

## Background and Regulatory Issues

The purpose of this chapter is to set the stage for understanding the various considerations to make when establishing best practices for a not-for-profit organization's audit committee. In other words, to determine those characteristics of these organizations that make them so distinctive that simply mimicking the requirements of audit committees established by other types of organizations (such as the Sarbanes-Oxley Act of 2002, which applies to publicly traded companies) would fail to result in what could be considered best practices for a not-for-profit organization's audit committee.

Specifically, this chapter will address the following:

- The types of not-for-profit organizations covered by this book
- The unique characteristics of not-for-profit organizations
- The financial reporting environment for not-for-profit organizations
- Users of not-for-profit organization financial statements
- The regulatory environment for not-for-profit organizations

Understanding these basics will lay the framework for establishing best practices for whatever type of organization the reader is involved with.

### **TYPES OF NOT-FOR-PROFIT ORGANIZATIONS COVERED BY THIS BOOK**

The term “not-for-profit” encompasses a very broad range of organizations. Major colleges and universities, private schools, as well as hospitals and medical centers are typically organized as not-for-profit organizations. Social service organizations, such as homeless shelters, day care centers, senior citizen centers, are also likely to be set up as not-for-profit organizations. Most religious organizations, too, are established as not-for-profits. In addition, there is a broad range of very small organizations structured at a local level, such as parent-teacher associations, youth sports (soccer, baseball, etc.) groups, to name a few, that are not-for-profit in nature. And let us not leave out political, trade, and professional organizations, and country clubs. From this simple, far from inclusive list, you can see that the needs of a particular organization as to an audit committee will

vary greatly. The ideas presented throughout this book will attempt to strike a middle ground—that is, a mid-sized not-for-profit organization. Where appropriate, ideas for reducing or strengthening the role of an audit committee will be presented so that small and larger organizations can customize the suggestions for their particular circumstances.

## UNIQUE CHARACTERISTICS OF NOT-FOR-PROFIT ORGANIZATIONS

What makes not-for-profit organizations so special that they need their own best practices for their audit committees? The easy answer is that not-for-profit organizations do not have as their primary motive the objective to make a profit. But this answer does not explain what makes not-for-profit organizations unique, particularly from a financial accounting and reporting perspective, so let's look at this in a little more depth.

Fortunately, the Financial Accounting Standards Board (FASB), which establishes generally accepted accounting principles (GAAP) for not-for-profit organizations, has already examined this question and presented its “concepts” in its FASB’s Concepts Statement No. 4 (“Objectives of Financial Reporting by Nonbusiness Organizations”). Although this concepts statement is fairly old (it was issued in 1980), it was later used by the FASB to formulate the accounting and financial reporting requirements used by not-for-profit organizations today. Therefore, audit committee members would be well advised to gain at least a general understanding of the concepts presented in this document so that they can better work with the foundation of the financial reports issued by not-for-profit organizations.

### PERSPECTIVE:

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You may be familiar with the debate over whether accounting standards should be more “principles-based” or “rules-based.” In other words, should accounting standards present accounting objectives and the basic principles required to be used by an organization in its financial reporting, or should accounting standards present detailed, specific rules for how specific types of transactions are accounted? Recent publicized accounting failures demonstrate that some organizations may have been clever enough to “get around” specific rules, yet technically comply with GAAP, while probably violating the principle (or spirit) on which those particular rules are based. Having a basic understanding of the conceptual framework of financial reporting for not-for-profit organizations can help audit committee members ask the right questions, to ensure that their organization is complying with both the rule and the spirit of any particular accounting standard.

The Concepts Statement No. 4 (Con-4) highlights the following differences between business and nonbusiness enterprises:

Receipts of significant amounts of resources from resource providers who do not expect to receive either repayment or economic benefits proportionate to resources provided.

A donor that makes a contribution to a not-for-profit organization does not expect a direct benefit of a similar economic amount from the organization as a result of the contribution. Sometimes these types of transactions are called *non-exchange transactions* because the contribution is not exchanged for something; rather, it is given without the expectation that something will be received in return. Contrast this to a business-type transaction where you pay a specific price for some item or service. You are not interested in paying more than the amount of the economic benefit that you receive in return. For example, you pay for the gasoline received when you fill up your car. Many not-for-profit organizations engage in both nonexchange and exchange transactions. A good example would be a not-for-profit school. Tuition is paid for the right to attend the school—an exchange transaction. At the same time, students, parents, and alumni are solicited for contributions to the school. These contributions would be nonexchange transactions.

Some transactions have characteristics of both exchange and nonexchange transactions. For example, assume the aforementioned school holds a bake sale to fund new books for its library. Yes, you would get a cake for your contribution, but you probably wouldn't have bought that cake for the same amount at the local bakery. The transaction is partially an exchange transaction and partially a nonexchange transaction.

Operating purposes that are other than to provide goods or services at a profit or profit equivalent.

This should be fairly obvious from the name “not-for-profit organization,” but it deserves comment to help establish the financial reporting framework that is necessary to understand. A different way to look at this concept is to recognize that a not-for-profit organization's goal is not always to maximize revenues and to minimize expenses, resulting in the greatest amount of excess revenues over expenses. On the revenue side, a not-for-profit organization may not always charge its “customers” the highest that it can for the services it provides. Often, providing services at below a market rate may be the objective of the not-for-profit organization. On the expense side, a distinction needs to be made between an organization's administrative costs and its program costs. While it's true that not-for-profit organizations generally try to minimize their administrative expenses, this is not usually the case with program expenses. Program expenses are those spent on supporting the activities of the not-for-profit organization's reason for being. Most not-for-profit organizations try to spend as much on programs as they possibly can without jeopardizing their financial well-being.

On balance, a typical not-for-profit prefers to report in its financial statements a balance between its revenues and expenses, resulting in a small excess or deficiency of revenues over expenses. When a not-for-profit organization's revenues consistently exceed its expenses, it becomes difficult to make the case to donors that their contributions are necessary, since it appears that the organization has more money coming in than it is spending. On the other hand, consistently overspending the revenues that come in can lead a not-for-profit organization to a precarious, or worse, financial condition.

Many additional factors may influence a not-for-profit organization's financial operating practices. For example, a not-for-profit organization may try to have surplus revenues in the short run because it is trying to accumulate resources for some significant program or construction activity that it anticipates in the future. It is important that audit committee members understand these considerations when reading and reviewing the not-for-profit organization's financial statements.

Absence of defined ownership interests that can be sold, transferred, or redeemed, or that convey entitlement to a share of a residual distribution of resources in the event of liquidation of the organization.

Not-for-profit organizations are created by organizers that come to own no stock or other ownership interest in the organization. These organizations are set up according to various state not-for-profit corporation laws, and obtain tax-exempt status after application to the Internal Revenue Service. The organization has to be set up for purposes of pursuing what it defines as its objective, or *exempt function*, that is appropriate and allowable for a not-for-profit organization. The organization cannot be created for purposes of providing a private financial benefit to the organizers of the organization, successor governing board members, or management members outside of their normal compensation. In other words, a not-for-profit that has accumulated significant net assets by consistently having excesses of revenues over expenses can't be sold or transferred to someone else, nor can the board, management, or the original organizers share in these accumulated resources for their own benefit. Not-for-profit organization audit committee members should be aware of these requirements because they are so different from those of business enterprises. This concept will be reinforced later in this book when we cover conflicts-of-interest statements, which will be recommended to be completed by audit committee members.

## **FINANCIAL REPORTING ENVIRONMENT OF NOT-FOR-PROFIT ORGANIZATIONS**

This section is not intended to present a comprehensive guide to not-for-profit GAAP and financial statement preparation. A number of other resources devoted to specific not-for-profit accounting and financial reporting issues are available to audit committee members. (I have written one such resource, titled *Not-for-Profit Accounting Made Easy*, also published by John Wiley & Sons, Inc. [2002], which an audit committee member will find useful.) Rather, this section describes what

an audit committee member should know, and be thinking about, when reading a set of not-for-profit organization's financial statements. As such, let's consider the following important topics regarding the financial reporting environment of not-for-profit organizations.

## Basic Financial Statements

As noted earlier, the accounting and financial reporting rules known as GAAP for not-for-profit organizations are established by the FASB. The American Institute of Certified Public Accountants (AICPA) also publishes statements of position, accounting and audit guides, staff position papers, and other resources that, while not as authoritative as FASB statements, contribute to the body of knowledge that constitutes GAAP for not-for-profit organizations. Much of the audit committee's function that is discussed in this book involves ensuring that these basic financial statements are presented fairly in accordance with GAAP. The basic financial statements for not-for-profit organizations comprise the following elements.

**Statement of Financial Position.** Many nonaccountants would probably refer to the statement of financial position as a balance sheet. This statement provides a snapshot of a not-for-profit organization's assets, liabilities, and net assets. Net assets represent the difference between total assets and total liabilities. The statement of financial position is prepared as of the not-for-profit organization's fiscal year-end.

**Statement of Activities.** The statement of activities presents the increases and decreases to a not-for-profit organization's net assets over a period of time, which for annual financial statements, is for the period representing the entire fiscal year. This statement basically represents the not-for-profit organization's operating or income statements, displaying items that both increased net assets (such as contribution revenues) and decreased net assets (such as resources spent on program or administrative activities.)

**Statement of Cash Flows.** The statement of cash flows provides information about the not-for-profit organization's receipts and disbursements of cash. Cash receipts and disbursements in the cash flow statement are classified into three categories: operating activities, investing activities, and financing activities.

**Notes to the Financial Statements.** Many readers of the financial statements of not-for-profit organizations overlook the importance of the notes that are part of those statements. The notes are not simply an add-on to the basic financial statements; they are an integral part of the financial statements. The sources for the requirements of the notes to the financial statements are many. Each new FASB statement or pronouncement that is issued, more often than not, includes some new disclosure requirements that must be contained in the notes to the financial statements to address some specific aspect of the new statement or pronouncement.

In addition to the notes required by new statements or pronouncements, there are some core notes that must be included. One of the most significant notes, which is generally the first one reported, is the summary of significant accounting policies. In certain circumstances, not-for-profit organizations can choose among a number of acceptable accounting principles to use. Where such choice exists, the summary of significant accounting policies helps to understand which policies were chosen. This is an important note for audit committee members to read and comprehend. The audit committee should be aware of the selection of accounting policies by the not-for-profit organization and be satisfied that appropriate selections are being made. Sometimes organizations, including not-for-profits, select accounting policies because they serve some particular need or desire of management, rather than strictly on the merits of the various alternatives. While this may be fine for each individual accounting policy selected, the cumulative effect of accounting policy elections may indicate that the financial reporting practices of the organization are aggressive or conservative. Audit committee members should try to get a sense for how and why accounting policies are selected and be comfortable with them individually and collectively.

### **The Annual Report**

Many midsize to large not-for-profit organizations issue an annual report, which is often called a glossy annual report that includes the basic financial statements and other information. The term “glossy” refers to the coated, shiny paper on which the annual report is printed. In addition to the basic financial statements, the annual report usually contains pictures of the organization’s programs in action, a letter from the president or executive director, descriptions of program activities, and information about major donors. Because the annual report contains the basic financial statements, audit committee members should review the document to familiarize themselves with its contents and to serve as a control—that is, to ensure that the information presented does not conflict with anything in the basic financial statements. For example, if the executive director’s letter in the annual report states that contributions increased 20 percent from the prior fiscal year, but the financial statements report a decrease in contributions, that inconsistency must be resolved, either by correction of the executive director’s letter or inclusion of an explanation as to why this isn’t, in fact, an inconsistency. The not-for-profit organization’s independent auditors should also read the entire annual report to identify any inconsistencies or discrepancies within the basic financial statements.

### **Interim Budgetary Reporting**

The annual preparation and issuance of financial statement presented in accordance with GAAP would, by itself, generally not be considered sufficient for the day-to-day financial management of a midsize to large not-for-profit organization. First, financial statements presented in accordance with GAAP do not include a requirement to report any comparison of actual financial results with the organization’s budget. Such a comparison provides an interesting insight as to how well

management anticipates future financial activities through its budget and how well it executes its financial plan to “live” within the budget. Audit committee members should keep in mind that incentives to management to manipulate financial results take many forms. Although a not-for-profit organization does not report earnings per share as a financial performance indicator, certainly management is interested in knowing how the organization’s actual results compare to its budget; accordingly, comparisons to budget may be an area that provides an incentive to management to manipulate financial results. For example, assume a large pledge for a contribution wasn’t finalized until the week after the fiscal year-end, resulting in contribution revenues for the year being slightly overbudget instead of slightly underbudget. In this case, wouldn’t there be an incentive for management to move that contribution back and report it in the earlier fiscal year? The point is not to suggest that most not-for-profit organization managers would do this, but to make you aware of these types of incentives and to stress the budget as an important performance indicator in the not-for-profit environment.

The second concept in this section deals with “interim” reporting in comparison with budgeted amounts. If an organization only compares budget to actual results after the end of the fiscal year, there is no time to make corrections to activities during the year to come closer to the budgeted amounts. These comparisons should be performed at least quarterly; but for midsize to larger not-for-profit organizations, monthly comparisons are probably more appropriate. These comparisons are important components of the internal control of the organization. The audit committee should be concerned with whether the organization’s management regularly reports these amounts (along with explanations for variances and plans to remediate problems) to the governing board as a whole or to the budget or finance subcommittees of the governing board.

## **USERS OF NOT-FOR-PROFIT ORGANIZATION FINANCIAL STATEMENTS**

An audit committee member might wonder why it is important to understand who are the primary readers and users of not-for-profit organization financial statements. Knowing the users of financial statements helps in making judgments about whether the financial statements are fairly stated in accordance with GAAP. Why is this the case? Basically, the preparation of financial statements involves many judgments, and many of these judgments concern the concept of what is “material” to the financial statements. Materiality is defined in another FASB Concepts Statement (No. 2, “Qualitative Characteristics of Accounting Information”) as “the magnitude of an omission or misstatement of accounting information that, in light of the surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.” So materiality is based on the potential effect that the item being considered might have on a reader of the financial statements. Accordingly, it’s a good idea for the committee members to have some perspective on the typical readers of not-for-profit organization financial statements.

In the environment of business organizations, specifically publicly traded companies, audit committee members can readily understand the primary users of financial statements. The audit committee members are elected to the governing board by shareholders, who have a keen interest in the financial reporting of the organization, since the financial performance reflected in the financial statements has an impact on the corporation's share price. Long-term debt holders and other creditors are also interested in whether the corporation has the ability to repay these debts in the future, and look to the financial statements as a primary means of making this assessment. In contrast, audit committee members of not-for-profit organizations have to ask themselves who are the primary users of the financial statements of not-for-profit organizations, because the answers are not quite as obvious as for public companies.

Looking again to the FASB's Concepts Statement No. 4, we find the following four groups that might be interested in the financial statements of not-for-profit organizations. These groups are not meant to be an all-inclusive listing of every type of individual who might read a not-for-profit organization's financial statements. Rather, it is meant to stimulate thought into what type of information may be important to various readers of a not-for-profit organization's financial statements, and to recognize that there are important differences between readers of not-for-profit financial statements and business organization financial statements.

### **Resource Providers**

The most common resource providers to not-for-profit organizations are contributors. A contributor is, for example, very interested in knowing how much of the money received as contributions by not-for-profit organizations is used in its program activities, compared with how much is spent on general and administrative expenses, including fund-raising. A contributor making a long-term commitment for a capital program to a not-for-profit organization might also be interested in whether the organization is financially stable and whether it will still be in existence by the time that the capital program is completed. A contributor who imposes restrictions as to the purpose or timing of the use of a particular contribution may also be interested in seeing whether the organization has properly noted those restrictions in the financial statements.

A second type of resource provider includes those that are members of not-for-profit membership organizations. Examples include trade and professional associations, such as those for accountants, lawyers, physicians, engineers, and so on. Members are interested in knowing that their dues are being put to good programmatic use, to benefit them.

Several other types of resource providers that would be interested in a not-for-profit organization's financial statements include lenders, suppliers, and employees. Lenders and suppliers have an obvious interest in evaluating whether the not-for-profit organization will be able to repay any loans or credit extended as part of routine purchases of supplies. Employees are interested in knowing the financial soundness of the organization to determine such things as whether their payroll taxes, pension contributions, health insurance premiums, and so on are

being paid timely. In addition, employees would be interested in knowing whether an organization has adequate resources to provide for salary increases in future years.

### **Constituents**

Constituents are those who use and benefit from the services rendered by the not-for-profit organization. In the case of membership organizations, these may be the parties of the resource providers just described.

### **Governing and Oversight Bodies**

These would include the not-for-profit organization's governing board, which may use the financial information provided in the financial statements to oversee and appraise the managers of the organization. Oversight bodies include national headquarters of organizations with local chapters, accrediting agencies, and agencies acting on behalf of contributors or constituents.

### **Managers**

Managers of a not-for-profit organization are responsible for carrying out the policy mandates of governing bodies and managing the day-to-day operations of an organization. Managers include the managing executives appointed by the governing body, such as the executive director, and staff, such as fund-raising and program directors.

## **REGULATORY ENVIRONMENT OF NOT-FOR-PROFIT ORGANIZATIONS**

One mistake that a not-for-profit organization audit committee member can easily make is to believe that not-for-profit organizations are relatively free of regulation. While it's true that these organizations are generally not publicly traded companies subject to the accounting and financial reporting requirements of the United States Securities and Exchange Commission, it would be incorrect to assume that there are no regulatory oversights. Audit committee members must not let themselves be blinded by the good works that a not-for-profit organization may be performing, if the same organization is running afoul of the regulations to which it is subject.

Let's look at two levels of regulation that would be common to most not-for-profit organizations: federal and state.

### **Federal Regulation**

The first level of regulation to consider at the federal government level is that which is provided by the Internal Revenue Service (IRS). The IRS is the organization that grants a not-for-profit organization its exemption from federal income

taxes. Does this mean that once an organization is granted such exemption it is free and clear of any IRS rules and regulations? Far from it. Let's consider a few areas by way of example:

- *Annual information return.* Not-for-profit organizations (except the very small ones) must file annual "information returns" with the IRS. This return is commonly referred to as Form 990, although there are some variations of it for small organizations and private foundations.
- *Unrelated business income tax.* To the extent that the organization earns income in ways not related to its exempt purpose, these earnings are subject to an unrelated business income tax, which must be paid to the IRS, fairly similar to a regular corporate income tax.
- *Payroll taxes.* While some not-for-profit organizations may be exempt from federal unemployment tax, generally this tax will apply, as well as all of the other payroll taxes, such as Social Security and Medicare taxes.
- *Prohibited or limited activities rules.* Depending on the Internal Revenue Section code under which a not-for-profit organization obtains its tax exemption, there are rules as to the types of activities an organization may engage in, particularly in the area of political activities and lobbying. In addition, the organization cannot be operated in such a manner that it privately benefits members of management or the governing board beyond normal amounts for compensation for services. Failure to follow these rules could result in monetary sanctions against the not-for-profit organization or, far worse, loss of its tax-exempt status.

The second level of federal regulation involves not-for-profit organizations that are recipients of federal awards, such as federal grants, loans, cooperative agreements, or contracts. These requirements apply whether the not-for-profit organization receives the federal award directly from a federal agency or indirectly, such as those passed through a state or local governmental entity or another not-for-profit organization. The requirements involve how the federal awards programs are managed, the various compliance requirements that must be adhered to in spending money under the various programs, and the annual audit and requirement requirements, which are commonly referred to as a *Single Audit*.

Keep in mind that not-for-profit organizations are, of course, subject to many other federal requirements, as are business enterprises, such as equal opportunity in employment and family leave requirements.

## State Regulation

Not-for-profit organizations are also subject to regulation by states. These regulations will vary by state, but the following examples illustrate the complexity of some of these requirements:

- *Annual registration and reporting requirements.* Not-for-profit organizations are incorporated under the laws of a particular state. States generally have

annual registration requirements using a form designed and issued by each particular state. Often, these registration forms must be accompanied by the financial statements of the not-for-profit organization. Based on the size of the organization, the financial statements may be required to be reviewed or audited by an independent auditor.

- *Raising funds in other states.* States generally have requirements that not-for-profit organizations incorporated in other states must register in order to solicit contributions within that state. Accordingly, not-for-profit organizations that raise funds in a number of states will need to comply with the various requirements of these states.
- *Oversight by state attorneys general or charities bureaus.* Again, depending on the structure of each individual statement, there will generally be a branch of the state government that has responsibility for monitoring the activities of the not-for-profit organizations incorporated or soliciting funds within that state.
- *Sales taxes.* A not-for-profit organization's tax-exempt status is unrelated to its responsibilities to collect and remit to state or local governments any sales taxes due on items or services that are sold by the not-for-profit organization.

The preceding points are certainly not meant to describe all of the regulations with which a not-for-profit organization must comply. Rather, they are meant to provide examples to not-for-profit audit committee members of the types of regulations to which these organizations are subject.

## SUMMARY

This chapter provides a broad overview of not-for-profit organizations in general, and some of the financial reporting considerations of these organizations in particular. Understanding the context of the environment in which not-for-profit organizations operate is an important best practice for audit committee members of these organizations.

