Net Assets & Contributions

Proper financial reporting is essential for not-for-profit (NFP) organizations to maintain transparency, donor confidence, and regulatory compliance. Despite their best intentions, many NFPs consistently make critical errors in their financial statements. Understanding the classification of net assets and the nuances of contribution revenue recognition, particularly the distinction between conditional and unconditional promises, is foundational for accurate financial reporting.

Net Assets Classification

For not-for-profit entities, net assets are broadly categorized into two main classes as per updated guidance (ASU 2016-14), simplifying the previous three-tier structure (unrestricted, temporarily restricted, or permanently restricted).

- **Net Assets Without Donor Restrictions**
    - These are funds that the organization can use at its discretion to support its mission.
    - They include general donations, revenues from services, and other unrestricted resources.
    - Previously known as unrestricted funds, they are often referred to as general operating or general support. Many individual contributions fall into this category.
- **Net Assets With Donor Restrictions**
    - These funds come with **specific donor-imposed restrictions on their use**.
    - They encompass what was formerly termed temporarily restricted (funds limited by a particular use or time) and permanently restricted funds (funds that carry a permanent restriction).
    - **Time restrictions** are satisfied by the passage of a defined period of time.
    - **Purpose restrictions** are satisfied by performing defined activities.
    - Examples include grants for specific programs, projects, or individual contributions intended for a particular campaign.
    - **Permanent endowments** are a specific type of donation where the principal amount is to be maintained in perpetuity, with only the investment income available for use. These funds are always classified as net assets with donor restrictions.

Reclassification of Net Assets: When the conditions or restrictions on donor-restricted net assets are met, those funds **must be reclassified to net assets without donor restrictions**. This reclassification ensures financial statements accurately reflect available resources. For instance, if a $300,000 donation is restricted for a library renovation and $200,000 is spent, that $200,000 is reclassified to net assets without donor restrictions, while the remaining $100,000 stays restricted until used. It is important to remember that expenses are generally covered by net assets without restrictions, so when restricted funds are used, they are first released from restriction and moved to net assets without restrictions before being expensed.

For financial analysis, planning, and decision-making, it is crucial for an organization to understand what portion of its net asset position is without restriction. Accounting rules require nonprofits to record all income from a multi-year grant in the year it is received; without separating restricted dollars, this can lead to inflated surpluses in the first year and artificial deficits in subsequent years.

Contributions and Revenue Recognition

Determining whether funding arrangements are contributions or exchange transactions is a common struggle for many NFPs. Under ASU 2018-08, the key distinction lies in **whether the resource provider receives commensurate value in return**. This clarification impacts the timing of revenue recognition and the reporting of obligations and restrictions.

- **Definition of a Contribution**: A contribution is defined as an **unconditional transfer of cash or other assets**, or an unconditional promise to give, to an entity, or a reduction, settlement, or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner. For a transfer to be a contribution, it must be both **voluntary and nonreciprocal**.
- **Definition of an Exchange Transaction**: An exchange transaction is a **reciprocal transfer** where each party receives and sacrifices approximately **commensurate value**. In the simplest form, these are purchases of goods and/or services where each party gives and receives something of equal value.

This distinction is important because contributions and exchange transactions are governed by **different accounting pronouncements**: Contributions fall under ASC Topic 958 ("Not-for-Profit Entities"), while exchanges are subject to guidance like ASC Topic 606 ("Revenue from Contracts with Customers"). The application of these different rules affects when revenue is recognized.

Conditional vs. Unconditional Contributions and Promises

ASU 2018-08 introduces the concept of **barriers** in identifying conditions that would preclude the recognition of a contribution as revenue, generally leading to more contributions being classified as conditional.

- **Unconditional Contributions**:
    - **Definition**: These are contributions where the donor imposes **no requirements or conditions that must be fulfilled** before the contribution can be used or kept.
    - **Recognition**: **Unconditional contributions are always recognized as revenue immediately** upon receipt, regardless of any donor-imposed restrictions.
    - **Classification**: They are classified as either **with donor restriction** or **without donor restriction** based on the donor’s intent. For example, a $50,000 cash donation with no restrictions is recognized as revenue without donor restriction, while $30,000 worth of equipment donated for a new program, though unconditional, would be recognized as revenue with donor restriction.

- **Example**: A donor's pledge of $10,000 for a new garage that is unconditional and restricted to that purpose should be recorded as restricted revenue immediately.

- **Conditional Contributions**:
  - **Definition**: Conditional contributions require the recipient organization to **fulfill specific conditions or actions before the contribution becomes available**.
  - A donor-imposed condition exists when it's determinable from the agreement that a recipient is entitled to the contribution **only if a barrier is overcome**.
  - Conditional contributions must have **both** a barrier that must be overcome and a right of return to the provider for assets transferred (or a right of release of the promisor from its obligation). The agreement doesn't need to explicitly state a right of return/release, but it must be clear enough to support a reasonable conclusion.
  - **Indicators of a Barrier** (no single indicator is determinative):
    - **Measurable performance-related barrier**: e.g., achieving a specified service level, number of units, or a matching requirement.
    - **Limited discretion by the recipient**: e.g., requirements to follow specific guidelines for expenses, hiring specific individuals, or adhering to a specific protocol.
    - **Stipulations related to the purpose of the agreement**: e.g., a homeless shelter providing a specified number of meals. This does not include goals or budgets where no penalty is assessed for failure to achieve them.
  - **Recognition**: Conditional contributions are **not recognized as revenue until the conditions are substantially met** or explicitly waived by the donor. Revenue is recognized on the date the condition is met, not on the grant date.
  - **Funds Received Before Conditions Met**: If funds are received before meeting the conditions, they are recorded as a **refundable advance liability** because the organization may have to return the money if the condition is not met.
  - **Ambiguity**: If an agreement is ambiguous about whether a contribution is conditional or unconditional, ASU 2018-08 **presumes it is conditional**.
  - **Example**: A federal grant contingent on incurring qualifying expenses, where unspent money is forfeited, is a conditional contribution because it requires specific actions (incurring expenses) to be entitled to the assets. Similarly, a grant requiring specific career training for a minimum number of veterans and specifying a right of release if targets are not met is a conditional contribution.
- **Conditional Promises to Give (Pledges)**:
  - **Definition**: These are promises to give that **depend on the occurrence of a specific future event or action**.
  - **Recognition**: Conditional promises to give are **not recognized in the financial statements** (no receivable or revenue) until the conditions are substantially met. There is **no journal entry required** until the condition is met.
  - **Example**: A $750,000 pledge for a new arts center, conditional on raising an additional $250,000 in matching funds, is not recorded on the statement of financial position until the matching funds are secured.
- **Unconditional Promises to Give (Pledges)**:
  - **Definition**: These are promises to give where the donor imposes **no conditions for receipt**.

  - **Recognition**: Unconditional promises to give are **recognized as contribution revenue in the period the promise is made**, even if the cash is to be received in future periods.
  - **Classification**: They are typically classified as **with donor restriction** until the money is actually received, as it is not yet available for immediate use.
  - For pledges spanning multiple fiscal periods (e.g., $10,000 per year for four years), revenue is recognized at the **net present value** of the contribution. Increases in net present value are booked as contribution revenue, not interest.
  - **Example**: A corporate sponsor pledging $200,000 to be paid in equal installments over four years for general operations, with no conditions or restrictions, results in the entire $200,000 being recognized as contribution revenue in the current year, typically as revenue with donor restriction.

Donations Given in Exchange for Something

When a donor receives goods or services in return for their contribution, the revenue recognized is split into two components.

- **Fair Market Value (FMV)**: The fair market value of the goods or services received by the donor is recognized as **sales revenue**.
- **Contribution Revenue**: The excess of the total donation amount over the FMV of the goods or services received is recognized as **contribution revenue**.
- **Example**: If a local philanthropist donates $25,000 and receives a table valued at $5,000 and a thank-you photo worth $500, the total benefits received are $5,500. The contribution revenue would be $19,500 ($25,000 - $5,500), and $5,500 would be sales revenue.

Donated Goods and Services

- **Donated Services**: The value of donated services can be recognized if certain conditions are met. These conditions include:
  - Non-financial assets are enhanced.
  - Services requiring **special skills** are provided **by persons possessing those skills**, and the services would **normally have been purchased** by the organization (e.g., a CPA donating audit services).
  - The fair market value of the service is recognized as a **credit to contribution revenue** and a debit to either an asset (if non-financial assets are enhanced) or an expense account (if services are provided).
- **Donated Fixed Assets**: These are recorded at their **fair market value (FMV)** at the date of donation and are generally subject to depreciation. Revenue from donated fixed assets is usually recognized as unrestricted unless there are specific donor restrictions on their use or the proceeds from their sale.
- **Donated Collections**: NFPs have the option not to recognize donated works of art, historical artifacts, rare books, and similar collections as revenues or gains and assets if specific conditions are met: they are held for public exhibition, education, or research

(not financial gain); they are protected and preserved; and there is an organizational policy requiring sale proceeds to be used for acquiring other collection items.

By carefully distinguishing between unconditional and conditional contributions, recognizing unconditional contributions and promises immediately, and properly allocating donations that include goods or services, organizations can ensure their financial statements accurately reflect their financial health and the stewardship of donor funds. Consistent application of these GAAP principles and seeking professional accounting advice are crucial for high-quality reporting.