provides statistics on revenue and expenses of NFPs | www.nccs.urban.org |
| Nonprofit Risk Management Center | Provides information to help NFPs control their risks | www.nonprofitrisk.org |
| The *NonProfit Times* Online | Articles from the *NonProfit Times* newspaper and links to other sites | www.nptimes.com |
| Office of Management and Budget (OMB) | OMB information and literature, including cost circulars | www.whitehouse.gov/omb/agency/default |
| Private Company Financial Reporting Committee | Information on the initiative to further improve FASB's standard-setting process to consider needs of private companies and their constituents of financial reporting. | www.pcfr.org |
| USA.gov | Portal through which all government agencies can be accessed | www.usa.gov |