

Help Your Nonprofit Clients Improve Their Accounting for Capital and In-Kind Donations

Kennard Wing, Teresa Gordon, Mark Hager, Tom Pollak and Patrick Rooney

Opening factoid: American individuals, estates, foundations and corporations gave an estimated \$240.72 billion to charitable causes in 2003, up from \$234.09 billion in 2002. Source: Giving USA 2004

Many nonprofit organizations, especially smaller ones, lack skilled financial professionals either on staff or on the board. Auditors and other external CPAs are in an excellent position to help these clients present their financial results in ways that will avoid misunderstanding and confusion on the part of financial statement users both inside and outside the client organization.

Two areas that have created special problems for nonprofits are accounting for large capital donations and for in-kind donations. We'll look at the problems first; then show you accounting solutions you can bring to your clients.

Capital Gifts

Let's look at the problem with capital gifts first. Without equity or earned revenue streams sufficient to service debt, nonprofits must raise special capital contributions to make large capital expenditures. According to SFAS 116, Accounting for Contributions Received and Contributions Made, contributions are generally recognized as revenue in the year the commitment is made. That results in the organization having a large reported annual surplus in the year a capital contribution is received, and a series of smaller annual deficits in the years following until the purchased asset is fully depreciated.

As an example, consider a food bank we studied as part of the Nonprofit Overhead Cost Project (see sidebar). The organization had received a \$60,000 grant to purchase two new refrigerated trucks. As shown in Exhibit A, their reported annual surplus that year was \$50,000.¹ Not only was the organization's operating loss that year camouflaged by the capital gift, but the organization had such a large surplus, it apparently needed no additional funds. A number of the organization's funders didn't want to renew their grants. Fundraising staff with no financial training had to try to explain to foundation program officers with no financial training what had happened with the capital grant, and that they really did need the money, despite what the financials said.

SFAS 116 has a solution for this problem that needs to be more widely adopted. Under paragraph 16 of that document, nonprofits are permitted to adopt a policy that gifts of long-lived assets (or cash to purchase them) have an implied time restriction that is satisfied gradually over the life of the asset. By recognizing a portion of the gift equal to depreciation each year, the organization eliminates any surplus or deficit associated with the gift. For physical assets that get depreciated, this is the approach we recommend. Exhibit B shows what the Statement of Activities would look like in the first year if this approach were adopted, assuming \$5,000 of gift recognition and depreciation is appropriate for the partial year the trucks were in use. SFAS 116 requires that organizations adopting such a policy disclose the fact.

For gifts of assets that don't get depreciated, such as land, a different approach is preferable. Under paragraph 23 of SFAS 117, Financial Statements of Not-for-Profit Organizations, organizations are permitted to segregate operating and non-operating items in the Statement of Activities. We recommend organizations take advantage of this

¹ The numbers in all exhibits have been changed to protect anonymity.

flexibility to segregate non-depreciable capital gifts from operating items. This approach does not eliminate the large surplus in the year of the gift, but at least it allows users of financial statements to see the operating surplus or deficit separate from any capital items. Assuming Exhibit A includes a donation of land worth \$55,000, Exhibit C shows how the financials would change with this approach.

Neither approach is complicated or expensive. Together, they can make a significant difference to your nonprofit client.

In-Kind Donations

Now let's look at the mischief with in-kind donations of goods, space, and services. Especially for smaller non-profits, the value of these non-monetary transactions can exceed that of all monetary transactions. We studied several such organizations in detail as part of the Nonprofit Overhead Cost Project.

The most serious problem relates to donated goods, which are capable of creating annual surpluses and deficits based on inventory swings that have little to do with how well the nonprofit is being managed financially. Consider the same food bank that bought the refrigerated trucks. One year, they moved up the date of a major food drive that historically had taken place just after the end of the fiscal year, to just before. As a result of the increase in inventory of donated food from the end of the previous fiscal year, they reported an annual surplus of \$200,000 (See Exhibit D). Again, their funders couldn't understand why an organization that was so flush was still submitting grant proposals. Fundraising staff with no financial training had to explain to foundation program officers with no financial training the accounting rules for in-kind gifts, and that they couldn't pay salaries or rent with canned green beans. The next year, the food drive

again fell after the end of the fiscal year. As a result, the organization reported a \$200,000 deficit (See Exhibit D). Funders normally take large deficits as a sign of poor financial management, and avoid supporting such charities. Fundraising staff with no financial training had to explain to foundation program officers with no financial training the concept of inventory profits and losses.

In-kind donations also create a second problem. With no distinction between cans and cash, the organization in Exhibit D appears to be a \$2.5 million operation, all of it fungible. The reality, though, is that 80 percent of that is donated food, and the scale of monetary operations at this organization is closer to \$500,000. Users of financial statements can draw a variety of erroneous conclusions as a result of the lack of distinction between monetary and in-kind items. This second problem occurs with all types of in-kind donations valued under GAAP, whether of goods, space, or professional services.

SFAS 117 has a solution for both these problems that needs to be more widely adopted. The same paragraph 23 we relied on to segregate operating and capital items can also be used to segregate monetary and non-monetary transactions. Exhibit E shows this approach applied to the financial statement in Exhibit D. With the inventory swings reported in a separate section, we can see both the true scale of monetary operations and their resulting surplus or deficit. Although donated space and services are not shown in this example, they should also be included with other in-kind donations.

Preparers of financial statements could also help by using the direct method to present the Statement of Cash Flows, because in-kind revenues and expenses do not

appear. The indirect presentation is understood by few and fails to illuminate the true nature of operations like that of the food bank we studied.

Although these changes will be of great help to users of financial statements, several cannot currently be implemented on Form 990. Capital gifts can be recognized over the life of the purchased asset on that form, but it contains no provision for separating operating from capital items, or donated goods from cash donations. Donations of space and services are already segregated from cash donations on Form 990.

The FASB lists seven objectives for nonprofit financial reporting in Concept Statement No. 4, which can be simply summarized: portray economic reality without misleading the user. As our study shows, the way capital gifts and in-kind donations are normally treated readily creates such misunderstanding. By bringing the solutions described here to the attention of their nonprofits clients, the public accounting profession can provide a service not only to those clients, but to the public at large.

Practical Tips to Remember

- Large capital gifts can cause misleading surpluses and deficits.
- For capital gifts of depreciable assets (or cash to purchase them), prevent this problem by recognizing the gift gradually over the life of the asset. Nonprofits adopting such a policy must disclose it.
- For capital gifts of non-depreciable assets (or cash to purchase them), prevent the problem by segregating capital from operating items in the Statement of Activities.
- In-kind gifts can cause misleading surpluses and deficits, and mask the scale and financial condition of a nonprofit.
- Prevent these problems by segregating in-kind revenue and expense items from monetary items on the Statement of Activities.
- Use the direct method for presenting the Statement of Cash Flows.

The Nonprofit Overhead Cost Project

The goal of the 5-year project was to understand how nonprofits raise, spend, measure, and report funds for fundraising and administration, and to work with practitioners, policymakers, and the accounting profession to improve standards and practice in these areas. The overall study had three major phases: analysis of over 250,000 IRS Forms 990, in-depth case studies of nine organizations, and 1,500 responses to a survey of U.S. nonprofits. An exploratory survey of nonprofit auditors was also conducted. The project was supported by The Atlantic Philanthropies, the Ford Foundation, the Charles Stewart Mott Foundation, The David and Lucille Packard Foundation, and the Rockefeller Brothers Fund.

Resource

www.coststudy.org contains a variety of publications from the Nonprofit Overhead Cost Project, resources for nonprofit financial management and useful links related to nonprofit accounting

Authors

Kennard Wing, CMA is Principal of Kennard T. Wing & Co., a consultancy providing planning, research and evaluation services to the nonprofit sector. His email address is kennarwing@aol.com.

Teresa Gordon, CPA, Ph.D is Professor of Accounting at the University of Idaho. Her email address is tgordon@uidaho.edu.

Mark Hager, Ph.D. is a Senior Research Associate at the Center on Nonprofits and Philanthropy at the Urban Institute in Washington, D.C. His email address is mhager@ui.urban.org.

Thomas Pollak, JD is Assistant Director of the National Center for Charitable Statistics at the Urban Institute in Washington, D.C. His email is tpollak@ui.urban.org.

Patrick Rooney, Ph.D. is Director of Research at the Center on Philanthropy at Indiana University and Associate Professor of Economics and Philanthropic Studies at Indiana University-Purdue University Indianapolis. His email address is rooney@iupui.edu.