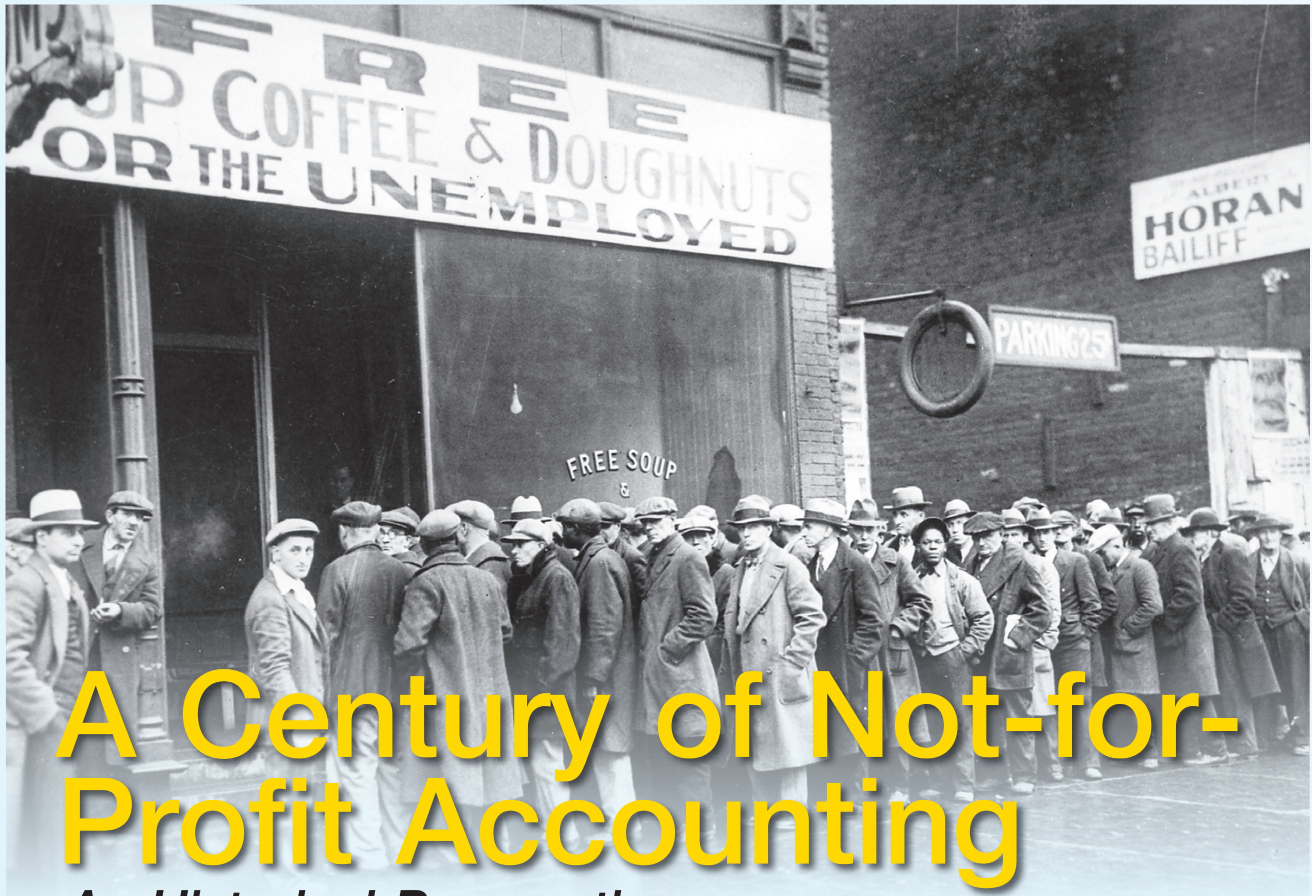
90th Anniversary
1930-2020



A Century of Not-for-Profit Accounting

An Historical Perspective

By Lenore C. Sanchez, Scott A. Brown, and Joseph A. Izzo

In Brief

Just as the business world has changed in the past 90 years, so has the world of not-for-profit (NFP) organizations. NFPs have grown in size and scope, creating pressure from potential donors for clearer, comparable financial reporting. Government oversight has intensified in the wake of scandals, while the increased availability of government funding has led to greater auditing and governance requirements. Given the current state of the world, it is hard to know what the future will bring for the NFP sector.

Not-for-profit (NFP) organizations distinguish themselves from for-profit entities through their purpose and mission. The missions of NFPs generally focus on activities and goals that benefit the community on a local, national, or global level. The IRS classifies NFPs as tax-exempt organizations under IRC section 501(c), of which there are 29 types. According to the IRS's most recent Statistics of Income for 2015, NFP organizations have more than $3.8 trillion in assets and $2.9 trillion in revenue. They have accounting systems and standards that are, in some cases, uniquely theirs. What did NFPs look like in the early 1900s? How have they evolved over the last century through changes in fundraising approach, financial reporting, and legal reform? And what does the future hold?

The Dawn of Philanthropy

In 1889, Andrew Carnegie, steel magnate turned philanthropist, authored "The Gospel of Wealth," which inspired others to donate as well. His philanthropic mindset, pro-

motions, and efforts are thought to have influenced the passing of the Tariff Act of 1913, which granted tax exemption to organizations with missions solely for the purposes of charity, religion, education, and science. One year later, the first federated fund was formed, enabling an entity to collect charitable funds from the public on behalf of an NFP. The War Revenue Act of 1917 allowed individuals to take a tax deduction for charitable contributions for the first time ever. Individuals, businesses, and the government understood the importance of NFPs, and the act would help NFPs endure the uncertainties of wartime.

It was around the turn of the 20th century that a duo of fundraising pioneers initiated innovative fundraising techniques that would set new standards in the amounts raised by NFPs. Charles Sumner Ward and Frank L. Pierce from the Young Men's Christian Association (YMCA) paved the way for a level of fundraising previously unseen. During a capital campaign held by the YMCA, Ward and Pierce hired a publicist to run the campaign and secured both individual and corporate sponsors by selling advertisements. They introduced the use of a "Campaign Clock" to instill urgency into the fundraising effort and hit their targeted goal. Years later, in 1917, President Woodrow Wilson called on Ward to assist with fundraising on behalf of the American Red Cross. Ward, again using his innovative techniques, raised unprecedented amounts of money and exceeded all expectations.

Financial Reporting—The Early Years

Financial statements of NFPs during the early 20th century bore little similarity to today's financial statements. There was little guidance for NFP financial statement presentation; as a result, financial reporting varied greatly. Notations, such as a sentence or two identifying the main source of income for a specific account or fund, or that related to the financial statements, served as disclosures. Each fund or account could have more than one statement. The terminology used for different statements varied and was not formalized or uniform. Some NFPs presented financial information by account and fund with no summation. Information reported by one NFP organization might be extremely detailed, while another NFP might summarize amounts by line item and categorize them as either administration or program, similar to today.

Other peculiarities included listing contributors by name and the amount of contribution, and reporting amounts by dollars and cents. One 1920s NFP financial statement included, at the end of each fund or account report, "E. & O. E." apparently the equivalent of a disclaimer identifying that errors and omissions are excepted.

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Financial reports were reviewed with a degree of care and diligence, as certain pages of the financial reports were marked as "Examined and Approved" with the names of individuals, and next to the names "Auditing Committee." The Auditing Committee did not include the Treasurer, whose name was included at the bottom of select reports. (NFPs were not required to have an audit committee until 2013.) Other NFP financial statements included only the Treasurer's signature, while others did not indicate any sign-off.

As today, there was some degree of standardization in the reporting to the IRS care of the Form 990. But the 990 of decades ago was different from the form of today.

The presentation requirements of financial statements in the 1920s were much different than today's requirements. But it is clear that underlying fundamentals and components of current concepts took root in those early years. They have since grown to address the current needs of not-for-profit organizations, stakeholders, and regulatory agencies.

Scandals and Government Oversight

The occurrence of accounting scandals over the last century shaped the way financial information is reported and organizations are governed. Due to lack of regulation, the early history of NFPs was filled with petty crimes; for example, in 1918, the secretary of the Cripples' Welfare Society, George W. Ryder, pleaded guilty to using mail fraud to solicit and use donations for his personal gain. But many of these scandals failed to generate much notoriety or alter accounting practices.

Most of the accounting scandals that brought about significant change occurred in the for-profit arena, with the reforms that followed extending to NFPs. For example, one of the largest financial scandals of the 20th century was perpetrated by McKesson & Robbins, Inc.'s owner Phillip Musica. Musica, who was a convicted felon and previously used another company as a front for bootlegging, recruited three of his brothers to generate fraudulent sales documents and paid commissions to a shell distri-

bution company under their control. The treasurer, Julian Thompson, eventually discovered the bogus distribution company and determined that approximately $20 million of $87 million in assets on McKesson & Robbins balance sheet was phony. The SEC, which had been formed in 1934, investigated the company in 1938. In the wake of this fraud, the SEC required all public companies to have an audit committee consisting of "outside" directors and to seek approval for the appointment of auditors from shareholders. In addition, the American Institute of Accountants (now known as the AICPA) adopted auditing standards that would require auditors to verify accounts receivable and inventory; standards that are followed to this day.

A series of accounting scandals in the early 2000s involved enormous public companies; first Enron, then Tyco, followed by WorldCom. These scandals cast a negative light on the accounting profession and led to the collapse of Arthur Andersen, one of the world's largest accounting firms. In response, the U.S. Congress passed the Sarbanes-Oxley Act (SOX) in 2002, representing the most sweeping set of new regulations since the 1930s. Although SOX was focused on protecting shareholders of public companies, there were many provisions that impacted NFPs.

As a direct result of the document destruction practices that occurred during the Enron scandal, SOX created new document retention and destruction guidelines with large penalties for noncompliance. SOX also included harsh penalties for retaliation for both SEC filers and NFPs alike. Many states, such as New York, used SOX as a model to make NFP organizations more accountable for their financial reporting and governance structures. New requirements included setting a minimum threshold for NFPs to undergo a certified audit, having executive compensation reviewed and approved by board trustees, having the CFO and CEO sign off on any financial documents and verify accuracy and timeliness of filings, formalizing the drafting and enforcing of conflict of interest policies, guarding against self-dealing, and forming audit committees whose responsibilities would include appointing independent external auditors.

One of the many and important fiduciary responsibilities of those charged with governance is ensuring that the management of a NFP entity has developed proper internal controls for the protection and oversight of its charitable assets. In 1992, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) released *Internal Control–Integrated Framework.* Years later, in 2013, COSO issued a revised *Internal Control–Integrated Framework* to account for changes in business and operating environments that had become more complex and technologically driven. The COSO framework established 17 principles over five components to achieve three categories of objectives: operations, reporting, and compliance. Today, the COSO framework is used by most U.S. listed companies as the basis for compliance with SOX, as well as by NFP organizations and governmental entities.

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Federal Awards and the Single Audit

In addition to the private sector, the federal government has historically played an important part in the support of NFP organizations. The amount of federal grant awards has grown over time (estimated to be $750 billion in 2019), as has the complexity of grant agreements. With the continued growth of these awards, Congress became concerned about how these grants were being administered and monitored by pass-through entities. Most of the assurance received by the federal government has traditionally been through audits of individual federally funded programs.

As the number of agencies awarding grants grew, this process became difficult and time-consuming. In order to improve its oversight ability, the federal government instituted the Single Audit Act of 1984. The act created standardized audit requirements for states, local governments, and Indian tribal governments that receive and use federal financial assistance programs. In 1985, the United States Office of Management and Budget (OMB) issued OMB Circular A-128, *Audits of State and Local Governments,* to help federal award recipients, as well as auditors, implement requirements under the Single Audit Act.

OMB extended the Single Audit Act's requirements in 1990 to include NFPs by issuing OMB Circular A-133, *Audits of Institutions of Higher Education and Other Non-Profit Organizations,* which superseded OMB A-128. Circular A-133 standardized the single audit to include all states, local governments, NFPs, and institutions that receive funds from the federal government. It was referred to as a "single audit" because it consolidated multiple individual audits of nonfederal entities required for each federal award into a single audit. The stated purpose

of the single audit was to promote sound financial management of government funds by nonfederal organizations, promote uniform guidelines for audits, and reduce burdens on government and NFPs by promoting efficient and effective use of audit resources. Although well-intentioned, these goals have not always been met.

Circular A-133's complex set of compliance requirements created a significant burden on smaller NFPs, particularly those that did not have the capacity to properly administer the federal grant awards. In December 2013, the OMB addressed this and other concerns by issuing *Uniform Administrative Requirements, Cost Principles, and Audit Requirements.* This new guidance combined what had previously been eight separate OMB circulars into a single set of rules referred to as the Uniform Guidance. The OMB also eased some of the burden of smaller NFP organizations by raising the minimum threshold of expenditures of federal awards from $500,000 to $750,000.

Changes in Financial Reporting

For much of the 20th century, NFPs presented their financial statements using a fund accounting format. NFPs spent considerable time ensuring that their annual financial statements accurately reflected the balances in the often numerous funds they used in their operations. Furthermore, lacking formal accounting guidance, NFPs often recorded unconditional contributions to the funds only when cash was received.

Because of the diverse and inconsistent approach to financial statement presentation among NFPs, users of the financial statements, such as donors, members, creditors and other stakeholders, found comparability difficult. Recognizing this, in June 1993, FASB issued SFAS 116, *Accounting for Contributions Received and Contributions Made,* and SFAS 117, *Financial Statements of Not-for-Profit Organizations,* to enhance the relevance, understandability, and comparability of NFP financial statements.

With the issuance of SFAS 116, FASB created new requirements related to how NFPs record and present contributions received and contributions made. SFAS 116 required that all contributions received, including unconditional promises to give, should be recognized as revenue in the period received at their fair value. Contributions made should be recognized as expenses in the period made at their fair value. Conditional promises to give, whether received or made, should be recognized when they become unconditional; that is, when the conditions are substantially met.

SFAS 116 also introduced the terms "restricted revenue" and "net assets." It required NFPs to distinguish between contributions received that increase permanently restricted net assets, temporarily restricted net assets, and unrestricted net assets. In addition, it also required recognition of the expiration of donor-imposed restrictions in the period in which the restrictions expire. The change to "net assets" terminology eliminated the term "fund balances" that NFPs had been using.

SFAS 117 created standards for NFPs' general-purpose external financial statements and required the financial statements to provide certain basic information and meet the common needs of external users of those statements. SFAS 117 created the requirement for all NFP financial statements to have a statement of financial position (formerly the balance sheet), a statement of activities (combining the previous statement of revenues and expenditures by function) and a statement of cash flows. It also required reporting the amounts of an NFP's total assets, liabilities, and net assets in a statement of financial position; reporting the change in an NFP's net assets in a statement of activities; and reporting the change in its cash and cash equivalents in a statement of cash flows. Furthermore, it required the classification of an NFP's net assets and its revenues, expenses, gains, and losses based on the existence or absence of donor-imposed restrictions. Finally, it required NFPs to report the amount for each of three classes of net assets—permanently restricted, temporarily restricted, and unrestricted—in a statement of financial position. The change in net assets for each of these classes would be displayed in a statement of activities.

The changes put in place by SFAS 116 and SFAS 117 would continue in effect for more than two decades.

Endowment Funds

For many years, permanent endowment funds have been a popular gift vehicle for donors who want to ensure a perpetual and continuous stream of income to NFPs of their choice. Since 1972, donor-designated endowment funds were regulated by the Uniform Management of Institutional Funds Act (UMIFA). Market crashes, including the burst of the dot-com bubble in the early 2000s and the global financial crisis of 2008, hastened the need for updated guidance. On July 17, 2006, the Uniform Prudent Management of Institutional Funds Act (UPMIFA) was approved by the National Conference of Commissioners on Uniform State Laws; UPMIFA replaced and updated key provisions of UMIFA. Unlike prior law, UPMIFA provides NFPs the ability to spend endowment funds below their original historic dollar value. This allows NFPs to use restricted funds for mission-related programs even in a severely down market environment, if deemed prudent.

UPMIFA was passed as uniform law; however, each state adopted and enacted its own version. The New York Prudent Management of Institutional Funds Act (NYPMIFA), New York's version of UPMIFA, went into effect on September 17, 2010. In addition to prudence factors

required by UPMIFA to be considered by those charged with governance in managing, investing, and spending endowment funds, New York added other safeguards to further protect endowment funds. Among those safeguards is NYPMIFA's requirement to consider alternative sources of revenue prior to authorizing the expenditure of endowment fund earnings. It also mandates NFPs to provide donors with the alternative to opt out of the law if the donor's gift instrument was executed prior to September 17, 2010.

In response to the regulatory changes affecting endowment funds, FASB issued Staff Position (FSP) 117-1, which provides NFPs with guidance regarding the net asset classification of donor-restricted and board-designated endowment funds. Prior to this FSP, there was inconsistency with how donor- and board-designated endowment funds were classified and the type and amount of disclosure reported.

FSP 117-1 requires accounting for donor-restricted endowment funds using permanently restricted and temporarily restricted net assets. Permanently restricted net assets include amounts that must be retained permanently in accordance with explicit donor stipulations or determined by the governing board in the absence of such stipulations. Amounts not classified as permanently restricted, such as investment earnings, should be classified as temporarily restricted until appropriated for expenditure by the governing board.

In addition to net asset classification guidance, FSP 117-1 also enhanced disclosures for NFPs with donor- and board-designated endowment funds. The required disclosures include a description of the governing board's interpretation of the law and the organization's policies for investment and appropriation of expenditure (spending policy). Additional enhancements also include disclosure of the composition of endowments by net asset class and a reconciliation of the activity in the fund.

The New York Not-for-Profit Revitalization Act

The New York Not-for-Profit Revitalization Act was signed into law in 2013 and further amended in 2016. It was the first major change to the laws that govern NFPs in New York in 50 years. The purpose of this legal overhaul was to reduce the unnecessary burdens and costs placed on smaller NFPs and to strengthen governance and accountability overall. To achieve this, the act established new threshold requirements for the submission of annual financial statements prepared in accordance with GAAP to the New York State Charities Bureau. It also strengthened governance and accountability of NFPs by mandating the formation of an audit committee and defining its role, along with that of the external CPA and the board. The act also brought about mandatory whistleblower and conflict of interest policies, as well as guidance on related-party transactions.

The last century brought with it changes that could not have been imagined when the NFP landscape first began.

Financial Reporting Now

In 2016, FASB introduced the most significant financial reporting change for NFPs in almost 25 years. Accounting Standards Update (ASU) 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities,* was issued with the purpose of improving financial reporting for NFP organizations. The ASU's intent was to make NFP financial statements more transparent and easier to understand. The following are the ASU's more significant requirements:

- The three previous classes of net assets—unrestricted, temporarily restricted, and permanently restricted—are now condensed into two classes: without donor restrictions and with donor restrictions;
- Expenses must be reported by their natural and functional classifications;
- Liquidity must be disclosed in both quantitative and qualitative forms; and
- Detailed disclosure is required for board-designated net assets and the purpose of the designated funds.

FASB has devoted significant attention to the accounting for NFPs in recent years, as evidenced by the guidance in ASU 2016-02, *Leases,* ASU 2014-19, *Revenue from Contracts with Customers,* and ASU 2018-08, *Clarifying the Scope and Accounting Guidance for Contributions Received and Contributions Made.*

NFP Watchdog

As the number of charitable NFP organizations has grown over the decades—more than 1.7 million exempt organizations are registered on the IRS Exempt Organizations Business Master File Extract—potential donors have been met with solicitations from organizations spanning a wide variety of sizes and missions. Although transparent and comprehensive financial statements provide potential donors with an insight into the fiscal operations and financial health of NFPs, many contributors want information beyond what appears in the financial statements.

In 1992, Charity Watch, formerly known as the American Institute of Philanthropy, was formed for the purpose of assisting donors in evaluating charities.

Since then, other watchdog and ratings agencies, such as GuideStar, Charity Navigator, and Give Well, have provided information and ratings about charitable organizations. Their common goal is to keep the public informed and confident in their charitable-giving decisions.

In addition to using information provided by watchdog agencies, today potential donors can easily access websites to acquire information about an organization's mission, programs, governance, prior tax return filings, and more. Data is available for easy analysis of metrics. An NFP organization's eligibility to be awarded grants and revenue from tax deductible donations is often disclosed as well. It is also useful for donors to compare one NFP's performance metrics with another's.

Important NFPs of the Past Century

The past century has seen the formation of thousands of NFPs working to better society. Many of them have survived operational changes, fundraising challenges, and regulatory constrictions. Those that endured for a century or longer are remarkable, as not only did they experience economic and societal changes firsthand—they were also able to establish themselves as important influencers.

Some of the organizations that withstood the test of time and are still making an impact on society today include the American Cancer Society, American Museum of Natural History, American Philosophical Association, American Red Cross, Association of American Universities, Boy Scouts of America, Daughters of the American Revolution, Girl Scouts of the USA, National Business League (formerly known as the National Negro Business League), Rotary International (formerly known as the National Association of Rotary Clubs in America), Salvation Army, and YMCA. The United States formation of these organizations took place between 1841 and 1913.

The NYSSCPA's NFP Committee

When the AICPA recommended its Proposed Statement of Position 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations* to FASB in 1978, it became evident that significant accounting changes were on their way for NFPs such as hospitals, colleges and universities, voluntary health and welfare organizations, and state and local governmental units.

As a way to assist and educate members serving and working in the not-for-profit community with these coming changes, the NYSSCPA formed its inaugural NFP committee in the 1970s. The committee would provide a means for professionals and NFP specialists to focus on accounting and auditing matters specific to the NFP sector. Throughout its history, the committee has been very active in commenting on exposure drafts as new standards were being developed. Accounting firms of all sizes are represented on the committee; this niche is one of the fastest growing in the profession. Today, it is one of the NYSSPCA's largest committees.

What Will the Future Bring?

As the world brings constant change, one can only guess how different the NFP sector will be in the future. Considering the operational issues some organizations are now facing, it is quite conceivable that NFPs with similar missions will combine, enabling them to have a greater impact. The merging of NFPs could result in fewer, larger organizations, making it even more difficult for smaller organizations to compete for funding from government and private sources. The focus of many NFPs is likely to shift as well, as concerns grow over social and environmental issues.

Fundraising will continue to evolve, forcing organizations to seek creative ways to raise money. Traditional galas may be replaced by virtual events, or eliminated altogether. Due to increased technology and social media, organizations will have greater ease reaching a larger pool of potential donors at a lower cost. With a changing population, it is probable that nearly all fundraising will be internet-based. Federal and local tax rules concerning the deductibility of charitable contributions are likely to change as well, perhaps even regularly depending upon the party in office.

Outsourcing of administrative tasks may become commonplace, as it will allow more time for staff and management to focus on program-related functions. Outsourcing may eventually transform into full artificial intelligence automation, further streamlining and simplifying administrative tasks such as accounting and bookkeeping. With continued technology advances, organizations will have easy and affordable access to resources that will enable them to extend their reach virtually. It is very possible that local, regional, and national organizations will expand their missions well beyond their current geographic operating areas.

The last century brought with it changes that could not have been imagined when the NFP landscape first began. Wars, the Great Depression, market crashes, financial scandals, and pandemics all affected NFP organizations in ways that were unforeseeable. Nevertheless, many NFPs have continued to thrive. With continued challenges, one could expect to see NFPs adapt to the changing operational environment. What will that world look like? Time will tell. ■

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