Chapter 1

Introduction

Gray shaded text in this chapter reflects guidance issued but not yet effective as of the date of this guide, March 1, 2018, but becoming effective on or prior to June 30, 2018, exclusive of any option to early adopt ahead of the mandatory effective date. Unless otherwise indicated, all unshaded text reflects guidance that was already effective as of the date of this guide.

Scope

Entities

1.01 This Audit and Accounting Guide covers entities that meet the definition of a not-for-profit entity (NFP) included in the FASB Accounting Standards Codification (ASC) glossary. That definition is

an entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity:

a. Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return
b. Operating purposes other than to provide goods or services at a profit
c. Absence of ownership interests like those of business entities.

Entities that clearly fall outside this definition include the following:

a. All investor-owned entities
b. Entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance entities, credit unions, farm and rural electric cooperatives, and employee benefit plans.

As noted in the preceding definition, NFPs have characteristics (a), (b), and (c) in varying degrees. An entity could meet the definition of an NFP without possessing characteristic (a), (b), or (c). For example, some NFPs, such as those that receive all their revenue from exchange transactions, receive no contributions.

1.02 This guide applies to the following nongovernmental NFPs:

- Animal protection and humane organizations
- Cemetery organizations
- Civic and community organizations
- Colleges and universities
- Elementary and secondary schools
- Federated fund-raising organizations
- Fraternal organizations
- Labor unions
Not-for-Profit Entities

- Libraries
- Museums
- Other cultural organizations
- Performing arts organizations
- Political action committees
- Political parties
- Private and community foundations
- Professional associations
- Public broadcasting stations
- Religious organizations
- Research and scientific organizations
- Social and country clubs
- Trade associations
- Voluntary health and welfare entities
- Zoological and botanical societies

Additionally, the guidance in this guide applies to all entities that meet the definition of an NFP in paragraph 1.01, regardless of whether they are included in this list.

1.03 Paragraph 1.02 states that this guide applies to certain nongovernmental NFPs. The FASB ASC glossary defines a nongovernmental entity as an entity that is not required to issue financial reports in accordance with guidance promulgated by GASB or the Federal Accounting Standards Advisory Board (FASAB). When an NFP meets the definition for a governmental entity in paragraph 1.04, the appropriate generally accepted accounting principles (GAAP) for the financial statements of the NFP is promulgated by GASB. Therefore, other than paragraph 1.04, the accounting and financial reporting guidance in this guide does not constitute category (b) accounting and financial reporting guidance for NFPs that meet the definition for a governmental entity because the AICPA did not make this guide applicable to such governmental NFPs, and GASB did not clear it.

1.04 As noted in AICPA Audit and Accounting Guide State and Local Governments, public corporations\(^1\) and bodies corporate and politic are governmental organizations. Other organizations are governmental if they have one or more of the following characteristics:

- Popular election of officers or appointment (or approval) of a controlling majority of the members of the organization’s governing body by officials of one or more state or local governments

\(^1\) Black’s Law Dictionary defines a public corporation as:

An artificial person (for example, a municipality or a governmental corporation) created for the administration of public affairs. Unlike a private corporation it has no protection against legislative acts altering or even repealing its charter. Instrumentalities created by the state, formed and owned by it in the public interest, supported in whole or part by public funds, and governed by managers deriving their authority from the state. Sharon Realty Co. v. Westlake, Ohio Com. Pl., 188 N.E.2d 318, 323, 25 O.O.2d 322. A public corporation is an instrumentality of the state, founded and owned in the public interest, supported by public funds and governed by those deriving their authority from the state. York County Fair Ass’n v. South Carolina Tax Commission, 249 S.C. 337, 154 S.E.2d 361, 362.
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- The potential for unilateral dissolution by a government with the net assets reverting to a government
- The power to enact and enforce a tax levy

Furthermore, organizations are presumed to be governmental if they have the ability to issue directly (rather than through a state or municipal authority) debt that pays interest exempt from federal taxation. However, organizations possessing only that ability (to issue tax-exempt debt) and none of the other governmental characteristics may rebut the presumption that they are governmental if their determination is supported by compelling, relevant evidence.

The preceding definition of a government is category (b) accounting and financial reporting guidance for governmental entities because GASB has cleared it. Therefore, NFPs meeting the previously listed criteria are subject to the accounting standards promulgated by GASB and, as applicable, should refer to those standards and the related interpretive guidance in AICPA Audit and Accounting Guide State and Local Governments.

1.05 Providers of health care services that are described in FASB ASC 954-10-15 are not covered by this guide and should refer to the AICPA Audit and Accounting Guide Health Care Entities. That guide applies to entities whose principal operations consist of providing or agreeing to provide health care services and that derive all or almost all of their revenues from the sale of goods or services; it also applies to entities whose primary activities are the planning, organization, and oversight of such entities, such as parent or holding companies of health care entities. The health care guide does not apply to voluntary health and welfare entities (see paragraph 1.06), but it does apply to not-for-profit health care entities that have no ownership interest and are essentially self-sustaining from fees charged for goods and services (as described in paragraph 8 of FASB Concept No. 4, Objectives of Financial Reporting by Nonbusiness Organizations).

1.06 If a provider of health care services meets the definition of a voluntary health and welfare entity in the FASB ASC glossary, it should follow this guide. That definition is as follows:

A not-for-profit entity (NFP) that is formed for the purpose of performing voluntary services for various segments of society and that is tax exempt (organized for the benefit of the public), supported by the public, and operated on a not-for-profit basis. Most voluntary health and welfare entities concentrate their efforts and expend their resources in an attempt to solve health and welfare problems of our society and, in many cases, those of specific individuals. As a group, voluntary health and welfare entities include those NFPs that derive their revenue primarily from voluntary contributions from the general public to be used for general or specific purposes connected with health, welfare, or community services. For purposes of this definition, the general public excludes governmental entities when determining whether an NFP is a voluntary health and welfare entity.
Basis of Accounting

1.07 The focus of this guide is financial statements prepared in accordance with GAAP in the United States under the assumption that the NFP will continue to operate as a going concern. Unless liquidation is imminent, an NFP prepares its financial statements under the assumption that it will continue to operate as a going concern. When liquidation is imminent, FASB ASC 205-30 provides guidance on how an entity should prepare its financial statements using the liquidation basis of accounting and describes the related disclosures that should be made. FASB ASC 205-30-25-2 provides the characteristics that determine whether liquidation is imminent.

1.08 Cash-, modified cash-, or tax-basis financial statements can be a viable alternative to GAAP-basis financial statements whenever the NFP is not contractually required—legally or otherwise—to issue GAAP financial statements. Guidance on financial statements prepared with a special purpose framework (formerly referred to as an other comprehensive basis of accounting or OCBOA) is found in the audit, not accounting, literature. AU-C section 800, Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks, addresses special considerations in the application of auditing standards to an audit of financial statements prepared in accordance with a special purpose framework, which is a cash, tax, regulatory, contractual, or an other basis of accounting.

1.09 In addition, the Practice Aid Accounting and Financial Reporting Guidelines for Cash- and Tax-Basis Financial Statements provides nonauthoritative guidance on financial statements prepared in conformity with a special purpose framework.

1.10 This guide is not intended for use in preparing financial statements in accordance with International Financial Reporting Standards (IFRSs). The council of the AICPA has designated the International Accounting Standards Board (IASB) as the body to establish IFRSs for both private and public entities pursuant to the "Compliance With Standards Rule" (ET sec. 1.310.001) and the "Accounting Principles Rule" (ET sec. 1.320.001) of the AICPA Code of Professional Conduct. The IASB does not have a reporting model designed specifically for NFPS; however, the IASB and FASB have indicated that they will jointly consider the applicability of their conceptual framework project to private sector not-for-profit organizations after FASB completes its work for a conceptual framework for private sector business entities Paragraph 1.12 discusses situations when an auditor practicing in the United States is engaged to audit and report on financial statements prepared in conformity with accounting principles generally accepted in another country or to perform an audit in accordance with International Standards on Auditing (ISAs).

Level of Service

1.11 This guide provides auditing considerations and reporting guidance for CPAs that are engaged to audit and report on financial statements in accordance with generally accepted auditing standards (GAAS) for nonissuers.
Many NFPs are required by state regulations, bond covenants, or grantors to have an audit. Other levels of service are offered by CPAs, but those are not the focus of this guide.

1.12 This guide also assumes that the independent auditor will be reporting on financial statements prepared in accordance with U.S. GAAP. If an auditor practicing in the United States is engaged to audit and report on financial statements prepared in conformity with accounting principles generally accepted in another country or to perform an audit in accordance with ISAs, the auditor should be aware of and consider the following additional publications:

- Paragraphs .42–.43 and .A42 of AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*, which discusses auditor's reports for audits conducted in accordance with both GAAS and another set of auditing standards
- Paragraph .A9 of AU-C section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*, which discusses reporting if an entity prepares one set of financial statements in accordance with accounting principles generally accepted in the United States of America and another set of financial statements in accordance with another general purpose framework (for example, IFRSs promulgated by the IASB)
- AU-C section 910, *Financial Statements Prepared in Accordance With a Financial Reporting Framework Generally Accepted in Another Country*

**GAAP for NFPs**

1.13 FASB ASC is the single authoritative source of U.S. accounting and reporting standards for nongovernmental entities; that is, it is the source of GAAP for nongovernmental entities. The council of the AICPA has resolved that FASB ASC constitutes accounting principles as contemplated in the "Accounting Principles Rule" of the AICPA Code of Professional Conduct.

1.14 NFPs should follow the guidance in all effective provisions of FASB ASC unless the specific provision explicitly exempts NFPs or its subject matter precludes such applicability. FASB ASC 958, *Not-for-Profit Entities*, contains only incremental industry-specific guidance. NFPs should follow that industry-specific guidance and all other relevant guidance contained in other FASB ASC topics that does not conflict with FASB ASC 958.

1.15 Most of the guidance in FASB ASC topics 105–899 applies to NFPs, although the application of certain provisions by NFPs may be unclear because those provisions specify the financial statement display of financial statement elements or items without considering the net asset reporting model included in FASB ASC 958. Nevertheless, NFPs are required to follow those effective provisions. FASB ASC 958-10-45-1 states that NFPs should consider the reporting objectives of the guidance when exercising judgment about how to best display elements, such as in which net asset class. Examples of those provisions include the following:

- FASB ASC 205-20, about discontinued operations
- FASB ASC 220-20, about unusual or infrequently occurring items
1.16 The guidance in FASB ASC topics 905–999 applies to entities operating in certain industries. An example of such guidance is FASB ASC 920, *Entertainment—Broadcasters*. Some NFPs conduct activities\(^5\) in those industries and should apply the guidance concerning the recognition and measurement of assets, liabilities, revenues, expenses, and gains and losses to the transactions unique to those industries. However, in applying that guidance, NFPs should follow the financial statement display guidance in FASB ASC 958, even though it may conflict with display that would result from applying the other industry's guidance.

1.17 Per FASB ASC 105-10-05-2, if the guidance for a transaction or event is not specified within a source of authoritative GAAP for that entity, an entity should first consider accounting principles for similar transactions or events within a source of authoritative GAAP for that entity and then consider nonauthoritative guidance from other sources. An entity should not follow the accounting treatment specified in accounting guidance for similar transactions or events if that guidance either (a) prohibits the application of the accounting treatment to the particular transaction or event, or (b) indicates that the accounting treatment should not be applied to other transactions or events by analogy.

1.18 Accounting and financial reporting practices not included in FASB ASC are nonauthoritative. Sources of nonauthoritative accounting guidance and literature include, for example, practices that are widely recognized and prevalent either generally or in the industry; FASB Concept Statements; AICPA Audit and Accounting Guides; AICPA Issues Papers; IFRSs; pronouncements of professional associations or regulatory agencies; *Technical Questions and Answers*; and accounting textbooks, handbooks, and articles. The appropriateness of other sources of accounting guidance depends on its relevance to particular circumstances, the specificity of the guidance, the general recognition of the issuer or author as an authority, and the extent of its use in practice. For example, FASB Concept Statements would normally be more influential than other sources in this category.

1.19 The guidance in FASB ASC that specifically exempts NFPs from its scope includes guidance on earnings per share, reporting comprehensive income, segment disclosure, and variable interest entities.\(^6\) Other financial reporting guidance, such as that concerning common stock, issuance of convertible debt, stock purchase warrants, share-based payments, payment of dividends, and certain financial instruments with characteristics of both liabilities and equity, typically does not apply to the kinds of entities covered by

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\(^5\) Such activities may be conducted by (a) for-profit entities owned and consolidated by NFPs, (b) divisions of NFPs, or (c) entire NFPs, such as those operating as not-for-profit broadcasters.

\(^6\) In accordance with FASB Accounting Standards Codification 810-10-15-17(a), an NFP is subject to the variable interest entities standards only in the unlikely case of an NFP that is used by business reporting entities in a manner similar to a variable interest entity in an effort to circumvent the provisions of the variable interest entities subsections.
this guide because NFPs do not have ownership interests similar to business entities. However, the guidance included in the effective provisions of those topics applies to all for-profit entities owned by NFPs, whether owned wholly or in part.

Fund Accounting and Net Asset Classes

1.20 Fund accounting is a technique used by some NFPs for purposes of internal recordkeeping and managerial control and to help ensure that the use of resources is in accordance with stipulations imposed by donors and other resource providers and with self-imposed limitations designated by those charged with governance. Under fund accounting, resources are classified into funds associated with specific activities and objectives.

1.21 Montgomery's Auditing notes that as used in nonprofit accounting, a fund is an accounting entity with a self-balancing set of accounts for recording assets, liabilities, the fund balance, and changes in the fund balance. Separate accounts are maintained for each fund to ensure that the limitations and restrictions on the use of resources are observed. Though the fund concept involves separate accounting records, it does not entail the physical segregation of resources. Fund accounting is basically a mechanism to assist in exercising control over the purpose of particular resources and amounts of those resources available for use.\(^7\)

Fund accounting is discussed further in chapter 16, "Fund Accounting," of this guide.

1.22 FASB ASC 958-205-05-7 states that "[t]he Not-for-Profit Entities Topic does not use the terms fund balance or changes in fund balances because in current practice those terms are commonly used to refer to individual groups of assets and related liabilities rather than to an entity's net assets or changes in net assets taken as a whole..." As discussed in chapter 3, "Financial Statements, the Reporting Entity, and General Financial Reporting Matters," of this guide, FASB ASC 958-210-45-1 requires that the amounts for each of three classes of net assets (permanently restricted, temporarily restricted, and unrestricted) be displayed in a statement of financial position. FASB ASC 958-220-45-1 also requires that the amounts of change in each of those classes of net assets be displayed in a statement of activities.

position. The "Pending Content" in FASB ASC 958-220-45-1 also requires that the amounts of change in each of those classes of net assets be displayed in a statement of activities.\(^8\)

1.23 Therefore, reporting by individual funds or fund groups is not required. However, FASB ASC 958-205-45-3 does not preclude providing disaggregated information by individual funds or fund groups, as long as the required aggregated amount for each class of net assets is displayed as indicated previously. How an NFP maintains its internal accounting and recordkeeping systems is a matter outside the purview of standard setting.

1.24 Some NFPs may continue to use fund accounting for purposes other than reporting in conformity with GAAP, and some may provide disaggregated information in the financial statements beyond the minimum requirements of GAAP. A particular fund balance may fall completely into one of the net asset classes or may be allocated to more than one net asset class, as discussed in chapter 16.

1.25 The accounting and auditing issues concerning each particular asset, liability, or class of net assets (financial statement elements) are not a function of the element's internal classification or financial statement subclassification. Accordingly, this guide is organized by financial statement elements and not by type of fund or groups of funds. Chapter 16 contains a discussion of the relationship of an NFP's fund balances to its net asset classes.

**Other Resources for Financial Reporting by NFPs**

1.26 As a complement to this guide, the Financial Reporting Alert *Not-for-Profit Entities* (for management) and the Audit Risk Alert *Not-for-Profit Entities Industry Developments* (for auditors) are issued annually. The Audit Risk Alert provides an overview of economic and industry conditions, regulatory developments, and recently issued accounting and auditing pronouncements that may affect audits of NFPs. It also includes information about how to obtain many of the publications referred to in this guide and a list of useful internet sites.

1.27 Examples of financial statements of NFPs are not included in this guide. The following AICPA publications and websites, some of which have financial statements that can be used as examples, may assist in preparing or auditing financial statements of NFPs:

- The Audit Guide Government Auditing Standards and Single Audits
- The Audit Risk Alert Government Auditing Standards and Single Audit Developments
- *Not-for-Profit Entities: Checklists and Illustrative Financial Statements*

\(^8\) The amendments in FASB Accounting Standards Update No. 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities*, are effective for annual financial statements issued for fiscal years beginning after December 15, 2017 (for example, years ending December 31, 2018 and years ending June 30, 2019), and for interim periods within fiscal years beginning after December 15, 2018. Application to interim financial statements is permitted but not required in the initial year of application. Early application of the amendments is permitted.
The website of the AICPA’s Not-for-Profit Section, which is a centralized resource developed to support NFPs and the professionals who serve NFPs, found at www.aicpa.org/nfp

*The AICPA Audit Committee Toolkit: Not-for-Profit Organizations*

*Not-for-Profit Entities—Best Practices in Presentation and Disclosure*

The website for Electronic Municipal Market Access (EMMA), (http://emma.msrb.org), which is the official source for municipal disclosures and market data maintained by the Municipal Securities Rulemaking Board. EMMA contains official statements and continuing disclosures for NFPs with tax-exempt bonds

The websites of membership associations that represent the interests of subsectors of the nonprofit sector, such as the National Association of Colleges and University Business Officers and the Council on Foundations

The websites of NFPs that are considered peers of the reporting entity

The websites of regulatory agencies, such as the secretary of state

The websites of organizations that collect and provide information about NFPs, such as guidestar.org