Behind the Numbers:
The Problem with Nonprofit Accounting Rules
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In 1993 the Financial Accounting Standards Board (FASB) did something which since then has caused problems for nonprofit organizations all over the country: they issued Statement of Financial Accounting Standards #116, Accounting for Contributions Received and Contributions Made.

Among the provisions of this accounting rule is a requirement that an organization recognize as revenue a grant or pledge in the period the grant or pledge was made, assuming the grant or pledge contained no donor-imposed conditions. Though the revenue will be unrestricted or restricted depending on the donor's stipulations, it is nevertheless recorded as revenue even though the cash from the grant or pledge may come in a later period, and even though the purpose or time period for which the grant was given may also occur in a future period.

The rule creates an unusual problem for nonprofit organizations that receive multi-year grants or pledges, or for a single-year grant that extends beyond the current fiscal year into the next. Consider this example: an organization receives a three year program grant of $300,000 with donor restrictions that $100,000 be spent on the program this year, $100,000 in Year Two, and $100,000 in Year Three. Assuming no conditions, the organization is required to recognize the entire $300,000 as revenue, split between unrestricted revenue ($100,000) and temporarily restricted revenue ($200,000), in Year One. Thus, when considering the Statement of Activities in total, the organization has something of a windfall in Year One in that revenue has been recognized in advance of the cash being spent and, in this example, before all the services have been performed.

While Year One reaped the benefit of this accounting rule, years two and three are not so fortunate. In Year Two, $100,000 shifts from being temporarily restricted to being unrestricted, but in total no new revenue is created. Yet our organization is still incurring $100,000 in program expenses in Year Two. So, with no new revenue from this grant and with expenses of $100,000, our organization now has a loss on this grant of $100,000. In Year Three the same situation occurs, generating another loss of $100,000.

This rule has the effect of violating a basic accounting principle of "matching" revenue and expense. Instead revenue is recognized up front while the expenses are incurred over the life of the grant. The result is that Statements of Activity for nonprofits that receive large multi-year grants have greater volatility in their total change in net assets than if they were able to follow the traditional accounting principle of matching revenue and expenses.

Accordingly, nonprofit Executive Directors and board members have a great deal of difficulty interpreting their Statement of Activities when it shows a loss in years two and three, as in our example, when in fact they know their program is breaking even. This can cause tremendous angst as organizations, already confused about what their numbers mean, now worry how they look to potential future funders. The organization may be further perplexed when they sit down to prepare their budget for the upcoming year as they wonder how to treat these “carryover funds,” a phrase we often hear in our accounting practice, in their budget for next year.

If this accounting rule creates such a problem, it is reasonable to ask why the FASB implemented this rule in the first place. The FASB explains this in paragraphs 44 and 45 of FASB 116:

“44. To accomplish its mission, the FASB strives to improve the usefulness of financial reporting by focusing on the primary characteristics of relevance and reliability and on the qualities of comparability and consistency. The usefulness of information about an entity increases if that information can be compared with similar information about other entities or about the same entity in other periods. To the extent that similar contributions are subject to the same requirements for recognition and disclosure, financial reporting will be improved. In return for some sacrifice of freedom of choice, adherence to externally imposed standards brings a gain from greater comparability and consistency and also a gain in credibility.”

“45. A major benefit of this Statement is the increased comparability, consistency, and credibility of financial reporting that will result from eliminating some of the inconsistencies in current guidance. The Board believes that financial reporting of not-for-profit organizations will significantly improve by consistently recognizing (a) restricted contributions as revenues, (b) unconditional promises to give as assets and revenues or as liabilities and expenses, and (c) certain contributed services.”

Summarizing the above paragraphs, the FASB was looking to make nonprofit financial reports consistent and comparable. The “sacrifice of freedom of choice” referred to in paragraph 44 refers to the accounting treatment of multi-year grants prior to 1993 when many nonprofits recorded the unearned or future years portion of their award as a liability on their Balance Sheet. As the grant was used for its intended purpose the liability would be reduced and taken into revenue. Thus, total revenue more accurately reflected the economics of the grant. However, this created differing practices among nonprofits as to how this liability was accounted for. FASB 116 solved this by taking away this freedom, requiring the grant to be recognized as revenue in its entirety in the year of the award.

So what is to be done about this? Fortunately, the accounting rules provide a partial solution to this problem. A nonprofit Statement of Activities contains information in several columns: unrestricted, temporarily restricted, and, if it applies, permanently restricted. Each year, as the time and purpose restrictions are met, temporarily restricted revenue shifts to the unrestricted column. So, if one were to focus on the unrestricted column, the reader would get a more representative picture of what the revenue and expenses for the year really were. This is at least a partial consolation for those organizations who struggle with the requirements of FASB 116. Unfortunately, while

this may work for the reader of an audit, it does not help the reader of the organization's Form 990 tax return since those same columns -- unrestricted, temporarily restricted, and permanently restricted -- are not on the front page of the Form.

A solution to handling “carryover funds” during the budget creation process for accrual organizations is to develop budgets on both a cash and an accrual basis to accurately reflect the revenue position of the organization.

Lastly, organizations should take comfort in knowing that the major foundations across the country are all quite familiar with the accounting rules and their impact on revenue recognition for grants and pledges and are therefore sophisticated enough to understand FASB 116’s impact nonprofit organizations’ financial statements.

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