The Effects of Senate Bill 1205, Act 141 on Accounting

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The accounting for permanently restricted net assets received and held by a not-for-profit organization for its own use is described in FASB No. 124. In the simplest situation, the donor restricts the asset contributed but not the income and gains earned thereon, and the not-for-profit organization can invest the contributed assets as it wishes.

The contribution is recorded as a permanently restricted net asset at the fair value of the assets received. The permanently restricted amount does not change. Accounting income—interest, dividends, rent, etc. earned on the investments—and gains and losses are recorded as unrestricted net assets and are available for use as the organization sees fit.

This article presents a discussion of accounting interpretations for the treatment of the income and gains on permanently restricted assets held by a not-for-profit corporation when the donor has not placed a restriction on income and gains.

Pennsylvania Law

Pennsylvania state law defines income on permanently restricted investments and limits the amount that may be "spent" by the organization in a given year to that income. The intent is to protect the underlying purchasing power of the contributed assets. Pennsylvania law does not address the accounting treatment for these investments.

Act 141 took effect in December 1998 and also addresses assets held in trust by a third party. These trusts are not addressed in this article.

Act 141

If an organization does not make an election under Act 141, income which can be spent equals accounting income. However, if the board of directors makes the written election under Act 141, a "total return" concept as defined by Act 141 is used to compute income.

If the election is made, the board selects a spending rate of two percent to seven percent each year. This percentage is applied to the average market value of the investments at the end of the prior year. Average market value is computed based on a minimum of three previous years. Generally, the investments included in the computation include the original, permanently restricted contribution plus the related undistributed amounts earned and included in temporarily restricted net assets.

Act 141 Translated for GAAP

Act 141 income is computed without regard to actual accounting income or gains earned or realized during the year. In theory, the original contribution could ultimately be spent if the return on investments is less than the percentage elected. This has led some practitioners to suggest that the original contribution should be recorded as temporarily restricted. However, Act 141 does not support this position. It directs boards to adopt a spending policy which is "consistent with the long-term preservation of the real value of the assets." Such a policy would preclude spending the original contribution.

FASB 124 contemplates situations in which the fair market value of the investments falls below the original contribution amount. When this happens, the financial statements reflect permanently restricted net assets equal to the original contribution amount.

When is the Act 141 Restriction Met?

Some practitioners suggest that organizations compute annual income using a spending rate under Act 141 and transfer that amount to unrestricted net assets for use by the organization. They believe that the Act 141 test has been met and the income computed using the spending rate is no longer restricted by law. The income is now available for use at the discretion of the organization.

On the other hand, other practitioners believe that the income computed using the spending rate under Act 141 must actually be spent during the year. The definition of "spent" is also subject to discussion. Income that is not spent during the year is still temporarily restricted by Act 141 at year end. Under Act 141, income is recomputed each year and there are no carryovers from the prior year. Under this interpretation, the organization cannot accumulate unrestricted income related to permanently restricted contributions for use in future years outside of the annual Act 141 income computation.

Other Considerations

Donors often restrict the use of the income. The organization's records should document compliance with these restrictions. In addition, contributions from many donors are often invested together. The accounting for these pooled investments must document that each participant in the pool has received its fair share of income and that amounts spent do not exceed the Act 141 limits.

The specifics of each situation should be carefully considered to determine the appropriate accounting treatment and how much is available for spending in a given year. Not-for-profit organizations should work together with their attorneys and accountants to develop an appropriate treatment for each contribution.

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