ACCOUNTING
CONTINUING EDUCATION

Nonprofit GAAP Refresher
(NGR4)

KAPLAN

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Unit 1

Industry Update

LEARNING OBJECTIVE

After completing this unit, participants will be able to:

- Understand the challenges facing not-for-profit (NFP) entities in 2021 in an effort to assess risk to the entity.

INTRODUCTION

This year's industry update focuses on the evolving landscape of NFP entities. The following topics are discussed:

- Fundraising and recruitment challenges
- Financial reporting challenges and trends
- COVID-19 implications
- Impact of government reform initiatives
- Cyber threats

STATE OF NFPs

The financial performance of NFPs in the United States must cope with stock market outcomes, government reform initiatives, and an ambiguous political environment. In addition, NFPs are challenged with fundraising/funding and recruitment/workforce issues. In the most recent *Nonprofit Financial Priorities Benchmark* survey sponsored by Wipfli, NFPs ranked fundraising and recruitment as their top overall challenge.[1]

[1] https://www.wipfli.com/insights/articles/np-2019-nonprofit-outlook-survey-report

Fundraising Challenges

By the end of 2019, NFPs had fundraising as their top challenge. It is believed that lower year-end fundraising results for many NFPs at the end of 2018 were a direct result of the change in tax law on giving. Specifically, NFPs saw a drop in the number of donors who give in the lower to middle end of the giving range. In 2020 many NFPs saw significant drops in donations as a result of the COVID-19 pandemic. While some US-based NFPs have seen extraordinary increases in donations in 2020 to address the COVID-19 crisis ($11.4 billion) and racial inequalities in the country ($7.6 billion), a 2020 survey by the Nonprofit Finance Fund found that 75% of NFPs are seeing reduced earned revenues, 50% reduced contributions, and 27% reduced government revenue. To magnify this issue, many NFPs are simultaneously seeing a significant increase in the use of their services.[2] Some NFPs have not changed their business models with the times and contributions from individuals, particularly at special events, have decreased. This situation increases the risk of potential efforts to overstate or mischaracterize contributions.

Forward thinking NFPs are recognizing that the way they approach their constituents (donors, volunteers, and beneficiaries) may not yield the same results as in the past. Communication needs, donation mechanisms, and constituent preferences are different now and will continue to evolve in the future as millennials take a larger role and members of the silent generation and baby boomers age out.

As a result:

NFPs May Need To:	**This Could Lead To:**
Have a certain level of donations or other revenue sources in order to obtain matching grants	Misclassification of funding
Pay operating expenses when cash is tight	Use donor restricted net assets for unrestricted purposes
Show a level of contributions that may be needed to demonstrate they are a viable entity	Inflate contributions or revenue through receivables
Need to obtain additional financing to stay afloat	Alter the books and records to inflate assets or minimize liabilities
Meet debt covenants	Alter the books and records to improve ratios or other metrics
Cover certain operating expenses when unrestricted revenue sources have declined	Categorize some expenses as allowable for grant purposes when they are not or over allocate payroll or other costs to grants

Some NFPs "borrowed" from restricted funding to pay operating expenses believing that they would be able to pay it back. This has not happened for many of them as the underlying problem of decreased funding remains.

As NFPs look at fundraising development opportunities in 2021 and beyond, they need to become versatile and respond to the rise of online and mobile giving. According to the Wipfli survey, the

[2] https://nff.org/covid-19-survey-results

share of gifts given through these mediums continue to increase year after year. NFPs will have to adapt to this shift in giving which may require an upfront financial investment in technology and time commitment.

Recruitment Challenges

NFPs largely sustain themselves on grants, donations, and government funding. As such, they must cope with strict budgetary limitations. While NFPs are the third largest workforce in the United States, budgetary restraints impact many NFPs' ability to pay employees reasonable salaries, which in turn causes a recruitment and workforce challenge. Additionally, NFPs also must abide by numerous laws impacting employers, even with their limited resources. For instance, NFPs must comply with the Affordable Care Act which requires employers, including NFPs, to offer health insurance if they employ 50 or more individuals. In addition, NFPs must also comply with other federal laws such as the Fair Labor Standards Act which sets the federal minimum wage and stipulates that certain employees who work over 40 hours in a week must receive overtime pay.

NOTE: Be sure to check the applicable overtime regulations in the jurisdiction in which your NFP operates, as some states have overtime laws that are more stringent than the FLSA standards.

Financial Reporting Challenges and Trends

It is the responsibility of every board member of NFPs to understand the NFP's financial health and to ensure that resources are properly used to support compliance with the approved financial plans. Each board member has a fiduciary responsibility to examine financial information before each board meeting and ask questions they may have to exercise appropriate due diligence. As part of its responsibility, board members should have a foundational understanding of the financial reporting requirements of NFPs.

One of the more recent financial reporting changes deals with contributed nonfinancial assets. In September 2020, FASB issued ASU 2020-07, *Presentation and Disclosures by Not-for-Profit Entities for Contributed Nonfinancial Assets*, that address presentation and disclosure of contributed nonfinancial assets. Contributed nonfinancial assets include fixed assets (e.g., land, buildings, and equipment); the use of fixed assets or utilities; materials and supplies (e.g., food, clothing, or pharmaceuticals); intangible assets; and recognized contributed services. The ASU provides new presentation requirements for contributed nonfinancial assets. Specifically, NFPs are now required to present contributed nonfinancial assets as a separate line item in the statement of activities, separate from contributions of cash or other financial assets.

Financial reporting requirements are ever changing and NFPs are becoming more complex. Workiva and the Journal of Accountancy[3] collaborated on a research project to identify where the challenges were occurring. These have implications for both large and small entities.

Number 1: The biggest takeaway from the survey was that finance, accounting, and compliance personnel do not trust the data. The most significant issue was due to verifying the data followed by the need to aggregate data from a number of systems, the cost to produce financial reports, and

[3] AICPA, Journal of Accountancy, November 2018. *2018 Financial Reporting Survey: Challenges and Trends,* Workiva White Paper.

the changing requirements from regulators. In addition, respondents commented on the changing requirements of their external auditors.

Number 2: Collecting data consumes almost one-fourth of the time the chief executive spends on financial reporting. CEOs spend approximately 21% of the time on managing reviews, 29% of the time analyzing data, and 27% of the time manipulating and preparing data.

Number 3: Many entities have more than one financial reporting system. Aggregating data is the most challenging issue that they face. Many of those responding indicated that they are considering purchasing technology to help to solve that issue.

Number 4: Finance teams believe that they spend too much time creating reports and are not able to spend sufficient time analyzing the data.

Number 5: Over one-half of the respondents believed that their internal controls were below average or needed improvement.

COVID-19 Implications

The novel coronavirus disease, COVID-19, has created an environment of unrest and uncertainty for many NFPs that has called into question the sustainability and survivability of these organizations. Smaller NFPs already struggling with funding and cash flow issues have been devastated by the COVID-19 pandemic and are closing their doors. Others are fighting to keep their heads above water with the help of various governmental assistance programs like the SBA's Payroll Protection Program (PPP) and EIDL Loans. The pandemic has put a spotlight on the importance of disaster planning and financial stability efforts for NFPs.

Auditors should consider the following COVID-19 impacts on planning and performing annual audits of NFPs:

- Performance of audits remotely due to COVID-19 related closures
- Internal controls and segregation of duties may be impacted by staff absences and reductions
- Going concern considerations
- Accounting for PPP and EIDL loans
- Possible new loans or lines of credit taken out in an effort to meet ongoing cash flow needs (and related debt covenants)
- Modifications or extinguishment of liabilities
- Contingent losses
- Insurance recoveries
- Cash management issues
- Possible mergers/acquisitions with other NFPs with similar missions

- Declining revenues due to lower levels of giving from donors
- Decreased revenues due to cancelled fundraising events
- Employee turnover resulting from layoffs
- Increased overall level of fraud risk due to health and financial threats
- Single audit requirements for pass-through funding from federal programs for NFPs providing COVID-19 related assistance to program recipients
- Delays in effective dates of new accounting and auditing standards (SAS 141)
- Asset impairments
- Fair value measurements
- Subsequent event consideration and disclosures, such as
  - decreased investment holdings due to market decreases during the pandemic,
  - election after year-end to terminate operations, and
  - government oversight and reform.

Form 990

Form 990 was updated for the following changes for 2018 filings and beyond:

- For tax years beginning after December 31, 2017, IRC §4960 imposes an excise tax on an organization that pays to any covered employee more than $1 million in remuneration or pays an excess parachute payment during the calendar year that falls within an employer's tax year (Part V – also see Form 4720).
- For tax years beginning after December 31, 2018, an excise tax of 1.4% is imposed on net investment income of certain private colleges and universities with at least 500 tuition-paying students (more than 50% of which are located in the United States) and investment assets of at least $500,000 per student (Part V).
- Unrelated trade or business activities is increased by the amounts paid for employee fringe benefits related to qualified parking or mass transit expenses. This change has nothing to do with amounts paid or incurred directly connected to an unrelated trade or business which is regularly carried on by the organization. (NOTE: The December 2019 Taxpayer Certainty and Disaster Tax Relief Act repealed this provision which may result in the need to amend prior filed tax returns.)
- A change was made to Schedule B, *Schedule of Contributors*, so that NFPs no longer have to report the names and addresses of donors on Schedule B. However, NFPs must continue to maintain this information in their internal records. The disclosure requirements still remain for §501(c)(3) organizations, §4947(a)(1) nonexempt charitable trusts, and §527 political organizations.

- The changes brought about by FASB's ASU 2016-14 caused changes in the form in Part X. It changes the way that NFPs classify net assets by requiring the assets to be categorized into two groups: those with donor restrictions and those without donor restrictions. Some NFP entities filing for 2018 and beyond will have different net asset classifications other than those listed in their 2017 filings. The changes are as follows:

Unrestricted net assets (change to net assets without donor restrictions)	No change. All net assets without donor restrictions will be reported on line 27
Net assets with donor restrictions – timing or purpose restrictions or both (prior to the implementation of ASU 2016-14, they were classified as temporarily restricted)	Preparers have a choice. They may either show the net assets with purpose or timing restrictions or both on line 28, or they can move and combine them on line 29
Net assets with donor restrictions – timing or purpose restrictions or both (prior to the implementation of ASU 2016-14, they were classified as permanently restricted)	Preparers have a choice. They may either show the net assets restricted to perpetuity on line 29 the way they were in 2017 if they showed those timing restrictions or both on line 28, or they can combine them on line 29

- Part VI of Form 990 (Governance, Management, and Disclosure) now also includes many questions related to organizational practices. For instance, one question now requires NFPs to disclose if Form 990 was made available to the full board prior to filing with the IRS. Since Form 990 is open to public inspection, it is extremely important that if an NFP answers "yes" to this question, each board member actually does receive a copy of the return. It is also recommended for the accountant preparing the Form 990 to walk through the document with all interested board members, the audit committee, and management.

Simplification of Excise Taxes on Private Foundations

One area of change for NFP entities from recent legislation deals with the simplification of excise taxes on private foundations. Since 1969, private foundations have been subject to a two-tiered tax approach. Under the old rules (for tax years beginning on or before December 20, 2019), the private foundation paid either a 1% or 2% tax on net investment income depending on the private foundation's charitable expenditures. This two-tiered tax approach has now been eliminated. Excise tax on net investment income for private foundations is changed to a single rate of 1.39% for tax years beginning after December 20, 2019.

This tax must be reported on Form 990-PF, *Return of Private Foundation*. Payment of the tax is subject to estimated tax requirements.[4] Nonexempt private foundations are also subject to this tax, but only to the extent that the sum of the excise tax plus tax on unrelated business income, applied as if the foundation were tax-exempt, is greater than income tax liability for the year.

While this change means a private foundation can no longer qualify for a reduced 1% net investment income tax, it also streamlines the tax and allows private foundations to increase distributions in times of need without a penalty.

[4] For more information concerning payment of estimated tax, see the Instructions for Form 990-PF at https://www.irs.gov/pub/irs-pdf/i990pf.pdf.

Payments in Lieu of Taxes (PILOTs)

Every state exempts some or all of the property owned by charitable NFPs from property taxes. Even though they do not have the legal authority to do so, some municipalities attempt to impose discriminatory taxes or fees on NFPs by demanding so-called "voluntary" PILOTs. The assessment may be called by different terms (e.g., taxes, fees, or PILOTs).

Many NFPs pay little or no property tax since they rent or own small amounts of property. Colleges, universities, hospitals, independent schools, and churches may own significant amounts of land so the payments could be substantial.

Governments are looking for ways to fund services and their costs are rising, so over the last several years, more of them have been requesting PILOTs or fees to cover the costs of government services. Grant Thornton conducted a survey to see how prevalent the activity was. In that survey, which included NFPs across the United States, 3% were paying service fees, 8% were making PILOTs, and 31% were paying taxes.

Some entities believe they should be making payments because it is the right thing to do and their missions support that. Not all feel that way and two universities hired a consultant to show the city how much it benefitted from having the university as a resident. The study confirmed that the positive economic impact (jobs, etc.) benefitted the government more than the cost of the services provided by the city.[5]

Since there has been an increase in the prevalence of PILOTs, NFPs should be prepared for the likelihood they will be asked to provide them.

Health Insurance Portability and Accountability Act Compliance

The Health Insurance Portability and Accountability Act (HIPAA) sets strict guidelines for safeguarding personal health information an entity may interact with. HIPAA is comprised of different components that regulate how certain types of organizations are required to handle health information. NFP compliance to HIPAA is required if the NFP interacts with health information in any way. For instance, compliance is required if an NFP:

- procures health insurance for its employees;
- obtains medical information from its clients (or volunteers);
- provides health care services; or
- provides services to others in the health care field.

NFPs must implement and maintain compliance with HIPAA requirements. This not only includes protection of health information in physical form but also includes the network and processes over which health information is handled.

HIPAA violations are categorized in four tiers based on the violators' level of culpability for the violation as follows:

[5] Payments in Lieu of Taxes, a whitepaper available to members of the not-for-profit section. https://www.aicpa.org/interestareas/notforprofit/resources/financialaccounting/pilot.html.

- Tier 1: the person did not know (and, by exercising reasonable diligence, would not have known) that the person violated the provision;
- Tier 2: the violation was due to reasonable cause, and not willful neglect;
- Tier 3: the violation was due to willful neglect that is timely corrected; and
- Tier 4: the violation was due to willful neglect that is not timely corrected.

As of April 2019, the annual penalty limit imposed by the Department of Health and Human Services for Tier 1 violations is $25,000. The annual penalty limits for Tier 2 and 3 violations are $100,000 and $250,000, respectively. The penalty limit for Tier 4 violations is set at $1.5 million. These limits are adjusted for inflation annually. State attorney generals also have the authority under the Health Information Technology for Economic and Clinical Health (HITECH) Act to hold NFPs accountable for the exposure of the protected health information of state residents and can file civil actions with the federal district courts. HIPAA violation fines can be issued up to a maximum level of $25,000 per violation category, per calendar year. An NFP impacted by a data breach that affects residents in multiple states could also be ordered to pay HIPAA violation fines to attorney generals in multiple states.

EXAMPLE

The Arc of Erie County, an NFP in Buffalo, NY, was fined $200,000 in penalties for violating HIPAA. In February 2018, the Arc of Erie County learned clients' protected health information, including full names, Social Security numbers, gender, race, primary diagnosis codes, IQ scores, insurance information, addresses, phone numbers, dates of birth, and ages, were exposed on its website.

Even though the NFP reported that the site was only for internal use, HIPAA has strict guidelines on how covered organizations need to handle protected health information. HIPAA mandates a thorough risk analysis of electronic systems storing and transmitting health data. Had the Arc of Erie County conducted such analysis, they would have been aware of their vulnerability due to an openly accessible patient record system. Since 2015, 3,751 of the NFP's clients were affected when unauthorized third parties accessed information.

Source: https://ag.ny.gov/press-release/2018/ag-underwood-announces-200000-settlement-buffalo-non-profit-exposing-clients

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Cyber Threats

NFPs face many similar challenges and opportunities as for-profit entities. Technology is improving the capability for entities to connect both within an organization and external to the organization. If utilized appropriately, technology can increase efficiency, facilitate partnerships across time zones, and provide supplementary avenues to increase fundraising. Several cloud-based accounting systems that are available to NFPs have integrated accounting and compliance platforms that will make daily tasks effortless. Additionally, many other systems used by NFPs (i.e., payroll, expense tracking, payment systems, etc.) can be incorporated with a cloud technology enterprise system. This could make an NFP more effective with its data being made accessible for faster decision making. The challenge for NFPs is to identify ways technology can modernize practices and change how they are executing strategy in terms of scope, impact, and price. NFPs should ensure that they have appropriate IT personnel, policies, and infrastructure to

promote strategic positioning to maximize efficiency. For instance, NFPs should consider having appropriate IT strategy, suitable capital for hardware and software, a gateway for the board/management to track documents, and policies and procedures implementing controls for data access and security. At the same time, NFPs need to also consider their cybersecurity defenses as they continue to rely on technology to enhance their missions. In recent years, many NFPs have been targets of hackers.

Ten years ago, this issue plagued larger companies but did not register very high on the NFP risk scale. Today, data breaches can cause significant financial and reputational damage to a NFP. NFPs collect personally identifiable information such as health information, social security numbers, employee and volunteer records, and billing information, and this information, even with a good internal control system, is subject to breach. The impact on the entity and its employees can be damaging. Stolen data can be sold or used by the hackers. Sometimes what hackers want is payment. Organizations, particularly hospitals, are being blackmailed into paying ransom to hackers in order to regain access to data and in the case of a Muncie, Indiana, NFP, to return the data and not publish it.[6] There can also be legal and regulatory ramifications.

According to Verizon's *2019 Data Breach Investigations Report*, ransomware attacks are still going strong, and account for nearly 24% of incidents where malware was used. Ransomware has become so commonplace that it is less frequently mentioned in the media unless there is a high-profile target in the mix. However, it is still a serious threat to all industries, including NFPs. Ransomware can stop the processing of an entity until a ransom is paid to unlock the system. Most NFPs will pay the ransom to get back up and running again. By 2021, ransomware damage costs are estimated to hit $20 billion, 57 times more than it was in 2015, according to Cybersecurity Ventures. This makes ransomware the fastest growing type of cybercrime. The cost was $325 million in 2015 and $11.5 billion in 2019.

Cybersecurity and data security are related but deal with different aspects of information technology management. Cybersecurity focuses on protecting network and infrastructure from attacks. Data security focuses on securing personal information. There are a variety of laws regulating both types of issues.

According to Venable, a national law firm, cybercrimes affect approximately one million victims daily and cost over $450 billion a year, globally. This is a 200% increase in cost from 2010 to 2015. [7] Allianz Group, a leading global corporate insurance carrier, noted that in 2020, cyber incidents ranks as the most important business risk in its annual risk barometer. Compare this with 2013, where cyber incidents were ranked 15th in its annual risk barometer. [8] This increase risk is driven by organizations' increasing reliance on their data and IT systems. Overall, cyber incidents are becoming more sophisticated and targeted as criminals seek higher rewards with extortion demands. The Ponemon Institute identified that the three main causes of data breach from its study, *2020 Cost of Data Breach Report*,[9] are:

- Malicious attack (52%)

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[6] https://nonprofitquarterly.org/2017/06/08/nonprofit-cybersecurity-pay-attention/

[7] https://www.venable.com/files/Event/8f068f95-0d0d-47c1-8045-df53e73a1445/Presentation/EventAttachment/c3d6a15c-9bd9-429d-a4ba-b9c18afc604b/Top-Ten-Cybersecurity-Tips-for-Nonprofits-Managing-Your-Technical-and-Legal-Risks-handouts-02-02-2.pdf

[8] https://www.agcs.allianz.com/news-and-insights/expert-risk-articles/allianz-risk-barometer-2020-cyberincidents.html

[9] https://www.ibm.com/security/digital-assets/cost-data-breach-report/#/pdf

- System glitch (25%)
- Human error (23%)

This illustrates that although cybercrime is a very real threat, many breaches could be prevented by better internal controls.

The ongoing COVID-19 pandemic has had a significant impact on the way many NFPs operate, with large numbers of employees working remotely. This has caused an increased demand for video conferencing, cloud applications, and network resources. Seventy-six percent of organizations that participated in the Ponemon Institute study indicated that remote work make responding to a potential data breach a much more difficult ordeal. The study found that remote work during the COVID-19 pandemic would increase the time to identify and contain a potential data breach. The study also found that by having a remote workforce, the total average cost of a data breach increased by nearly $137,000.

The degree of complexity of data security solutions and the skilled employees it takes to monitor and manage them is a barrier to implementation. The cost is also a factor for many NFPs. The following table outlines several threats that NFPs face:

Threat	**Defined**
Hackers/hacktivists	Hackers are people who use computers to gain unauthorized access to data. They can be criminal groups, cyber criminals, script kiddies (a person who uses existing computer scripts or code to hack into computers because they don't have the expertise to write their own). A hacktivist is a hacker with a political agenda.
Insiders	Insiders look for deficiencies in internal controls to gain unauthorized access to data, or if they are authorized to have access, use the data for gain.
Spyware/malware	Spyware is a type of software that enables a user to obtain covert information about another's computer activities by transmitting data covertly from their hard drive. Malware is software that is intended to damage or disable computers and computer systems.
Ransomware	Ransomware is a type of malicious software from crypto virology that threatens to publish the victim's data or perpetually block access to it unless a ransom is paid.
Social engineering	Social engineering is psychological manipulation of people into performing actions or divulging confidential information. Examples: posing as IT personnel to get employees to divulge their passwords, learning the company lingo to convince employees they are legitimate, pretending to be law enforcement, IRS, or other types of agents. These threats can be in person, via email, other electronic means, or on the phone.

A risk assessment is an important step in identifying all of the areas where the network is vulnerable starting with an inventory of digital assets. The Nonprofit Technology Network (NTEN) suggests that the first step in assessing a NFP's data risks is to take inventory of all the data the NFP collects and identify where it is stored.[10] NFPs should answer these questions:

- What data do we collect?
- What do we do with it?
- Where do we store it?
- Who do we share it with?
- Who is responsible for it?
- What do we do when we are done with it?
- Do data we collect about individuals or other entities know we have it?
- Do they know what we do with it?
- Does it identify them personally?
- What do we do if they want their data back?

As part of its data inventory assessment, NFPs should consider the cost associated with maintaining all the data it maintains as well as the associated benefits of maintaining such data. Many NFPs may find that there is data that is kept that may not be needed. In such instances, NFPs should decrease or limit the data they amass and modernize their storage process (as well as their process for destroying data). One helpful approach is to divide data identified into the following three categories: (1) data that cannot be lost, (2) data that cannot be exposed, and (3) nonessential data. In some instances, some data identified may be classified as both data that cannot be lost *and* exposed. This would indicate that these items are the NFP's highest priority to protect. This is the first step towards mitigating risks.

NFPs will continue to confront new and evolving cyber risks that they will need to mitigate. To help address these challenges, NFPs should consider utilizing the guidance *Managing Cyber Risks in a Digital Age*, released by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in collaboration with Deloitte Risk & Financial Advisory in December 2019.[11] The guidance provides insight into how NFPs can leverage the five components and 20 principles of the Enterprise Risk Management (ERM) Framework to identify and manage cyber risks. The guidance notes that the fast-evolving cyber threat landscape makes it imperative for organizations to increase their cyber proficiencies and capabilities so that they may effectively assess how well these risks are being addressed.

As part of its assessment, NFPs should consider its need for insurance. Cybersecurity insurance is available, and while it may not mitigate reputational risk, it can be very helpful in paying for the remediation that will need to be performed after an attack. It is important to develop policies and

[10] https://www.nten.org/article/assessing-risk-protect-valuable-data/

[11] To access this guidance, visit: https://www.coso.org/Documents/COSO-Deloitte-Managing-Cyber-Risk-in-a-Digital-Age.pdf

procedures and then provide security awareness training to users. The NFP should also develop an incident response plan to help contain any breach that occurs.

It is important to evaluate the NFP's firewalls and spam filtering system. In addition, it is important to perform operating system updates. Intrusion prevention and detection software could be used in addition to next-generation anti-virus/anti-malware software. Many entities are using multi-factor authentication. Some fixes are as easy as forcing staff to use different and changing passwords, and ensuring that the training that should be given to all employees on cybersecurity is thoroughly understood so it can be implemented. This includes verifying when transactions involve cash as noted in the illustration that follows.

EXAMPLE

A hacker infiltrated the IT system of a NFP and was able to read email and interoffice communications on the entity's server. The Controller and the CFO were having a series of discussions over email and through interoffice communications about a wire transfer that was to occur when the amount became known. One day the Controller got an email from the CFO instructing him to transfer $200,000 to the vendor as they had previously discussed. The email sounded like it came from the CFO (the hacker had learned the entity lingo and acronyms). The Controller made the transfer to the vendor with the routing number and account specified in the email. It was not until later that day when he saw the CFO that he learned that the email was not real.

Note that hackers have the ability to do new things every day. In a similar instance, a vendor made a communication to a NFP asking them to change the payment routing instructions. The employee hovered the cursor over the email address to ensure it was from a bona fide employee at the vendor. Noting no discrepancy but still wanting to confirm that the instructions were authorized, the employee called the vendor. There she learned that no such instructions had been sent to the NFP.

Unit 2

Financial Statement Presentation and Disclosure

LEARNING OBJECTIVE

After completing this unit, participants will be able to:

- Identify and apply the requirements related to presentation and disclosure for NFP financial reporting

NFP ENTITIES AND FINANCIAL REPORTING

Recently issued guidance for NFPs simplifies and improves how NFPs classify net assets as well as the information presented in financial statements and notes about liquidity, financial performance, and cash flows. The intent of the guidance related to NFP's financial statement and presentations is to provide better information to donors, creditors, grantors, and others who rely on the financial statement of an NFP. Through the issuance of various standards in the last few years, FASB hopes to improve the usefulness of NFP financial statements and reduce the complexities and costs of financial reporting.

Defining the Entity

The NFP entity is described in the FASB ASC glossary as an "entity that possesses the following characteristics:

- Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return
- Operating purposes other than to provide goods and services at a profit
- Absence of ownership interests like those of business enterprises

The revised Audit and Accounting Guide for Not-for-Profit Entities (AAG-NPE) also identifies entities that **clearly** fall outside the definition:

- All investor-owned entities
- Entities that provide dividends, lower costs or other economic benefits directly and proportionally to their owners, members, or participants such as mutual insurance entities, credit unions, farm and rural electric cooperatives and employee benefit plans

Included in the definition of NFP entity by FASB ASC glossary and the AAG-NPE are:

- Cemetery entities
- Civic and community entities
- Colleges and universities
- Elementary and secondary schools
- Federated fundraising entities
- Fraternal entities
- Labor unions
- Libraries
- Museums
- Other cultural entities
- Performing arts entities
- Political parties
- Political action committees
- Private and community foundations
- Professional associations
- Public broadcasting stations
- Religious entities
- Research and scientific entities
- Social and country clubs
- Trade associations
- Voluntary health and welfare entities

- Zoological and botanical societies

These NFP entities are subject to the AAG-NPE. Health care entities that are considered NFP entities follow the Audit and Accounting Guide, *Health Care Entities* (Health Care A&A Guide).

Note: Common Interest Realty Associations (CIRAs) are NFPs but they do not follow ASC 958-605 and ASC 958-205, 210, 225 and 230. Guidance on CIRAs can be found in the AICPA Audit and Accounting Guide, *Common Interest Realty Associations*.

BASIC NFP FINANCIAL STATEMENTS

Specific literature for NFP entities can be found in ASC Section 958. Technical practice aids issued by the AICPA can be found in TIS Section 6140. These are not authoritative. In addition, the Accounting and Auditing Guide (AAG-NFP) provides a synopsis of FASB guidance specific to NFP entities along with recommendations by the AICPA Financial Reporting Executive Committee (FinREC). The appendix contains a complete set of financial statements where ASU 2014-16 has been implemented.

ASC 958, Not-for-Profit Entities, discusses the requirements for general-purpose financial statements. Financial statements for an NFP entity are called:

- Statement of Financial Position
- Statement of Activities
- Statement of Cash Flows
- Statement of Functional Expenses (information could also be in the notes or on the face of the statement of activities)

An entity may be considered a **voluntary health and welfare entity.** This means that it derives the majority of its support from the public. Where these entities were previously required to present a Statement of Functional Expenses, they like all other NFPs are required to have a functional expense presentation. The functional expense information may be presented in the form of a statement or a footnote. Although the statements are generally presented in the above order, entities that have primarily agency transactions should consider presenting the Statement of Cash Flows as the first statement.

Professional literature does not specify the titles of financial statements except for the statement of cash flows. Many NFP entities use the titles listed above. Others refer to the statement of financial position as the “balance sheet” and those with operations may prefer to refer to the statement of activities as the “statement of operations”.

Statement of Financial Position

Typically, the Statement of Financial Position will be presented in a columnar format **without** regard to net asset class distinction. This is because net assets are generally restricted, not the individual assets and liabilities themselves. The guidance permits an NFP entity to use a multi-column format to illustrate assets and liabilities by net asset class, but this is not common practice.

ASU 2014-16 changed the classification of net assets condensing the three categories down to two. Net assets will be classified as either with or without donor restrictions. This will have a significant impact on the face of the financial statements as illustrated in this manual. Disclosure of the designations within net assets without donor restriction as well as information about the restrictions within net assets with donor restrictions is required.

Combined Financial Statements

ASC 810-10-55 states that combined financial statements of commonly controlled entities could be useful. This may be true when there is common management or a controlling financial interest in several entities related in operations. In NFP entities, combined statements are often prepared when there are two or more affiliated entities. These statements do not take the place of consolidated financial statements. When they are prepared, intra-entity transactions should be eliminated. In addition, noncontrolling interests, different fiscal periods and other similar issues, should be treated the same way they would for consolidated financial statements.

Consolidating and Parent Only Financial Statements

ASC 810 states that parent entity financial statements could be needed in addition to consolidated statements to satisfy regulatory or other requirements. However, **consolidating statements** could be an effective way to present the parent information with the subsidiary information in a separate column(s).

It should be noted that parent-only statements are not permitted under GAAP as a substitute for consolidated financial statements. Technical practice aid TIS 1400.32 clarifies that consolidated financial statements are the general-purpose financial statements of a parent having one or more subsidiaries so parent-entity financial statements are not a valid substitute for consolidated financial statements.

Some entities will issue financial statements under the contractual basis of accounting due to a legal or regulatory agreement.

NOTE: Subsidiary-only statements are appropriate but the FinREC cautions entities to include all of the required related-party disclosures.

An example of combining financial statements follows.

EXAMPLE

Save the Trees
Combining Statement of Financial Position
June 30, 20X3
(in part)

	Save the Trees	Foundation	Total
Assets			
Cash and cash equivalents	$239,134	$ –	$ 239,134
Contributions receivable	52,503	–	52,503
Investments	443,218	3,252,211	3,695,429

Other assets	1,256		1,256
Total assets	$736,111	$3,252,211	$3,988,322

Another presentation that is not frequently used is a presentation by fund. The requirement to provide net assets by class and in total still applies. Note the summation of the net assets for each fund where applicable in the example below. The net assets without donor restrictions and net assets with donor restrictions for the various funds are summed at the bottom of the statement to present net assets in total.

EXAMPLE

Atlanta Jewish Children's Home
Statement of Financial Position
June 30, 20X3

Operating Fund – Assets	
Cash	$8,553
Investments	565,500
Prepaid Expenses	2,512
Total Assets – Operating Fund	$576,565
Property Fund – Assets	
Property and Equipment (net)	$852,122
Total assets – Property Fund	$852,122
Endowment Fund – Assets	
Cash	$152,352
Investments	1,500,000
Total Assets – Endowment Fund	$1,652,352
Total Assets – All Funds	$3,081,039
Operating Fund – Liabilities and Net Assets	
Accounts Payable	$15,229
Accrued Payroll	16,547
Notes Payable	132,555
Total Assets – Operating Fund	$164,331
Net Assets:	
Without Donor Restriction	$300,027
With Donor Restriction	112,207
Total Net Assets – Operating Fund	$412,234
Total Liabilities and Net Assets – Operating Fund	$576,565
Property Fund – Net Assets	
Without Donor Restriction	$852,122
Total Net Assets – Property Fund	$852,122
Endowment Fund – Net Assets	
Without Donor Restriction	$35,000
With Donor Restriction	1,617,352
Total Net Assets – Endowment Fund	$1,652,352

Total Liabilities	164,331
Net Assets – All Funds:	
Without Donor Restriction	$1,187,149
With Donor Restriction	1,729,559
Total Net Assets – All Funds	$2,916,708
Total Liabilities and Net Assets – All Funds	$3,081,039

The accompanying notes are an integral part of these financial statements.

Statement of Activities

With regard to the Statement of Activities, many NFP entities will choose a columnar approach because they find it easier to explain to their board of directors and other users of the financial statements. There are also those that use the layered approach. The literature does not specify a required or even preferred format. The only requirement is a presentation that illustrates the change in net assets in total and by class. The Statement of Activities will also typically include a reconciliation of net assets from the beginning of the year to the end of the year, but this is not required.

In September 2020, FASB issued ASU 2020-07, *Presentation and Disclosures by Not-for-Profit Entities for Contributed Nonfinancial Assets*, that address presentation and disclosure of contributed nonfinancial assets. Contributed nonfinancial assets include fixed assets (e.g., land, buildings, and equipment); the use of fixed assets or utilities; materials and supplies (e.g., food, clothing, or pharmaceuticals); intangible assets; and recognized contributed services. The ASU provides new presentation requirements for contributed nonfinancial assets. However, the ASU does not change existing recognition and measurement requirements for those assets.

NFPs are now required to present contributed nonfinancial assets as a separate line item in the statement of activities, separate from contributions of cash or other financial assets. The amendments in ASU 2020-07 should be applied on a retrospective basis and are effective for annual periods beginning after June 15, 2021, and interim periods with annual periods beginning after June 15, 2022.

Early adoption is also permitted.

Following are examples of the Statement of Activities incorporating the new presentation requirements for contributed nonfinancial assets using the columnar and layered formats.

EXAMPLE

Columnar Format

The NFP Museum
Statement of Activities
Year Ended December 31, 20X1
(in thousands)

	Without Donor Restrictions	With Donor Restrictions	Total
Revenues, gains and other support:			
Contributions of cash and other financial assets	$ 5,465	$ 6,578	$ 12,043
Contributions of nonfinancial assets	2,580	590	3,170
Fees	6,700		6,700
Investment return, net	7,555	20,800	28,355
Gain on sale of equipment	300		300
Other	210		210
Net Assets released from restrictions:			
Satisfaction of program restrictions	9,870	(9,870)	-
Satisfaction of equipment acquisition restrictions	2,000	(2,000)	-
Expiration of time restrictions	1,500	(1,500)	-
Appropriation from donor endowment and subsequent satisfaction of any related donor restrictions	8,800	(8,800)	-
Total net assets released from restrictions	22,170	(22,170)	-
Total revenues, gains, and other support	44,980	5,798	50,778
Expenses and losses:			
Program ABC	12,389	-	12,389
Program XYZ	7,892	-	7,892
Program 123	4,357	-	4,357
Management and general	3,485	-	3,485
Fundraising	3,111	-	3,111
Total expenses	31,234	-	31,234
Loss on building (Fire)	100	-	100
Actuarial loss on annuity trust obligations	-	20	20
Total expenses and losses	31,334	20	31,354
Change in net assets	13,646	5,778	19,424
Net assets at beginning of year	74,550	155,020	229,570
Net assets at the end of year	$ 88,196	$ 160,798	$ 248,994

EXAMPLE

Layered format

The NFP Museum
Statement of Activities
Year Ended December 31, 20X1
(in thousands)

Changes in net assets without donor restrictions:		
Revenues and gains:		
Contributions of cash and other financial assets	$	5,465
Contributions of nonfinancial assets		2,580
Fees		6,700
Investment returns, net		7,555
Gain on sale of equipment		300
Other		210
Total revenues and gains without donor restrictions		22,810
Net Assets released from restrictions:		
Satisfaction of program restrictions		9,870
Satisfaction of equipment acquisition restrictions		2,000
Expiration of time restrictions		1,500
Appropriation from donor endowment and subsequent satisfaction of any related donor restrictions		8,800
Total net assets released from restrictions		22,170
Total revenues, gains, and other support without donor restrictions		44,980
Expenses and losses:		
Salaries and benefits		14,859
Grants to other organizations		3,946
Supplies and travel		2,404
Services and professional fees		2,882
Office and occupancy		2,869
Depreciation		3,805
Interest		469
Total expenses		31,234
Loss on building (Fire)		100
Total expenses and losses		31,334
Increase in net assets without donor restrictions		13,646
Changes in net assets without donor restrictions:		
Contributions of cash and other financial assets		6,578
Contributions of nonfinancial assets		590
Investment return, net		20,800
Actuarial loss on annuity trust obligations		(20)
Net assets released from restrictions		(22,170)
Increase in net assets with donor restrictions		5,778
Increase in total net assets		19,424
Net assets at beginning of year		229,570
Net assets at end of year	$	248,994

In addition to the presentation requirements noted above for contributed nonfinancial asset, NFPs must also disclose the following:

- A disaggregation of the amount of contributed nonfinancial assets recognized within the statement of activities by category that depicts the type of contributed nonfinancial assets.
- For each category of contributed nonfinancial assets recognized:
  - Qualitative information about whether the contributed nonfinancial assets were either monetized or utilized during the reporting period. A description of the programs or other activities in which those assets were used is required, if utilized.
  - If applicable, the NFP's policy regarding monetizing rather than utilizing contributed nonfinancial assets.
  - An explanation of any donor-imposed restrictions associated with the contributed nonfinancial assets.
  - A description of the valuation techniques (and inputs) that are used to arrive at a fair value measure at initial recognition.
  - The principal or most advantageous market that was used to arrive at a fair value measurement if it is a market in which the recipient NFP is prohibited by a donor-imposed restriction from selling or using the contributed nonfinancial assets.

Comparative and Summarized Prior Year Information

NFP entities are encouraged, but not required, to present comparative statements. However, if the columnar approach is used, an entity may not want to present information by net asset class for two years and may choose to present summarized information for the prior. If this format is chosen, then the statements do **not** include the minimum information required by professional standards.

The AAG-NPE states that:

- The captions on the financial statements must have appropriate titles indicating the summarized nature of the information.
- A note to the financial statements should be included that describes the nature of the prior period information.
- The auditor should include an emphasis of a matter paragraph in his or her current year audit report to state that the summarized information has been derived from financial statements previously audited and the nature and date of his or her report on those statements. In those circumstances, the auditor's opinion paragraph should not cover the prior year's balance sheet, statement of activities, or statement of cash flows.

NOTE: The FinREC believes that if an entity presents summarized prior-year financial statements that do not include sufficient detail to conform to GAAP that they include all disclosures required by GAAP for both years.

Example of a Statement of Activities (in part) with appropriate captions, footnote and independent auditor's report follows.

EXAMPLE

Statement of Activities (in part)
Year Ended December 31, 20X3 with Summarized Financial Information
for Year Ended December 31, 20X2

	20X3 Without Donor Restrictions	20X3 With Donor Restrictions	20X3 Total	Summarized Information 20X2
Revenues, Gains and Other Support				
Contributions of cash and other financial assets	$ 50,575	$ 110,650	$ 161,225	$ 166,142
Contributions of nonfinancial assets	8,000	3,125	11,125	10,100
Grant revenue	255,000		255,000	200,000
Federal financial assistance	1,532,600		1,532,600	1,253,332
Investment return		5,250	5,250	6,225
Net assets released from restrictions:				
Satisfaction of time restrictions	12,570	(12,570)		
Satisfaction of purpose restrictions	75,000	(75,000)		
Total Revenues, Gains and Other Support	$1,933,745	$ 31,455	$1,965,200	$1,635,799

EXAMPLE

NOTE X – Prior Year Summarized Information

The financial statements contain certain prior year comparative information in total but not by net asset class. Such information does not include sufficient detail to constitute a presentation in conformity with generally accepted accounting principles. Accordingly, such information should be read in conjunction with the entity's financial statements for the year ended December 31, 20X2, from which the summarized information was derived.

Note that the following example of the Independent Auditor's Report moves the discussion of the summarized information out of the opening paragraph and into an "other matter" paragraph.

EXAMPLE

Independent Auditor's Report

We have audited the accompanying financial statements of The Neighborhood Hunger Project (the Hunger Project), which comprise the statement of financial position as of December 31, 20X3, and the related statements of activities and cash flows for the year then ended and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of the financial statements that are free from material misstatement whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit includes performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of The Neighborhood Hunger Project as of December 31, 20X3, and the changes in its net assets and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Report on Summarized Comparative Information

We have previously audited the Hunger Project's 20X2 financial statements, and we expressed an unmodified audit opinion on those audited financial statements in our report dated February 14, 20X3. In our opinion, the summarized comparative information presented herein as of and for the year ended December 31, 20X2 is consistent, in all material respects, with the audited financial statements from which it has been derived.

Statement of Financial Position

Sequencing of Financial Statement Elements

ASC 958-210 does **not** require a classified Statement of Financial Position. Assets and liabilities should be aggregated into homogeneous groups. Assets do not need to be disaggregated based on donor-imposed restrictions. Therefore, cash that is without donor restrictions does not have to be set apart from cash that is with donor restrictions but will be available for current use. Note that cash with restrictions or board designations for long-term purposes would be segregated.

Liquidity

The guidance requires that information be provided about the entity's **liquidity**. There are three ways to do this:

1. Sequence assets according to how quickly they could be converted to cash and liabilities in order of their maturity.

2. Classify assets and liabilities as current and non-current.

3. Disclose information about the liquidity in the notes to the financial statements.

Information about liquidity, including restrictions, should be disclosed in the notes if it is not on the face of the financial statements. ASC 958-210 states that when an NFP presents a non-classified statement of financial position, that cash and cash equivalents held temporarily in permanent endowment funds are included in the classification of long-term assets. This is also true of cash and contributions receivable that are restricted to investment in land, buildings and equipment.

If the statement of financial position is classified, then even if not set aside in special accounts, cash that would be used to liquidate long-term debt, payments to sinking funds or cash designated for expenditure for long-term assets should be excluded from current assets. This does not include cash to pay debt in the current period.

NOTE: The FinREC believes that when net assets reflect a donor's restriction to use them for a permanent or term endowment, for purchase of a long-lived asset or for another noncurrent purpose, the liquidity of the entity is impacted by its need to hold the assets necessary to comply with the restrictions. The discussion above related to sequencing, in their view, means that these items should be displayed separately on the face of the financial statements with a descriptive term or be captioned with a phrase such as "assets whose use has been limited or restricted". ASU 2016-14 imposes additional disclosures on liquidity as shown in the sample financial statements in the appendix to this section.

ASU 2016-14 requires additional disclosures related to an NFP entity's liquidity. NFP entities are required to provide qualitative as well as quantitative information on the way they manage their liquidity and availability of funds. This includes information about the availability of financial assets to meet general expenditures within one year of the financial statement date. Those assets that are unavailable due to donor restriction, law, contracts, board decisions, etc., are not presented as liquid financial assets.

The example disclosure, illustrated below, is required to be comparative.

EXAMPLE DISCLOSURE

Note B – Liquidity and Availability

Financial assets available for general expenditure, that is, without donor or other restrictions limiting their use, within one year of the balance sheet date, comprise the following:

Cash and cash equivalents	$3,651,231
Accounts receivable	312,216
Operating investments	502,491
Promises to give	132,505
Distributions form assets held under split-interest agreements	95,000
Distributions from beneficial interests in assets held by others	130,110
Endowment spending-rate distributions and appropriations	544,705
	$5,368,258

The organization's endowment funds consist of donor-restricted endowments and funds designated by the board as endowments. Income from donor-restricted endowments is restricted for specific purposes, with the exception of the amounts available for general use. Donor-restricted endowment funds are not available for general expenditure.

Our board-designated endowment of $3,511,186 is subject to an annual spending rate of 4.5%. Although we do not intend to spend from this board-designated endowment (other than amounts appropriated for general expenditure as part of our Board's annual budget approval and appropriation), these amounts could be made available if necessary.

As part of our liquidity management plan, we invest cash in excess of daily requirements in short-term investments, CDs, and money market funds. Occasionally, the Board designates a portion of any operating surplus to its operating reserve, which was approximately $135,583 and $155,687 at June 30, 20X0 and 20X1 respectively.

Noncompliance with Donor-Imposed Restrictions

The NFP entity is required to report its net assets consistent with donor restrictions. TPA[12] 6140.23 "Changing Net Asset Classifications Reported in a Prior Year" states that if the auditor identifies and proposes a reclassification in net assets due to an error, it should be treated like an error for financial reporting purposes, if material.

[12] Technical Practice Aids are issued by the AICPA on questions or concerns to practitioners.

If an NFP entity is not in compliance with donor-imposed restrictions including requirements that it maintain an appropriate composition of assets to comply with them, the noncompliance could result in a contingent liability, loss of future revenue or cause the entity to have a going concern issue. ASC 958-450 requires noncompliance with donor-imposed restrictions to be disclosed if there is a reasonable possibility that a material contingent liability could lead to a material loss of revenue or cause a going concern issue. If the noncompliance results from the entity's failure to maintain an appropriate composition of assets to comply with all donor restrictions, then the amount and circumstances should be disclosed.

Statement of Activities

ASC 958-225 does not prescribe the way that revenues, expenses, gains and losses and reclassifications (i.e., release from restrictions) be sequenced. Some of the ways that the guidance suggests that entities present the required information follow.

- Revenues and gains, reclassifications, expenses, and losses
- Revenues, expenses, gains, losses, and reclassifications
- Certain revenues less directly related expenses (followed by subtotal), other revenues, other expenses, gains and losses and reclassifications. An example of revenues that are shown with related expenses directly underneath might be related to a special events or revenue from some type of exchange transaction such as a gift shop in a museum.

Performing arts entities will often list their fee for service revenue and expenses first with a subtotal and then list the contributions below the "loss from operations". The purpose of this is to illustrate how much the NFP entity depends on donors to fund its activities.

Intermediate Measure of Operations

Many NFP entities such as private schools, colleges and universities, museums, performing arts entities and trade associations have business-type activities. ASC 958-225 permits these entities to include an intermediate measure of operations in its Statement of Activities as long as it is clear from the details on the face of the statement or a footnote what the operations are. Example wording for this intermediate measure might be "excess of operating revenue over expenses". Terms such as revenues over expenses, revenues and gains over expenses and losses, operating income or performance earnings are appropriate.

Some NFP business type entities, particularly healthcare entities, like to compare their results to comparable business entities. Accordingly, they are permitted to compare in a manner similar to business entities by classifying debt securities as available for sale or held to maturity and excluding the unrealized gains and losses on those securities from an operating measure within the statement of activities. NFP, business-oriented healthcare entities, however, are required to exclude certain gains and losses from a performance measure.

If an entity's use of the term *operations* is not apparent from the details provided on the face of the statement of activities, a description of the measure of operations including those items excluded from operations is required to be disclosed in the notes to the financial statements.

Other NFP entities such as colleges or universities with endowments will present internal board designations, appropriations, and similar actions on the face of the financial statements,

disaggregated and described by type of actions. This information could be provided in the footnotes if desired.

Some items are required to be included in the intermediate measure of operations:

- Impairment losses recognized for long-lived assets or asset groups to be held and used
- Any gain or loss recognized on the sale of a long-lived asset or disposal group if that asset or group is not a component of the entity
- Costs associated with an exit or disposal activity that does not involve a discontinued operation

The FinREC believes that an NFP entity should report the items that commercial business entities report in other comprehensive income outside the intermediate measure of operations. Examples are:

- Prior service costs or credits associated with pension benefits
- Gains or losses associated with pension benefits that are not recognized immediately as a component of net periodic benefit cost
- Foreign currency translation adjustments

Classification of Investments

Most NFPs do not classify investments in the three categories (trading, available for sale and held to maturity) the way that commercial entities do, so those items would be reported inside the performance indicator. One exception to that would be where the entity uses a spending rate formula or total return policy to determine the amount that will support operations as opposed to protect the endowment from loss of purchasing power.

Professional literature requires equity investments to be measured at fair value with changes in fair value recognized in net income. If the investment does not have a readily determinable fair value, the investment can be measured at cost less any impairment that results from observable price changes in orderly transactions for the identical or similar investment of the same issuer. This eliminates the classifications of equity investments as trading, available for sale, or held to maturity. This is not usually an issue for NFPs since the vast majority have always marked them to fair value. Health care entities are generally the only ones that have classified equity securities as trading and available for sale.

Following is the Statement of Activities that illustrates the use of an operating measure.

EXAMPLE

Kentucky Home School for Girls
Statement of Activities
Year ended June 30, 20X3

	Without Donor Restrictions	With Donor Restrictions	20X3 Total
Operating revenue			
Tuition and fees	$ 8,336,659	-	$ 8,336,659
Less: financial assistance	(2,340,254)	-	(2,340,254)
Net tuition and fees	5,996,405	-	5,996,405
Private gifts and grants	2,647,499	135,222	2,782,721
Investment return designated for operating activities	**129,437**	**-**	**129,437**
Government grants and contracts	183,681	-	183,681
Sales and services of auxilary enterprises	2,577,375	-	2,577,375
Other sources	103,400	-	103,400
Net assets released from restrictions:			
Investment return appropriated and released from restrictions for current operations from donor restricted	**203,173**	**(203,173)**	**-**
Total operating revenue and gains	11,840,970	(67,951)	11,773,019
Operating expenses			
Instructional	3,379,721	-	3,379,721
Academic support	945,181	-	945,181
Student services	2,541,611	-	2,541,611
Institutional support	3,606,205	-	3,606,205
Auxiliary enterprises	1,254,390	-	1,254,390
Total operating expenses	11,727,108	-	11,727,108
Operating revenues in excess of expenses	**113,862**	**(67,951)**	**45,911**
Non-operating activities			
Private gifts and grants for capital acquisition	-	1,156,417	1,156,417
Investment returns	632,809	-	632,809
Investment return appropriated for current operations from short term investments	**(129,437)**	-	**(129,437)**
Change in value of interest rate swap	(8,000)	-	(8,000)
Change in net assets	609,234	1,088,466	1,697,700
Net assets at beginning of year	3,801,563	6,412,514	10,214,077
Net assets at end of year	$ 4,410,797	$7,500,980	$11,911,777

Excerpt from Summary of Significant Accounting Policies

Intermediate Measure of Operations

The School's operating revenues in excess of expenses include all of the operating revenues and expenses that are an integral part of its programs and supporting activities, net assets released from donor restrictions to support operating expenditures, and transfers from Board-designated and other non-operating funds to support current operating activities. The measure of operations includes support for operating activities from both donor-restricted net assets and net assets without donor restrictions designated for long-term investment (the donor-restricted endowment and quasi-endowment) according to the School's spending policy. The measure of operations excludes investment returns in excess of (less than) amounts made available for current support, gains and losses on extinguishment of debt, and changes in fair value of the interest rate swap.

Reporting and Allocating Expenses

Expenses are required to be reported by **functional classification**. Examples of functions are 1) program related and supporting activities, 2) management and general, 3) fundraising, and 4) membership development.

ASU 2014-16 requires that all entities present additional information by natural and functional expense classification. The information can take the form of a statement or be included in a footnote, but all expense information must be presented. This could result in a reconciliation such as the one presented in the KIDZ KAMP, INC. (KIDZ KAMP) financial statements. The only expenses that are not required to be in the presentation are the external and internal investment expenses. They are netted against investment returns. In addition, disclosure will be required as to the methodology used for allocations of expenses.

The entity is required to provide **a description of its program activities** including its major classes of programs either on the face of the financial statements or in the notes.

	Program Services			Management	Fundraising and	Cost of	
	Advisory	Training	Total	and General	Development	Goods Sold	Total
Grants and other assistance	$ 294,261	$ -	$ 294,261	$ -	$ -	$ -	$ 294,261
Salaries and w ages	6,269,754	1,261,585	7,531,339	290,234	184,176	-	8,005,749
Employee benefits	1,198,503	390,865	1,589,368	99,963	21,222	-	1,710,553
Payroll taxes	441,580	94,927	536,507	29,619	9,923	-	576,049
Professional services	1,006,807	87,197	1,094,004	14,980	1,704	-	1,110,688
Accounting fees	-	-	-	40,073	-	-	40,073
Legal fees	-	7,939	7,939	-	-	-	7,939
Advertising and promotion	33,085	21,006	54,091	79,261	79,478	-	212,830
Office expenses	87,071	56,654	143,725	9,867	22,794	-	176,386
Information technology	37,858	706,535	744,393	12,399	14,653	-	771,445
Occupancy	346,601	29,799	376,400	14,918	53,427	-	444,745
Travel	70,957	18,283	89,240	93,292	-	-	182,532
Conferences, conventions and meetings	32,516	76,285	108,801	16,405	-	-	125,206
Interest	287,428	-	287,428	-	9,457	-	296,885
Insurance	100,500	12,556	113,056	8,443	930	-	122,429
Training and development	157,617	20,659	178,276	8,113	23,669	-	210,058
Product cost of goods sold	48,621	-	48,621	-	-	-	48,621
Cost of direct benefits to donors	-	-	-	-	-	12,501	12,501
Depreciation and amortization	944,870	74,425	1,019,295	110,818	13,960	-	1,144,073
Bad debt expense	-	-	-	24,001	-	-	24,001
Other	31,569	5,977	37,546		7,474	-	45,020
Total expenses by function	11,389,598	2,864,692	14,254,290	852,386	442,867	12,501	15,562,044
Less items included w ithin revenue, support and gains							
Cost of product sales	(48,621)	-	(48,621)	-	-	-	(48,621)
Cost of direct benefits to donors	-	-	-	-	-	(12,501)	(12,501)
Total expenses as presented on the Statement of Activities	$ 11,340,977	$ 2,864,692	$ 14,205,669	$ 852,386	$ 442,867	-	$ 15,500,922

Statement of Cash Flows

ASC 958-230 extends the provisions of ASC 230 (*Statement of Cash Flows*) to NFP entities. While the statements are basically the same as for other entities, there are some issues that arise due to the fact that the change in net assets includes items of an operating, as well as financing, nature.

The guidance expands the definition of financing activities to include resources that are donor-restricted for long-term purposes. As discussed in an earlier section, cash and cash equivalents that are restricted for long-term purposes will be segregated from cash on the Statement of Financial Position. Along the same lines, the receipt of contributions for long-term purposes will be a financing activity.

To accomplish this, on the statement (if prepared using the indirect method) such long-term contributions must be deducted from operating cash flows and included as a cash flow from financing activities. In addition, if the entity used the cash contribution to purchase equipment in the same period, there would be a line item in the investing section titled purchase of equipment.

When the FASB issued its ASU on NFP financial statements in 2016, it did not require the direct method of cash flows to be used for the cash flow statement. However, entities that use the direct method will not have to perform the reconciliation of operating activities because of provisions in ASU 2016-14**.**

NFPs frequently have restricted cash and cash equivalents in connection with bond agreements and arrangements with financial institutions, state departments of insurance and sometimes donor stipulations. ASU 2016-18 requires NFPs to show the changes in cash, cash equivalents and restricted cash and cash equivalents in the statement of cash flows. This guidance also eliminates the presentation of transfers between cash and cash equivalents and restricted cash and cash equivalents.

When cash and cash equivalents and restricted cash and cash equivalents are presented in more than one line item in the statement of financial position, a reconciliation to the totals in the captions is necessary either on the face of the statement of cash flows or in the notes to the financial statements.

EXAMPLE

Kidz Kamp, Inc.

Statement of Financial Position (in part)
June 31, 202X

Assets	
Cash and cash equivalents	$4,874,220
Operating investments	774,223
Accounts receivable, net	502,491
Promises to give, net	941,112
Prepaid expenses and other assets	2,290,813
Cash restricted to building projects	1,500,000
Property and equipment, net	23,306,381
Assets held under split-interest agreements	977,102
Beneficial interests in charitable trusts held by others	812,850
Beneficial interest in assets held by community foundation	1,094,842
Beneficial interest in perpetual trusts	4,081,382
Endowment	
Promises to give, net	2,501,416
Investments	27,027,131
Total assets	$70,683,963
Liabilities and Net Assets	
Accounts payable	$475,002
Accrued expenses and other liabilities	847,722
Deferred revenue	1,467,412
Line of credit	1,111,500
Liabilities under split-interest agreements	1,418,127
Capital lease obligations	69,214
Bonds and notes payable	5,572,605
Interest-rate swap	240,300
Total liabilities	11,201,882
Net assets	
Without donor restrictions	
Undesignated	3,345,218
Designed by the Board for operating reserve	300,000
Designated by the Board for endowment	6,511,186
Invested in property and equipment, net of related debt	17,150,885
	27,307,289
With donor restrictions	32,174,792
Total net assets	59,482,081
Total liabilities and net assets	$70,683,963

Kidz Kamp, Inc.

Statement of Cash Flows
Year Ended June 30, 202X

Cash Flows from Operating Activities	
Program service payments received	$12,910,429
Membership receipts	263,781
Gift show sales receipts	112,364
Receipts from federal and state contracts and grants	256,663
Contributions received, net of amounts restricted for long-term purposes	4,264,113
Receipts from special events	98,552
Distributions from beneficial interests and assets held by others	178,520
Other cash receipts	101,275
Grants paid	(264,261)
Payments for salaries, benefits and payroll taxes	(8,403,222)
Payments to vendors	(3,979,515)
Interest paid	(287,428)
Net Cash from Operating Activities	5,221,271
Cash Flows from Investing Activities	
Purchases of operating investments	(575,000)
Proceeds from sales of operating investments	183,520
Purchases of property and equipment	(1,507,903)
(Addition to) withdrawal from assets held under split-interest agreements	86,476
(Addition to) withdrawal from endowment	536,301
Net Cash used for Investing Activities	(1,276,606)
Cash Flows from Financing Activities	
Collections of contributions restricted to building project	200,000
Collections of contributions restricted to endowment	365,963
Payments to beneficiaries of split-interest agreements	(176,588)
Net borrowings (repayments) under line of credit	(50,000)
Principal payments on bonds, notes, and capital leases	(305,236)
Net Cash from Financing Activities	34,139
Net Change in Cash and Cash Equivalents	3,978,804
Cash, cash equivalents and restricted cash, Beginning of Year	2,395,916
Cash, cash equivalents and restricted cash, End of Year	$6,374,720
Cash paid during the year for interest	$441,514
Supplemental Disclosure of Non-Cash Investing and Financing Activity	
Accounts payable for property and equipment	$445,369

Note H

The following table provides a reconciliation of cash, cash equivalents, and restricted cash reported within the statement of financial position that sum to the total of the same such amounts shown in the statement of cash flows.

	6/30/202X
Cash and cash equivalents	$4,874,220
Cash restricted to building project	1,500,000
Total cash, cash equivalents, and restricted cash shown in the statement of cash flows	$6,374,220

Donations of Nonfinancial Assets

Many NFPs receive contributed nonfinancial assets (e.g., gifts-in-kind). These gifts are often improperly disclosed. The statement of cash flows requires a supplemental disclosure of noncash investing and financing activities. However, some items that are given in kind are operating in nature. These would not be disclosed in the supplemental schedule. Examples of noncash investing and financing activities would be contributions of buildings, securities, paid up cash surrender value of life insurance or recognized collection items.

Following is a chart that summarizes the classification of cash and cash flows in the statement.

Operating	Investing	Financing
Cash contributions without donor restrictions	Gross purchases of investments should be adjusted for amounts payable at period end to arrive at cash outflows for purchases	Lending activities
Agency transactions	Gross sales of investments should be adjusted for amounts receivable from investment sales at period end to arrive at cash inflows from the sale	Contributions restricted for fixed assets, endowments and other long-term purposes (actual received not the change in contribution receivable)
Cash receipts of donated financial assets if sold immediately provided the donor did not restrict the proceeds for a long-term purpose		Cash receipts from sale of donated financial assets if they were directed for sale immediately and the donor restricted the use for long-term purposes
		Cash overdrafts

- If construction in process and other fixed asset purchases are in payables at the end of the year, they would be disclosed as noncash transactions and an adjustment reducing the changes in net assets to arrive at operating cash flows.
- Contributions of securities are noncash transactions and an adjustment reducing the changes in net assets to arrive at operating cash flows if not sold immediately upon receipt.

- Contributions of beneficial interests are noncash transactions and an adjustment reducing the changes in net assets to arrive at operating cash flows.
- Net change in the value of an interest rate swap is a noncash adjustment to get to operating activities.
- Debt refinancing and refunding if no cash is transferred to the entity and it only enters into new terms.

Note that if equipment is purchased in a subsequent period, the proceeds from the sale of assets restricted for the purchase of equipment, as well as the purchase of equipment, would be reported as cash flows from investing activities.

FINANCIAL STATEMENT ISSUES

Identified below are areas where there may be weaknesses in financial reporting.

Gifts-in-Kind

The AICPA receives questions from practitioners through its technical assistance line. Following are questions and answers to selected frequently asked questions. This question that came up addresses an important consideration for many NFPs, gifts-in-kind.

Q: *Are NFPs required to use fair value for gifts-in-kind?*

A: ASC 820, Fair Value Measurement, defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." So yes, fair value measurement is required to measure gifts-in-kind.

The use of the most conservative value is not GAAP no matter if watchdog agencies would prefer it or auditors default to it. The problem is that valuation is very difficult and not only includes professional judgment but also may require appraisal which is costly.

The NFP should look to the exit value and the principal market for the donation. This is hard because the assets were generally not donated for resale. Therefore, there are no prior transactions making finding inputs is challenging. The principal market is one where the NFP would sell the asset with the greatest volume and level of activity. Therefore, the place where the goods are distributed might not be the principal market.

EXAMPLE

An NFP receives medical supplies from a U.S. pharmaceutical company and distributes them in developing countries that have no funds to pay for the supplies. If the medical supplies were sold in the U.S. that would be the principal market for valuation purposes. But since they were distributed in developing countries, those countries may be the principal market.

Legal restrictions could affect the determination of market participants and pricing inputs. Asset restrictions (not donor restrictions) that limit the legal sale of a gift-in-kind to certain markets

might affect the determination of the principal market. Pricing inputs should be identified according to the exit markets (inside or outside the U.S.).

EXAMPLE

An NFP was given land with a conservation easement. A conservation easement that limits the use of the land is a legal restriction specific to the land. Since these legal asset restrictions would be considered by a market participant buyer, the NFP should also consider them too. The NFP might never sell the donated easement, but even so, a hypothetical sale should be considered for purposes of determining fair value. The entity needs to identify any legal restrictions on the gift.

Donors may provide the NFP with values for the donations but this does not mean that they are appropriate. These values may not relate to the principal exit market of the NFP. Pricing inputs should be identified according to the exit markets (inside or outside the U.S.) and the NFP should perform its own valuation based on the principal market at the date of donation.

The fair value of the gift is determined at the point of donation. This may be important in that an NFP may purchase goods and services which in other situations might be considered exchange transactions. But a transaction may be part exchange and part contribution if there is an inherent contribution. The term inherent contribution is defined in the FASB glossary as "a contribution that results if an entity voluntarily transfers assets … in exchange for either no assets or for assets of substantially lower value, and unstated rights or privileges of a commensurate value are not involved." In most transactions, a fee exchanged reflects a purchase of goods or a reciprocal exchange transaction.

EXAMPLE

An NFP receives a parcel of land with a fair value of $50,000 but consideration paid was $10,000. The NFP recognizes a $40,000 contribution. The NFP should have a policy that states that management examine exchange transactions where the amount paid is less than fair value so that an inherent contribution can be recorded.

It is a good idea for an NFP to have a gift acceptance policy that addresses what gifts will be accepted by the NFP and identify any restrictions on acceptance of certain types of donations. For example, a gift of stock representing shares of a donor's business or stock that would be difficult to sell may have other implications. Alternative investments are subject to capital calls that an NFP may not want to deal with. Land may have environmental liabilities. Board members may provide inflated values and expect them to be used. It is also important to assess a gift before accepting it, especially if it may lead to a difficult valuation.

EXAMPLE

An NFP received fifteen works of art by the same artist from a donor who was donating his collection. The donor agreed to pay for appraisals for 3 of them per year for the next five years. The controller looked for market inputs but the artist was not widely sold enough. The controller did not want to make the donor angry so the gift was accepted. The appraisal bill was considerable, and even though the NFP expected to receive repayment, they were concerned that the donor may lose interest over the next four years and not pay.

Recently, watchdog agencies and the media have focused on the valuation of gifts of medical and other pharmaceutical supplies. If they are material to the NFP, it becomes even more important to have policies related to valuation. The *Red Book: Pharmacy's Fundamental Reference* may be helpful.

Several industry groups provide standards for valuing gifts-in-kind for members that are also available to the public. Well-known examples of these guides are the Accord Gifts-in-Kind Standards and the InterAction Private Voluntary Organization Standards.

Cost vs. benefit is an important consideration; however, the entity should be consistent in its valuation process since management is responsible for its judgments and estimates.

Q: *How do I value time donated by volunteers?*

A: Volunteers provide various services to NFPs. But not all volunteer hours are recognized as contributed services in the entity's financial statements. NFPs should recognize contributed services received if they (1) create or enhance nonfinancial assets or (2) are specialized skills that would otherwise need to be purchased. Contributed services that meet the definition for recognition are recorded at fair value. The fair value of contributed services that create or enhance nonfinancial assets may be measured based on the fair value of the asset created or enhanced.

An NFP will want to recognize the services at fair value remembering the discussion above, that fair value is an exit price in the principal market. Therefore, if the NFP receives the services of an attorney (specialized skill) and the attorney bills $500 an hour to his corporate clients but $300 an hour to his NFP clients, the appropriate rate to use would be $300 an hour since that would be the principal market.

NFPs sometimes provide or receive personnel services, at no charge, from affiliate organizations. Professional standards require a recipient NFP entity to recognize all services received from personnel of an affiliate that directly benefit the recipient NFP entity. Those services should be measured at the cost recognized by the affiliate for the personnel providing those services. However, if measuring a service received from personnel of an affiliate at cost will significantly overstate or understate the value of the service received, the recipient NFP entity may elect to recognize that service received at either (1) the cost recognized by the affiliate for the personnel providing that service or (2) the fair value of that service.

Functional Expense Classification

An examination of expenses by function and nature tells an important part of a NFP's story. Donors want to know how an NFP uses its resources. ASU 2016-14 requires all NFPs to produce a functional expense presentation. Prior to the effective date of the standard, only voluntary health and welfare entities were required to do this although the presentation was encouraged for all NFPs by the FASB. NFPs that are required to file Form 990 produce a statement of functional expenses as part of the core form. The requirements have caused questions to surface about what types of expenses are classified in the different sections. The primary sections are program, management and general, and fundraising. ASU 2016-14 requires all expenses except investment expenses to be included in the functional expense presentation. NFPs are most likely to put this disclosure in the form of a matrix which is included as a financial statement. However, the disclosure can also take the form of a footnote or even be presented on the face of the statement of activities.

The FASB ASC glossary defines functional classification as a method of grouping expenses according to the purpose for which costs are incurred.

- Program services – the activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the NFP entity exists.
- Supporting activities – all activities of an NFP entity other than program services. Generally, they include the following:
  - Management and general activities
  - Fundraising activities
  - Membership development activities

Program services should be analyzed to determine the most appropriate groupings. Smaller NFPs may have only one program classification but others will have more. The factors to consider are:

- Program objectives
- Nature of services
- Constituents served, including by geographic or other demographic criteria
- Magnitude of the program to the entity's overall activities
- Budgetary categories
- Oversight, regulatory, grant, or other compliance requirements that separate the program from others
- Other factors that may be relevant to financial statement users

Management and General Activities are those that are not identifiable with a single program, fundraising activity, or membership-development activity but that are indispensable to the operations of the entity.

The FASB guidance states that they include:

- Oversight
- Business management
- General record keeping
- Budgeting
- Financing
- Soliciting funds other than contributions and membership dues
- Responding to government, foundation, and other requests for proposals for customer-sponsored contracts for goods and services
- Administering government, foundation, and similar customer-sponsored contracts, including billing and collecting fees
- Disseminating information to inform the public of the NFP's stewardship of contributed funds
- Making announcements concerning appointments
- Producing and disseminating the annual report
- All management and administration except for direct conduct of program services or fundraising activities

Oversight and management will generally include the salaries and expenses of the governing board, the chief executive officer/executive director, and the support staff.

Fundraising activities induce donors to contribute money, other assets, or time. This could include publicizing and conducting campaigns, maintaining donor lists, conducting special events and other activities. Fundraising activities also include the cost of soliciting services even if they do not meet revenue recognition criteria according to TIS 6140.11, *Costs of Soliciting Contributed Services and Time that Do Not Meet the Recognition Criteria in FASB ASC 958*. TIS 6140.20, *NPE's Reporting No Fundraising Expenses*, states that an NFP entity that has contributions generally would have fundraising expense. If it only has minimal or no fundraising expense, there should be a good reason. It may be that volunteers do this work. It may be that there is one large donor or the name recognition of the entity causes it to obtain contributions with little or no fundraising. It could be a good idea to include an accounting policy that states the reason why this is the case. NFP entities that receive significant amount of support from related entities may need a footnote that discloses those related-party transactions.

EXAMPLE

The Church of the Holy Family's Mission Board receives a substantial portion of its support from the Diocese that allocates X% of the contributions received by its Diocesan Mission Board to Holy Family.

Fundraising activities are those undertaken to induce potential donors to contribute money, securities, services, materials, facilities, other assets, or time no matter whether the potential donor responds or not. Some donations of services are not recognized because they are not professional services that would have been incurred by the NFP or do not create or enhance a nonfinancial asset. The solicitation of these services is still considered fundraising.

These activities include:

- Publicizing and conducting fundraising campaigns
- Maintaining donor mailing lists
- Conducting special fundraising events
- Preparing and distributing fundraising manuals, instructions, and other materials
- Conducting other activities involved with soliciting contributions from individuals, foundations, government agencies, and others

Certain NFPs do not engage in fundraising activities. Churches, synagogues and other faith-based entities often do not engage in fundraising because they are sustained by member tithing, and volunteer-led entities may have minimal or no fundraising expense. This should be considered and documented. It may be wise to consider a footnote explaining this since watch-dog entities wonder why there is not fundraising expense when there are contributions.

Membership development activities include soliciting for prospective members and membership dues, membership relations, and similar activities. If no significant benefits are provided to members in exchange for their payment, then these activities are considered fundraising for the purpose of functional classification reporting.

EXAMPLE

The controller of a social service entity was preparing to implement ASU 2016-14. She identified all of the costs that she believed benefitted more than one function. One of the costs she had always identified as management and general was information technology (IT). Upon further evaluation, she decided that although the technology benefitted the accounting and financial reporting function and the human resource function, it also benefitted the fundraising and program functions. She enlisted the help of program and fundraising managers to help her with the allocation. Ultimately, they decided that the IT costs should be allocated on the basis of total modified direct costs. Amounts for the other functions were then reclassified out of general and administrative costs.

Other supporting activities are less common. But an entity may have one or more of the following:

- Costs of sales activities that are not program activities. For example, a thrift shop may be operated purely to generate funding. The same is true of a gift shop in, for example, a museum. It is possible that cost of goods sold could be a program expense.

- The entity may own an investment property that is rented to generate income. The expenses of owning and maintaining the property, and the costs of conducting the rental activities, are a separate supporting activity.

- Payments to local and national NFPs that cannot be allocated to other functional categories are a separate supporting service.

Of course, if the amounts are not material, then separate reporting may not be necessary.

EXAMPLE

The controller of an Alzheimer's Awareness NFP was preparing the functional expense statement. She evaluated the costs of goods sold generated by the store to determine its placement in the statement. Since the store only sold items that were associated with the conduct of the awareness program such as books, DVDs, and aids to help care for Alzheimer's patients, she classified the cost of goods sold as program expense.

Cost Allocation

The following are common errors identified by the AICPA in functional expense allocations:

- *Lack of expense allocation methodology*. Management is responsible for ensuring that its functional expense allocation is reasonable. ASU 2016-14 requires NFPs to disclose the methods it uses to allocate costs among program and support functions. NFPs should ensure that they have a reasonable methodology that is justifiable and documented.

- *Incorrect classification of management and general*. ASU 2016-14 requires that certain costs be solely allocated to management and general expenses because they benefit the organization as a whole. Examples of such costs include: HR, accounting, and payroll.

- *Insufficient allocation of costs to programs*. There are situations in which the AICPA have identified that NFPs are not allocating enough expenses to program services. For example, job assignments may change or employees may spend time on activities that are outside of their typical job duties. Understanding how NFP employees spend their time will help with a better allocation of costs.

- *Failure to consider joint costs.* Commonly conducted activities that have shared programmatic and fundraising purposes should be considered for allocation. However, many NFPs overlook this when preparing a functional expense allocation. FASB ASC 958-720 provides guidance to determine if joint costs meet the criteria for allocation.

- *Failure to consider the level of detail in natural expense presentation.* While there is no requirement dictating the level of detail a NFP must present for its natural component of expenses in the functional expense analysis, NFPs should consider its audience and what will be useful for them for a material perspective when disaggregating expenses.

- *Failure to appropriately allocate fundraising salaries expense.* NFPs that receive contributions typically have salaries associated with generating those contributions. However, many NFPs fail to adequately or reasonably allocate such expenses.

- *Inappropriate classification of investment-related activities.* Under ASU 2016-14, investment-related expenses should be netted with investment return on the statement of activities. These expenses should also be excluded from the functional expense analysis based on the standard presentation requirements.

Many of the expenses of the entity are directly attributable to the activity. However, other expenses relate to more than one program or supporting activity. The techniques used to allocate are common to all entities and the methodology used should be rational and systematic.

The guidance found in Title 2 U.S. Code of Federal Regulations (CFR) Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance), may also be helpful in allocating costs.

The FASB also provides guidance to consider. Some specific guidance to consider when allocating costs includes:

- FASB ASC 958-720-55 provides general guidance to be used in the classification and allocation of costs incurred in activities that include fundraising

- FASB ASC 958-720-45-25 states that occupying and maintaining a building is **not** a separate supporting service. The expenses associated with occupying and maintaining a building, such as depreciation, utilities, maintenance, and insurance, may be allocated among the NFP's functions based on the square footage of space occupied by each program and supporting service. If floor plans are not available and the measurement of the occupied space is impractical, an estimate of the relative portion of the building occupied by each function may be made.

- AICPA Q&A section 6960.12, "Allocation of Overhead" states that allocation of overhead is an inter-program transaction that should not be reported as revenue of the program providing the services, but rather as a reduction of expense of such program.

- FASB ASC 958-720-45-24 states that interest costs, including interest on a building's mortgage, should be allocated to specific programs or supporting services to the extent possible. Interest costs that cannot be allocated should be reported as part of the management and general function.

Allocation Methods

When expenses must be allocated to more than one function, the NFP entity should find a reasonable method of allocating any shared expenses. **There are other reasons for being careful to properly allocate expenses.**

- With donor restrictions, net assets are released from restriction when donor restrictions are met. To properly release the net assets from restriction, the entity may need to identify the direct and indirect costs associated with a contribution.

- Form 990-T requires the entity to state the costs associated with unrelated business income, some of which may be indirect.

- Some third-party reimbursements may provide for indirect as well as direct costs. In addition, the grant or other agreement may specify the amount of indirect costs that can be reimbursed.

Following are ideas on how an entity might reasonably allocate expenses:

- Complete a study of the activities at the end of each fiscal year related to time spent on activities by key personnel, use of space, and consumption of supplies.

- Have employees who spend time in more than one activity maintain time records. If the employees' activities do not vary much during the year, continuous time reporting may not be necessary. It may be sufficient to keep records periodically throughout the year to test a previously-determined allocation.

- Automobile and travel costs could be allocated either as they directly relate to an activity or in accordance with the time allocation.

- Telephone expense could be allocated on the basis of the extensions used or in accordance with the time allocations of personnel.

- An entity may wish to study the use of supplies. This would include postage. However, in many cases, postage can be tracked directly.

- Occupancy costs such as rent and utilities could be allocated as a function of space used for each activity.

- Depreciation could be allocated based on asset usage.

ASU 2016-14 also requires the entity to provide information on its allocation methods.

Simplifying the Allocation

Payroll and related costs are generally the most significant part of total expenses for an NFP. In order for functional expense reporting to be reasonable, an entity will need an accurate reporting system. Most employees, regardless of job title, will probably have some time allocated across the four expense categories.

EXAMPLE

The Executive Director of a medium-sized NFP was evaluating his activities related to their functional classification. He knew that he frequently assisted development staff with structuring or soliciting new gifts (fundraising). He also provided assistance with program deliverables (program services). He assisted in the development of the budget and communicated with the public on matters concerning the NFP (management and general). The entity did not have a policy of requiring management employees to keep daily time reports. Knowing the priority that is now put on functional expense allocation, the Executive

Director notified all management employees and those whose duties were split over more than one function to keep detailed records for one week every quarter to assist in the appropriate development of the allocation.

EXAMPLE

Note H – Functional Expenses

The financial statements report certain categories of expenses that are attributed to more than one program or supporting function. Therefore, expenses require allocation on a reasonable basis that is consistently applied. The expenses that are allocated include occupancy, depreciation, and amortization, which are allocated on a square footage basis, as well as salaries and wages, benefits, payroll taxes, professional services, office expenses, information technology, interest, insurance, and other, which are allocated based on estimates of time and effort.

Auditing Considerations

Since functional expense reporting is in the spotlight, the auditor will want to be sure that he/she has performed the appropriate level of work on the functional expense presentation.

- Planning – Evaluate the risk of material misstatement. Consider, for example, whether an NFP might have a reason to overstate program expenses. This might be because they are part of a federated fundraising arrangement that focuses on attaining a specific percentage of program expenses for participation.
- Consider common misstatements:[13]
  - Donor vs. agent – If an entity receives funds as an agent, these are not program expenses of the entity. The entity collects the funds to be disbursed where they have been designated to go.
  - Fundraising activities as program expenses – grant writing, volunteer recruitment, and solicitation of donations are not program expenses.
  - Gifts-in-kind – these gifts involving a specialized skill may be overstated due to volume or rate or they may be erroneously classified as program.
  - Joint costs – specific criteria must be followed to be able to allocate fundraising costs to other functions.
  - Inconsistent or misapplication – an entity's operations may change. For example, a program may be discontinued but the proportion of overhead allocated to programs remains the same. Misstatement can also occur due to management's bias to make fundraising and management and general expenses lower so they will look more appealing to funders or donors.

[13] Considerations for Auditing Functional Expenses by the AICPA. This document is included when the auditor participates in the Not-for-Profit Section.

- Net vs. gross reporting – discounts under sliding fee activities are not expenses but reductions of revenue. Special event proceeds should not be netted against expenses, in certain circumstances. To the extent that the expenses are reported by other than their natural classifications (salaries included in cost of goods sold or facility rental costs of special events reported as direct benefits to donors), they shall be reported by their natural classification in the functional expense analysis.

- Understand the entity's financial reporting process – Understand the significant categories of costs such as payroll and benefit costs, occupancy costs, grants made, etc., and determine how they are accounted for in the books and records including the groupings (e.g., by grant or other geographic location). How are the significant costs allocated among the functions?

- Understand the internal controls in place over the classifications of costs – Are the employees trained and knowledgeable about proper cost allocation? Is the process of coding the costs subject to supervisory review? Is the budget developed at a level of detail so that budget to actual reports would provide good control over cost allocation?

- Perform analytical procedures to evaluate consistency – Ask for an explanation of variances.

- Review expenses by nature and function starting with the largest expense and test the significant expense categories – Since personnel costs are generally the largest expense, make inquiries on how time is allocated and the level of documentation. Inquiry alone is not sufficient evidence but discussions are very informative. The information can then be compared to job descriptions and payroll cost allocations.

- Look at journal entries – Look at journal entries to determine if there have been any made that would increase certain functional expense categories. Trace the entries directly to the financial statement drafts.

- Detailed tests of larger items – It may be necessary to perform tests of larger categories such as personnel. This may involve taking a sample of time reports. This may be targeted to those employees who perform more than one function. If formal time reporting mechanisms are not used, determine whether management has taken steps to have employees perform time reporting, for example, once a quarter when formal time reports are not a part of the entity's processes.

Management Concerns

Management may be concerned that Charity Navigator and other raters are expecting an unreasonably high percentage of expenses to be in the program category. Where entities such as Charity Navigator, BBB Wise Giving, and GuideStar still evaluate the amount of program expenses to total expenses, there is a trend toward understanding that it takes funds to properly operate and manage an NFP.

In 2013, those three entities wrote a letter to the Donors of America stating that the "overhead ratio" is only one measure of an NFP's performance. They discussed what the *Stanford Social Innovation Review* referred to as the "Nonprofit Starvation Cycle". It stated that "overhead costs include important investments charities make to improve their work: investments in training, planning, evaluation, and internal systems – as well as their efforts to raise money so they can operate their programs. When we focus solely or predominantly on overhead ... we starve

charities of the freedom they need to best help the people and communities they are trying to serve."

Reporting Investment Expenses

ASU 2016-14 requires that an entity include direct internal investment expenses in its investment expenses and net them with the investment return. Some entities may already be doing this but others may not have ever considered it. The FASB defines direct internal investment expenses as those that involve the direct conduct or direct supervision of the strategic and tactical activities involved in generating investment return. These include, but are not limited to, the following:

- Salaries, benefits, travel, and other costs associated with the officer and staff responsible for the development and execution of investment strategy
- Allocable costs associated with internal investment management
- Supervising, selecting, and monitoring of external investment management firms

Direct internal investment expenses do not include costs that are not associated with generating investment return. For example, the costs associated with unitization and other such aspects of endowment management would not be allocated to investment expenses.

There have been implementation questions related to whether a person who reconciles investment report information to purchase and sales and performs analytical procedures are included in direct internal investment expenses. The entity should determine whether these costs are associated with management of investment firms that are instrumental in carrying out the investment activity or otherwise contributing to the direct conduct or direct supervision of the strategic and tactical activities involved in generating investment return.

EXAMPLE

The CFO of an NFP performed various activities related to investments. She managed the investment strategy of not only the general portfolio but the endowment portfolio. She performed analytical procedures to understand the investment return and how it relates to accomplishing the investment strategy. She supervised accounting for the investments. In this case, the work related to the strategy is considered investment expenses; the supervisory activity would not be, since it is related to accounting. That would be a management and general activity.

The FASB also:

- Eliminated the requirement to disclose the composition of investment return
- Eliminated the requirement to disclose the amount of investment expenses
- For NFPs with endowment funds, the roll-forward schedule in the endowment disclosure now only needs to present net investment return and not the components

The NFP may choose to present the information.

Liquidity

ASU 2016-14 requires additional disclosures related to an NFP entity's liquidity. NFP entities are required to provide qualitative as well as quantitative information on the way they manage their liquidity and availability of funds. This includes information about the availability of financial assets to meet general expenditures within one year of the financial statement date. Those assets that are unavailable due to donor restriction, law, contracts, board decisions, etc., are not presented as liquid financial assets.

The disclosures, illustrated below, were adapted from an AICPA white paper designed to help financial statement preparers in implementation. Note that the liquidity information is not required to be comparative in the year of implementation. The FASB provides NFPs the flexibility not to have to go back and accumulate the information for the prior year. Instead, the NFP may present the information for the year of implementation and then the following year, two years will be presented.

EXAMPLE DISCLOSURE 1

Note B – Liquidity and Availability

Financial assets available for general expenditure, that is, without donor or other restrictions limiting their use, within one year of the balance sheet date, comprise the following:

Cash and cash equivalents	$3,651,231
Accounts receivable	312,216
Operating investments	502,491
Promises to give	132,505
Distributions from assets held under split-interest agreements	95,000
Distributions from beneficial interests in assets held by others	130,110
Endowment spending-rate distributions and appropriations	544,705
	$5,368,258

The organization's endowment funds consist of donor-restricted endowments and funds designated by the board as endowments. Income from donor-restricted endowments is restricted for specific purposes, with the exception of the amounts available for general use. Donor-restricted endowment funds are not available for general expenditure.

Our board-designated endowment of $3,511,186 is subject to an annual spending rate of 4.5%. Although we do not intend to spend from this board-designated endowment (other than amounts appropriated for general expenditure as part of our Board's annual budget approval and appropriation), these amounts could be made available if necessary.

As part of our liquidity management plan, we invest cash in excess of daily requirements in short-term investments, CDs, and money market funds. Occasionally, the Board designates a portion of any operating surplus to its operating reserve, which was $135,583 at June 30, 20X1.

Certain NFPs may prefer to show the entire amount of their financial assets and then the amounts that are available for general expenditure within one year. Following is a sample disclosure of a college.

EXAMPLE DISCLOSURE 2

Note K – Available Resources and Liquidity

The College monitors the level of liquidity required to meet its operating needs and other contractual commitments, while also striving to maximize the investment of its available funds. It has various sources of liquidity at its disposal, including cash and cash equivalents, marketable debt and equity securities and lines of credit. Note L contains further information about the College's lines of credit.

For purposes of analyzing resources available to meet general expenditures over a 12-month period, the College considers all expenditures related to its ongoing activities of teaching, research, and public service as well as the conduct of services undertaken to support those activities to be general expenditures. Student loans receivable are not included in the analysis, as principal and interest on these loans are used solely to make new loans and are, therefore, not available to meet current operating needs.

In addition to financial assets available to meet general expenditures over the next 12 months, the College operates with a balanced budget and anticipates collecting sufficient revenue to cover general expenditures not covered by donor-restricted resources. Refer to the statement of cash flows which identifies the sources and uses of the College's cash and shows positive cash generated by operations for fiscal years 20X1 and 20X0.

As of June 30, 20X1, the following tables show the total financial assets held by the College and the amounts of those financial assets could readily be made available within one year of the balance sheet date to meet general expenditures:

Financial assets at year-end	
Cash and cash equivalents	$82,313
Accounts receivable (net)	62,520
Contributions receivable (net)	52,151
Student loan receivables (net)	26,632
Investments convertible to cash in the next 12 months	236,773
Other long-term investments	105,332
Total financial assets at year-end	$565,721
Financial assets at year-end available to meet general expenditures over the next 12 months	
Cash and cash equivalents	$82,313
Accounts receivable (net)	62,520
Contributions for general expenditures due in one year or less (Note K)	24,253
Payout on donor-restricted endowments for use over the next 12 months	7,352
Payout on quasi-endowments for use over the next 12 months	8,585
Investments not encumbered by donor or board restrictions	125,305
	$310,328

Another presentation takes the amount of financial assets available for general expenditure within one year and then adds other financial assets to it so that the user can see a reconciliation to total financial assets.

EXAMPLE DISCLOSURE 3

Note C – Liquidity and Availability

The College regularly monitors the availability of resources required to meet its operating needs and other contractual commitments, while also striving to maximize the investment of its available funds. For purposes of analyzing resources available to meet general expenditures over a 12-month period, the College considers all expenditures related to its ongoing activities of teaching, research, and public service as well as the conduct of services undertaken to support those activities to be general expenditures.

At June 30, 20X1, the College's financial resources were earmarked as follows:

Unencumbered financial assets	*$ 270,138*
Payout on donor-restricted endowments for use over the next 12 months	*7,352*
Payout on quasi-endowments for use over the next 12 months	*8,585*
Contributions for general expenditures due in one year or less	*24,253*
Financial assets available for general expenditures over the next 12 months	*310,328*
Student loan funds	*26,632*
Future expendable board designated funds	*12,321*
Future expendable donor restricted funds	*55,502*
Portion of donor-restricted funds to be held in perpetuity	*160,938*
	$ 565,721

In addition to financial assets available to meet general expenditures over the next 12 months, the College operates with a balanced budget and anticipates collecting sufficient revenue to cover general expenditures not covered by donor-restricted resources. Refer to the statement of cash flows which identifies the sources and uses of the College's cash and shows positive cash generated by operations for fiscal years 20X1 and 20X0.

The College's governing board has designated a portion of its unrestricted resources for endowment and other purposes. Those amounts are identified as board-designated in the table above. These funds are invested for long-term appreciation and current income but remain available and may be spent at the discretion of the Board.

The College also has a line of credit available to meet short-term needs. See Note F for information about this arrangement.

The following example disclosure is from a federated fundraising entity (FFE) that receives funds and makes allocations to agencies which are paid over a 12-month period. The entity also receives other donations during the year. The FFE has a policy to designate all net assets without donor restrictions. This policy results in a shortfall of financial assets to meet cash needs. However, the board makes all of these designated funds available as necessary to meet obligations as they come due.

EXAMPLE DISCLOSURE 4

Total financial assets	*$ 2,258,520*	*$ 2,358,520*
Donor-imposed restrictions:		
Funds subject to time restrictions	*-151,225*	*-162,220*
Endowments	*-85,000*	*-85,000*
Net financial assets after donor-imposed restrictions	*2,022,295*	*2,111,300*
Less:		
Board-designated funds	*-359,114*	*-484,636*
Agency allocations payable	*-1,986,542*	*-1,858,611*
Financial assets needed to meet cash needs for general expenditures within one year	*$ (323,361)*	*$ (231,947)*

Frequently Asked Questions Regarding Liquidity

Questions generally arise with the implementation of new standards. The question below were posted in an AICPA guest blog site.

Q: Does my not-for-profit need to set up a liquidity reserve?

A: Liquidity reserves are not required under GAAP. It may be a good idea to set one up but this decision would be made by management and the Board. If one is set up and approved by the board, then specific disclosure is required under ASU 2016-14. As it relates to the reserve, the classification of a liquidity reserve depends on the nature of the assets comprising the reserve and the ability of management to access them.

The FASB provides the following example in ASU 2016-14:

> The $1,300 liquidity reserve, created in a prior year when the governing board designated net assets without donor restrictions, was included as a reconciling item in Not-for-Profit Entity A's note on liquidity risk and the availability of resources because the intention of the designation was to support unanticipated liquidity needs and not general expenditures."

COMMON ISSUES WITH PRESENTATION AND DISCLOSURE

The financial statements of NFPs can be complicated depending on the size and activities/operations of the entity and they are often the first impression that a funding source or regulator has of the NFP. With the implementation of ASU 2016-14, it is a good time for management to make any necessary corrections. Following are some of the common issues noted in peer reviews and reviews by regulators.

Statement of Financial Position

- Current assets are presented but current liabilities are not (or vice versa).
- Cash and cash equivalents include items that are restricted or not available for current use. In health care entities, these items are typically captured – items limited as to use. Other entities may call the category restricted cash. Items that are frequently improperly included in cash and cash equivalents are as follows:
  - Cash held temporarily in the investment (or endowment account) until it can be invested
  - Cash and financial instruments with maturities of less than three months in a quasi-endowment fund
  - Investments purchased with resources that have donor-imposed restrictions on them such as an endowment fund
- Not reporting cash, contributions receivable and other assets restricted for long-term purpose separately.
- Including conditional contributions as receivables.
- Including a receivable from a funding source prior to the formal grant award.
- Recording deferred revenue for grants where cash has not been received and the amounts are characterized as exchange transactions or conditional contributions. If a grant is an unconditional contribution, then "with donor restrictions" is the appropriate way to record the transaction.
- Dues revenue receivable should not be recorded unless the member will receive goods or services as a benefit of membership.
- Promises to give are at net realizable value. Collectability should be evaluated before recording.
- Other investments are those that are not marketable securities include real estate, venture capital funds, partnership interests, oil and gas interests, equity securities without a readily determinable fair value or mortgage notes that are not debt securities. The NFP should use the same valuation method of all such investments.
- Some entities fail to distinguish between operating and capital leases. ASU 2016-02 changes the accounting for leases primarily including leased assets (over one year) as right of use assets and as liabilities. This standard became effective for years beginning after December 15, 2018 for those NFPs that are conduit bond obligors. For other NFPs, the effective date for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.
- Failure to account for deferred asset or liability related to an operating lease contract. Note the effective date of the new lease standard above.

- Leasehold improvements should be capitalized and amortized over their useful life or the lease term, whichever is shorter.
- An asset should be recorded for costs incurred for computer software programs that are developed or obtained for internal use.
- Board designated net assets are not donor restricted. They should be reported as “without donor restrictions” and identified as board designated.
- Donor restricted net assets should never have a negative value.
- Totals required by GAAP on the statement of financial position are total assets, total liabilities, total net assets, total net assets with donor restrictions and net assets without donor restrictions.

Statement of Activities

- Required totals are change in net assets, change in donor-restricted net assets, and change in net assets without donor restrictions.
- The change in net assets without donor restrictions should be displayed where there are multiple columns for net assets without donor restrictions.
- Contribution revenue related to promises to give in future periods are recorded as net assets with donor restrictions unless the donor indicates that they are intending to support the current period.
- Investment returns with donor-imposed restrictions should be reported as restricted.
- When an entity has restricted contributions for a purpose, they are used before net assets without restrictions are used. All purpose and timing restrictions must be met before releasing net assets from restriction.
- Exchange transactions are always categorized as without donor restrictions.
- Amounts receivable under a cost reimbursement contract are categorized as net assets without donor restrictions.
- Expenses are always reported as net assets without donor restrictions.
- Revenue and expense should be reported gross for special events and other activities that are an ongoing major or central part of the entity.
- Each entity should report expenses by function. They should have at least one category of program services as well as supporting services (management and general and fundraising). Membership may also be a separate category if applicable.
- Fundraising expenses should be reported and entities with contribution revenue will generally have fundraising expenses. There may be reasons why fundraising expenses are not reported such as tithing in religious organizations or an entity that raises money using only volunteers.

An entity may state this in a policy note to avoid confusion on the part of the user that may expect to see fundraising expenses.

- If an entity has more than one program service function, it should report them if they are significant.
- Contributed services that meet the criteria for reporting should be reported. Those that do not may be disclosed in the footnotes in terms of effort, such as volunteer hours that do not meet the revenue recognition criteria.
- Gifts-in-kind should be reported. NFPs are required to present contributed nonfinancial assets as a separate line item in the statement of activities, separate from other financial assets, including cash contributions.
- The costs of soliciting contributions should be recorded.
- Costs of soliciting funding for exchange transactions such as advertising are a management and general expense.
- When a donor changes the nature of a contribution, for example, from purpose restricted to without donor restrictions, this reclassification is appropriate. When mistakes are made as to classification of donations, this is a correction of an error.
- If an entity reports an intermediate measure of operations impairment losses for long-lived assets to be held and used, costs associated with the disposal or exit of an activity that does not involve a discontinued operation and gains or losses on the sale of long-lived assets that is not a component of an entity should be considered operating. Note that when an element is not material, the item could be disclosed outside the indicator.

Statement of Cash Flows

- Investments, purchases, and sales should be shown gross.
- Donor-restricted capital contributions are a financing activity.
- Noncash gifts for endowments or property, plant, and equipment are reported as supplemental noncash disclosures.
- If an entity obtains debt specifically for the acquisition of assets, then this is a noncash activity.
- Purchases and sales of property are reported gross.
- Contributions that are subsequently designated by the governing board for long-term purposes are an operating activity, not a financing activity.
- Investing activities include cash flows from purchases, sales and insurance recoveries of unrecognized noncapitalized collection items.
- Borrowings and repayments of long-term debt are reported gross.

- Cash paid for interest should be disclosed. Reporting interest expense instead of cash interest payments is incorrect.
- Payables and receivables related to investments are considered investment activities.
- The amount of capitalized interest included in construction in progress or property additions should be disclosed.
- Agency transactions are operating activities.
- Securities lending activities are financing activities.

Statement of Functional Expenses

- All expenses must be included even those shown in the revenue section of the statement of activities.
- Management and general expenses should not be allocated out to other functions. For example, costs associated with solicitation of funds other than contributions are still management and general even if the funds are for a program.

Notes to the Financial Statements

- Some preparers are forgetting the disclosures for summarized financial information.
- The capitalization policy for property, plant, and equipment should be disclosed.
- Discount rates used in present value measurements such as long-term promises to give or split interest agreements should be disclosed.
- Information should be disclosed about the programs or activities that had contributed services.
- The numeric value for the allowance for uncollectable promises to give should be disclosed.
- A schedule presenting contributions receivable in less than one year, in one to five years and thereafter should be disclosed.
- Significant accounting policies should be disclosed related to receivables from exchange transactions including the credit quality of financing receivables and allowances for credit losses. Examples of financing receivables are church mortgages held by a church development fund, student loans, loans receivables in housing associations, microfinance loans, program related investments of foundations and officer and employee note receivables.
- Investment income and gains are classified as unrestricted if the restrictions were net in the same year **if** there is a similar policy for classifying contributions.
- Advertising costs should be disclosed.

- Reclassifications that are corrections of errors should be disclosed as restatements. But if they are not corrections of errors, the reclassification made to prior period financial statements must be disclosed even if they had no effect on prior year change in net assets.
- The terms on long-term obligations should be disclosed.
- Minimum rental commitments should be disclosed by year for the next five years with the years after that disclosed as a single amount.
- Legal or non-donor restrictions on cash or other assets should be disclosed.
- Concentrations of risk should be disclosed.
- Disclosures of descriptive information for investments using net asset value per share as a practical expedient should be made.
- Endowment disclosures should be made.
- Fair value disclosures should be made.
- Cash and cash equivalents that are not securities do not belong in the fair value hierarchy table. However, a reconciliation could be made to reconcile to the financial statements.
- Interest rate swaps and beneficial interests and other assets and liabilities that are reported at fair value belong in the fair value hierarchy table.
- Joint cost disclosures are required where a cost is incurred for an activity and partially allocated from fundraising to other functional categories.
- Debt disclosures are required including the debt repayment schedule, collateral, interest rate, covenants and guarantees.
- The debt repayment schedule of a liquid facility such as a letter of credit should be disclosed.
- The stated maturity of the debt in situations where short-term obligations are classified as long-term because the NFP has the ability and intent to refinance the debt on a long-term basis should be disclosed.
- Significant events occurring after the balance sheet date but before the financial statements are available to be issued should be disclosed.
- Material related-party transactions should be disclosed.

Unit 3

General Accounting and Disclosure Issues

LEARNING OBJECTIVE

- Understand and navigate general accounting and disclosure issues related to NFP financial reporting

PUBLIC ENTITIES

Professional literature distinguishes between a public entity and a public business entity (PBE). The FASB issued a professional standard which contains the definition of a PBE which is used to determine which entities may apply the private company accounting and reporting alternatives within GAAP. NFP entities were carved out of the definition of the PBE along with employee benefit plans as they are not considered businesses.

This is important because certain accounting pronouncements, such as the pronouncement on revenue recognition and the one on leases are effective for NFPs at different times depending on if they are considered public entities or public business entities.

A public entity is one that meets any of the following conditions:

a. Its debt or equity securities trade in a public market either on a stock exchange (domestic or foreign) or in an over-the-counter market, including securities quoted only locally or regionally.

b. It is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).

c. It files with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market.

d. It is required to file or furnish financial statements with the SEC.

e. It is controlled by an entity covered by criteria (a) through (d).

CASH AND CASH EQUIVALENTS

Relevant Literature

- **ASC 958-230, Statement of Cash Flows**
- **Technical Q&A[14] 2110.06, Disclosure of Cash Balances in Excess of Federally Insured Amounts**

Just like those of other entities, NFP entity financial statements generally have one line item identified as cash and cash equivalents.[15] Unless prohibited by contract, agreement or law, cash from different sources can be commingled in bank accounts. When it comes to disclosure, NFP organizations should be sure to classify cash with donor-imposed restrictions related to its use or other limitations by outside parties (i.e., compensating balance requirements, cash held as collateral on debt obligations or for loaned securities) separately from cash to be used for operating purposes. In addition, boards of directors will frequently designate cash to be set aside for specific noncurrent purposes so separate classification would be important here as well. More often, though, it is net assets, not cash, that will be restricted. The important distinction here is the separation of cash that is able to be used for operating purposes and cash that is noncurrent.

Information relative to restrictions, designations or other limitations on the use of cash and cash equivalents should be presented on the face of the financial statements or in the notes.

Funds Deposited with a Related Entity

Certain entities deposit funds with a related entity, such as a national office or a church with a denominational body.

NOTE: The FinREC believes that in this case where there is a centralized cash management arrangement, those cash amounts would not be considered cash and cash equivalents unless the entity has legal title to the cash on deposit.

This is generally evidenced by the cash or cash equivalent being deposited in a demand deposit with the specific entity's name. Amounts in a cash pool are generally not short-term deposits and the entity would classify the deposit in the cash pool as a receivable from the related entity.

[14] Technical Information Service described in the literature as TIS is referred to as Technical Q&A throughout this manual as this is how practitioners refer to them.

[15] NFPs generally invest excess cash in cash equivalents. Cash equivalents are defined as investment vehicles that are readily convertible to cash and have original maturities of three months or less such as money market funds, commercial paper and treasury bills.

Concentrations of Credit Risk

Technical Q&A 2110.06 states that bank balances for an organization that are in excess of amounts insured by the FDIC are considered a concentration of credit risk.[16] Even if an organization has several accounts in its name, that organization is only insured up to $250,000 for the aggregate of all accounts in one bank.

The Technical Q&A qualifies its statement by saying that if there are small amounts over the insured limits in several banks, that disclosure is not required. This is a matter of judgment. The client should provide the auditor with a schedule so that materiality can be determined.

Disclosure Examples

EXAMPLE 1

Durham Agency for the Photographic Arts
Statements of Financial Position
June 30, 20X3 and 20X2 (in part)

	20X3	20X2
ASSETS		
Cash and cash equivalents	$208,000	$165,000
Unconditional promises to give, less allowance for uncollectable promises of $34,000 and $38,000	232,000	220,000
Receivable from Related Entity	15,000	10,000
Assets restricted to investment in equipment	183,000	–
	638,000	395,000
Endowment Fund Investments[17]		
Cash and cash equivalents	7,000	92,000
Long-term investments	504,000	500,000
Total endowment investments	511,000	592,000
Property and equipment, net	37,000	34,000
TOTAL ASSETS	$1,186,000	$1,021,000

[16] This refers to amounts that are in the bank, not the bank balance per the books.

[17] Note that this could be disclosed as one item with the detail in a footnote.

EXAMPLE 2

Note 1: Summary of Significant Accounting Policies

Cash and Cash Equivalents

The Agency considers all highly liquid investments with original maturities of three months or less to be cash equivalents. Cash and cash equivalents restricted to building projects, endowments that are perpetual in nature or other long-term purposes are excluded from this definition.

Assets Restricted to Investment in Equipment

During 2013, the Agency received a donation of cash which was restricted to the purchase of photographic equipment. At June 30, 2013, $183,000 had not been released from restriction.

EXAMPLE 3

Assets Limited or Restricted as to Use

Assets limited as to use is comprised of amounts set aside by the Board for future capital improvements, future funding of retirement programs and insurance claims, retirement of debt, and other purposes over which the Board retains control. The board may, at its discretion, subsequently use these funds for other purposes. Assets held by trustees under the bond indenture and self-insurance trust and benefit plan arrangements are also included. This caption also includes assets that are specifically restricted as to use by donors.

EXAMPLE 4

Note 5: Concentration of Credit Risk

KIDZ KAMP manages deposit concentration risk by placing cash, money market accounts, and certificates of deposit with financial institutions believed by us to be creditworthy. At times, amounts on deposit may exceed insured limits or include uninsured investments in money market mutual funds. To date, we have not experienced losses in any of these accounts.

EXAMPLE 5

Note 4: Cash and Cash Equivalents

The Society's bank balance on June 30, 2011 included interest bearing accounts which contained approximately $2,500,000 in excess of the FDIC insured limits.

Restricted cash and cash equivalents relate to the unspent portion of donor-restricted contributions for long-term purposes. These are not included in cash and cash equivalents in the statement of cash flows.

CONTRIBUTIONS, CONTRIBUTIONS RECEIVABLE, AND RELEASE OF NET ASSETS FROM RESTRICTIONS

Relevant Literature

- **ASC 958-605, Revenue Recognition – Account for Contributions Received and Contributions Made**
- **Technical Q&A 6140.03, Lapsing of Time Restrictions on Receivables that are Uncollected at their Due Date**
- **Technical Q&A 6140.04, Lapsing of Restrictions on Receivables if Purpose Restrictions Pertaining to Long-Lived Assets are Met Before the Receivables are Due**
- **Technical Q&A 6140.09, Reporting Bad Debt Losses**
- **Technical Q&A 6140.11, Costs of Soliciting Contributed Services and Time That Do Not Meet the Recognition Criteria in ASC 958**
- **ASC 820, Fair Value Measurements and Disclosures**
- **Technical Q&A 6140.12, Nondiscretionary Assistance Programs**
- **Technical Q&A 6140.24, Contribution of Certain Nonfinancial Assets, Such as Fundraising Material, Informational Material, or Advertising, Including Media Time or Space for Public Service Announcements or Other Purposes**
- **Technical Q&A 6140.25, Multiyear Unconditional Promises to Give – Measurement Objective and the Effect of Changes in Interest Rates**

Contributions represent **unconditional, nonreciprocal gifts of assets (or settlement of its liabilities)** from one entity to another. Contributions received can take the form of cash, fixed assets, investments, use of facilities or utilities, supplies, intangible assets and services. Contributions can also be unconditional promises to give these items. There are some inflows of assets that are not included in the definition of contributions. They are:

- Exchange transactions – In an exchange transaction, something of commensurate value is received
- Agency transactions – In an agency transaction, one organization functions as an agent, trustee or intermediary for the donor. This organization does not have control over the assets
- Tax exemptions, tax incentives, and abatements from a governmental entity

Donor-Imposed Restrictions

Contributions can be received with restrictions on its use. If the contribution is restricted, it means that the donor has identified certain limitations on the use of the contributed assets. Restrictions can be related to the timing of the use, that is, specific time periods in which or after which the assets can be used. Restrictions can also be related to specific purposes for which the assets can

be used. Of course, contributions can also be given without restriction as to either timing or purpose.

Whether they are actually received or whether they are promises to give increase a class of net assets as illustrated below. Although promises to give may not be legally enforceable, the guidance requires NFP organizations to recognize them at the date of donation unless they are conditional.

EXAMPLE

An NFP organization receives a donation of assets. Based on the criteria in the columns below, management records the donation as without donor restrictions or with donor restrictions as follows:

	Without Donor[18] Restrictions	With Donor Restrictions
Available for any purpose determined by the NPO	X	
Available according to timing or purpose specified by the donor		X
Contribution to be held in perpetuity but if not specified by donor or law the return is without donor restrictions		X
Restrictions met	X	(X)

An NFP organization may adopt a policy whereby with donor restricted contributions, whose restrictions have been met in the period of donation, are reported within "without donor restrictions" category of net assets.

The NFP organization may be notified by the donor of restrictions orally or in writing when the gift is made. Restrictions can also be implied based on the circumstances in which they were received; for example, in response to a long-term capital campaign. While this is the general rule, it is also possible that the donor will expressly state that the contribution is to be used to support activities of the current period. In this case, the contribution would be recorded as without donor restrictions.

Following is an example of the disclosure required related to net assets released from restriction. See the full set of financial statements in the appendix for the presentation of a release from restriction on the statement of activities.

EXAMPLE 1

Note J – Net Assets with Donor Restrictions

Net assets were released from donor restrictions by incurring expenses satisfying the restricted purpose or by occurrence of the passage of time or other events specified by the donors as follows for the year ended June 30, 20X1:

[18] Note that until the entity adopts ASU 2016-14, the terms "temporarily restricted" and "permanently restricted" will be used to further characterize net assets with donor restriction.

Expiration of time restrictions	*$ 15,000*
Satisfaction of purpose restrictions	
Operation of the training center	*801,146*
Educational programs	*247,793*
Financial aid	*219,021*
Distributions (proceeds are not restricted by donors)	
Beneficial interests in charitable trusts held by others	*36,872*
Assets held under split interest agreements	*11,888*
	1,331,720
Restricted-purpose spending-rate distributions and appropriations	
Educational programs	*130,619*
Financial aid	*75,240*
General use	*523,033*
	728,892
	$ 2,060,612

EXAMPLE 2

A shelter for battered women held a fund-raising campaign to build a new facility in a neighboring town. Fund-raising solicitations sent to potential donors requested pledges of support that would be paid to the Shelter over a 4-year period. The Shelter recorded the promises to give to be received in future periods as contributions with donor restrictions.

ASC 820, the guidance on fair value measurements, provides that fair value measurements be based on assumptions that market participants would use to price the asset. This could include restrictions on the sale or use of an asset if market participants would consider the effect of the restrictions in pricing the asset. ASC 820 states that restrictions that are an attribute of an asset and those that would transfer to a market participant are the only restrictions reflected in fair value.

EXAMPLE

A charitable organization received a gift of restricted stock from a donor. This stock could not be sold for approximately three years. When estimating fair value of this security, the organization took the restriction into consideration.

Donor restrictions that have been made by the donor for a particular contribution are not included in the measurement of fair value. They have been reflected in the classification of net assets.

Long-Lived Assets

An NFP organization may receive contributions of long-lived assets such as buildings or equipment or cash to purchase these items without instructions from the donor regarding how long the assets are to be used or what must happen to the proceeds if they are sold.

Prior to ASU 2016-14, the entity could elect to establish a policy whereby implied timing restrictions are placed on the asset over its useful life. In choosing this policy, the organization recorded the contribution as an increase to net assets with donor restrictions. When depreciation was recorded each period, an equal amount was released from restriction and reclassified to net assets without donor restrictions. If the asset was sold, any remaining with donor restricted net assets would be reclassified to net assets without donor restrictions and any gain would be reported as net assets without donor restrictions.

ASU 2016-14 eliminates this election. If there are no donor restrictions, the long-lived asset must be classified as support without donor restrictions. However, contributions of cash or other assets, such as investments, that are to be used to construct or acquire long-lived assets, have purpose restrictions until those restrictions are met. They would be recorded as with donor-restricted support. If those contributions are to be received over multiple years, they may have both timing and purpose restrictions. In addition, if amounts are to be paid to the organization over time, then discounting may be appropriate.

Technical Q&A 6140.04 discusses the release from restriction when the restrictions related to long-lived assets are met before the receivables are due. This might happen if the building is constructed with proceeds from long-term debt that is to be repaid as the payments on long-term promises to give are received. In this case, the NFP organization should consider the facts and circumstances around the promise to give. If the donor's intent was to support the activities of the current period, then there is no time restriction. If the donor intended the contribution to be current support, the restriction would be released when the last restriction in effect expired. In this case, it would be when the building was placed in service. The receivable does not have to be collected to be classified in net assets without donor restrictions. Further, as discussed in Technical Q&A 6140.03, timing restrictions associated with contribution receivables lapse when the payment is due, not when it is received.

EXAMPLE

A donor gave an NFP organization cash to build a building. The donor's intent as described in a letter to the NFP was to use the money in the current period to pay for any expenses incurred while building the building. The donor pledged to pay the $300,000 over a three-year period. If the NFP has spent the money on the building, then it is considered unrestricted support even though the cash will not be due for a year or two.

Although not a frequent occurrence, donors may put restrictions on their own gifts, as well as on other assets.

EXAMPLE

A donor to an NFP organization group home made a contribution in the amount of $100,000. It was to be restricted to pay for special services for the residents. As a condition of the gift, she also required that $25,000 from the entity's net assets without donor restrictions be reclassified donor restricted net assets. This would provide $125,000 to be invested so that the income could pay for certain special services to the residents.

Other Timing Considerations

Questions have arisen in practice about when timing restrictions should be released. When arrangements with donors specify future payment dates, the AICPA's Technical Q&A 6140.03 says that it is reasonable to assume a donor's gift is to support activities in each period in which a payment is scheduled. But when the donor does not pay on time, the amounts should be released anyway. Note that time restrictions on contributions receivable lapse when the receivable is due.

Measurement of Contributions

Contribution revenue should be measured at the fair value of the assets or services received or promised or the fair value of the liabilities satisfied. Note that contributions arising from unconditional promises to give that are expected to be collected **in less than one year** may be measured at net realizable value.

When contributions are to be collected in one year or more, they should be measured at fair value. For an unconditional promise to give which is expected to be collected in one year or more, the unit of account specified in ASC 958-605 is the individual promise to give. This means that the exit price is the amount that a market participant would pay to acquire the right to receive the cash from the donor. Although this would not happen, it is a good measurement focus. The NFP would assume that the market participant is stepping into the shoes of the NFP.

Valuation Technique

The fair value of a contribution may be based on the present value of future cash flows although this is not the only possible valuation method.

NOTE: The FinREC believes that a present value technique which is an application of the income approach will be the most prevalent technique used because no market exists for unconditional promises to give.

If this method is used, it includes an evaluation of the amount that will eventually be collected from the donors, as well as a discount reflecting the time value of money. Therefore, when promises to give are received that span one year or more, their present value should be determined and a discount recorded. If present value techniques are used to measure the fair value of unconditional promises to give, an NFP organization should determine:

- The amount and timing of future cash flows (cash promises to give)

- Expectations about the possible variations in the amount and timing of the cash flows (representing the uncertainty inherent in the cash flows)
- Price for bearing the uncertainty inherent in the cash flows
- Other factors market participants would consider

With noncash promises, consider the nature and quantity of assets expected to be received. Risk is considered when evaluating the donors' ability to pay as promised on the promises to give, along with its past collection experience and policies regarding the collection of past due promises to give.

When making a valuation, the NFP does not have to use exhaustive efforts to obtain credit information about a donor.

NOTE: Instead, the FinREC believes that the factors that are used might consider:
- Ability of the donor to pay derived from published credit ratings (i.e., a proxy for the donor's credit rating)
- Factors specific to the donor that might be relevant in assessing the donor's commitment, including their history, relationship to the entity, etc.
- Risk factors that might impact a donor such as economic conditions in a geographic area
- The NFP's experience in collecting a similar pledge
- Whether the underlying assets are held in an irrevocable trust or escrow

ASC 820-10-55 discusses two types of present value techniques – the discount rate adjustment (DRA) approach which is the more traditional approach and the expected present value approach (EPV).

DRA (the discount rate adjustment method) uses a single set of cash flows from the range of possible estimated amounts or what are the most likely cash flows. The discount rate used is derived from observed rates of return for comparable assets or liabilities that are traded in the market. This would be a market rate of return that corresponds to an observed market rate associated with conditional cash flows (the amount that market participants would demand for bearing the uncertainty inherent in the cash flows).

EPV Method 1 discusses a present value technique for which a risk-free rate of return is appropriate. The expected (probability weighted) cash flows (or expected value) are adjusted for general market risk by subtracting the cash risk premium. The risk adjusted expected cash flows will represent a certainty equivalent cash flow. The discount rate used is a risk-free rate.

EPV Method 2 uses a probability weighted cash flow or expected value. In this method, they are not risk adjusted. A risk-free rate is used and then adjusted for general market risk by adding a risk premium. This adjusted rate is the expected rate of return.

The AICPA Audit & Accounting Guide (AAG-NPE) points out that even though it appears that the DRA method may be the easiest to apply (since it uses a single set of cash flows and the discount rate is derived from observed rates) that it may be hard to estimate default rates and factor them into the discount rate. This approach would generally end up with a higher discount rate because with the EPV methods some of the uncertainty is considered in the probability-weighted approach where the DRA method considers the most likely cash flows.

Additionally, it is important to consider whether the NFP has a practice of not enforcing its right to receive promises to pay.

Conceptually, these methods should end up producing comparable results.

EXAMPLE

An independent school was about to begin a capital campaign. Since this was not its first campaign, it had some history of how collectable the promises to give were likely to be.

The CFO made the following assumptions:

a. 19X6 campaign – donations were 97% collectable.

b. 20X0 campaign – donations were 94% collectable.

c. 20X7 campaign – donations were 92% collectable.

d. There was a recession that impacted the 20X0 and the 20X7 campaign so that some donors were slower paying and a few donors were not able to pay at all. This happened at the end of the second year of the campaign's payout each time.

e. The economic recovery began in 201X and the economy has steadily improved in the local market. Payments on the 20X7 campaign have improved.

f. It appears from history that there is a downturn in the economy approximately every 6 years.

g. Donors who give in the silent phase rarely default. This represents the majority of the dollar promises to give. Use unsecured borrowing rate for wealthy individuals.

h. Corporations and foundations rarely default, use borrowing rate for corporate debt with excellent credit ratings and tax-exempt rate for foundations (tax effected).

Below is an illustration of the expected cash flows using the three methods incorporating the assumptions a through f.

Comparison of Present Value Techniques

Amount raised in the campaign	$	5,000,000
EPV Method 1		
Expected cash flows		
$5million X 10%		500,000
$4.6 million X 40%		1,840,000
$4.85million X 50%		2,425,000
Most likely cash flows		4,765,000

EPV Method 2		
Expected cash flows		
$5million X 10%		500,000
$4.6 million X 40%		1,840,000
$4.85million X 50%		2,425,000
Most likely cash flows		4,765,000
Discount Rate Adjustment		
95% chance of collectibility	$	4,750,000

Discount Rate

The issue with the discount rate is to take care not to double count the risk. Some of it is already incorporated in the cash flows. The discount rate takes into consideration those risks not already incorporated in the cash flows. Although all three methods are discussed in the AAG-NPE, the guide also states that determining a certainty-equivalent cash flow is impractical for unconditional promises to give. This lets out EPV Method 1.

Using EPV Method 2, some but not all of the risk is built into the expected cash flows. The evaluation also should take into account that market participants would seek a risk premium for taking the risk. The discount rate(s) to be used would be lower than the DRA method that uses only a single set of cash flows. Where the EPV Method would use an expected rate of return by a market participant, the DRA method may need more precision. In practice, few entities use the EPV Method 2.

Discount Rate for the DRA Method

The issues paper provides NFPs with a starting point to evaluate a risk adjusted discount rate (or more than one rate). A starting point for an individual donor might be based on the average credit characteristics of a homogeneous group of donors. The NFP might use a borrowing rate that would be available to that group of donors for unsecured debt. If the donor were a corporation, a risk-adjusted discount rate might be determined using the yield on publicly traded debt whether issued by that corporation or a similar corporation. The same would be true of a foundation but the issues paper cautions that the rate would be the taxable yield even if the foundation issues tax-exempt debt.

This is illustrated below using the assumptions g and h from the example above.

Donors	Percent dollars given	Dollars adjusted	Discount rate	PV FACTOR for 5 years		
Silent phase donors	85%	4,037,500	3%	0.86261	3,482,788	
Other donors (faculty, parents, etc)	8%	380,000	5%	0.78353	297,741	
Corporations	6%	285,000	3%	0.86261	245,844	
Foundations	1%	47,500	1%	0.95147	45,195	
		4,750,000			4,071,568	**Amount to record**

Dollars adjusted represents the expected cash flows using the DRA method (95%) times the percent given.

Contributions receivable – current	$915,000
Contributions receivable – 1-5 yrs.	$3,835,000
Discount on contributions receivable	$678,432
Contribution revenue with donor restrictions	$4,071,568

Subsequent Measurement – Clarified in TIS 6140.25

Once determined, the discount rate is **not** subsequently adjusted, unless the organization has elected to measure the promise to give at fair value in conformity with ASC 825, Financial Instruments – *Fair Value Option for Financial Assets and Financial Liabilities.* In that case, the discount would be revised at each re-measurement date.

The discount should be amortized using the effective interest method, unless another method would not result in a material difference. The amount amortized should be recorded as a contribution and increase the net asset class in which the contribution was originally reported.

EXAMPLE

A Nature Preservation Society received long-term promises to give in the amount of $120,000. The Society expected that $20,000 of those promises to give would not be collected based on its history with prior campaigns. The Society anticipated that of the remaining $100,000, an amount of $20,000 would be collected within the year. A risk adjusted rate of 4% was used to calculate the present value of the estimated cash flows for the 5-year period.

Contributions receivable – current	$20,000
Contributions receivable – 1-5 yrs.	$80,000
Discount on contributions receivable	$9,000
Contribution revenue – with donor restrictions	$91,000

Note D – Promises to Give

Unconditional promises to give are estimated to be collected as follows at June 30, 20X1:

Within one year	*$ 665,341*
In one to five years	*422,304*
Over five years	*122,000*
	1,209,645
Less discount to net present value at rates ranging from 2.96% to 3.50%	*(122,994)*
Less allowance for uncollectable promises to give	*(145,539)*
	$ 941,112

Promises to give appear as follows in the statement of financial position:

Promises to give, net	*$ 941,112*
Endowment promises to give, net	*2,501,416*
	$ 3,442,528

At June 30, 20X1, three donors accounted for 47% of total promises to give. Two contributors accounted for approximately 31% of total contribution revenue for the year ended June 30, 20X1.

Subsequent Measurement of Contributions Receivable

During the time that contribution receivables are outstanding, events may take place that affect their valuation and measurement. For example, a donor may determine that he/she does not have the ability to make good on the pledge. In this case, the NFP organization would write the pledge off as bad debt expense if the pledge was recorded in the net asset class without donor restrictions. If the pledge was recorded in the donor-restricted net asset class, the NFP organization would show a loss on contributions receivable.

Loss on contributions receivable	$4,000	
Allowance for uncollectable promises to give[19]		$4,000

The same procedure would apply in cases where the entity's estimation of the collectability of a group of promises to give had changed. Recoveries of previously recognized decreases in fair value that result from changes in the estimates of collectability should be recorded as reductions of bad debt or loss up to the amounts of decreases already recognized. ASC 958-310 and Technical Q&A 6140.09 state that bad debt losses may not be netted against contributions because losses are permitted to be netted only against gains.

Even though a donor may give a pledge or a donation to an NFP, it does not mean they will not ask for it back. Although the entity may have a legal right to the pledged or donated amount, many NFPs would prefer to return the gift and save adverse publicity. In this case, the amount may need to be removed from the appropriate net asset class.

The reporting could take place in the same form as the loss on promises to give illustrated above. If material, the entity may wish to put the amount on a separate line. Some entities with an operating indicator will show it outside operations.

EXAMPLE

Dogwood Botanical Society
Statement of Activities (in part)
Year ended December 31, 2013

	Without Donor Restrictions	With Donor Restrictions	Total
REVENUES, GAINS AND OTHER SUPPORT			
Contributions	$ 58,575	$ 113,775	$ 172,350
Grant revenue	55,000		55,000
Federal financial assistance	1,532,600		1,532,600
Investment return from endowment fund		5,250	5,250
Loss on promises to give		(18,000)	(18,000)

[19] Note that the direct write-off method is not acceptable under GAAP. However, where the organization knows of a specific pledge to be written off, such as in this example, the credit could be to contributions receivable. Note that the term "pledges" receivable is discouraged by the AICPA. They believe it is too vague.

Net assets released from restrictions			
Satisfaction of time restrictions	12,570	(12,570)	–
Satisfaction of purpose restrictions	75,000	(75,000)	–
TOTAL REVENUES, GAINS AND OTHER SUPPORT	$1,733,745	$13,455	$1,747,200
Loss on promises to give	$18,000		
Allowance for uncollectable promises to give		$18,000	

There may also be times where the value of contributions needs to be adjusted for changes in the expected fair value of the underlying asset. If the value of underlying equity securities with a readily determinable fair value and all debt securities increases, the entity would recognize additional contribution revenue. If there was a decline in value, the entity would recognize a decrease in contribution revenue. This adjustment would occur in the period in which the change occurs, in the net asset class in which the contribution is represented.

EXAMPLE

The following example contrasts a loss from the donor's inability to deliver with the subsequent decline in the value of the stock.

Scenario 1: During the year ended December 31, 2012, a donor pledged 1,000 shares of Home Depot stock which the organization recorded at $61 a share. This was fair value at the date of donation. It was recorded in the donor restricted net asset class. The stock was to be delivered on March 15, 2013.

The donor delivered the right number of shares but unfortunately, the stock was only worth $55,000 because of a decline in the market. Consequently, the NFP had a reduction of revenue.

Journal Entries:

Upon receipt of pledge:

Pledge receivable	61,000	
Contribution revenue – with donor restrictions		61,000

When the stock was delivered to the organization:

Contribution revenue – with donor restrictions	6,000	
Investment	55,000	
Pledge receivable		61,000

Scenario 2: During the year ended December 31, 2012, a donor pledged $61,000 of Home Depot stock which the organization recorded at that value at the date of donation. It was recorded in the donor-restricted net asset class. The stock was to be delivered on March 15, 2013.

However, the donor was unable to deliver sufficient shares with a value of $61,000 since the price had declined to $55 a share. She was $6,000 short. Consequently, the NFP had a loss of that amount.

Journal Entries:

Upon receipt of pledge:

Pledge receivable	61,000	
Contribution revenue – with donor restrictions		61,000

Donor delivers stock:

Investment	55,000	
Loss on pledge – with donor restrictions	6,000	
Pledge receivable		61,000

Note that the distinction here is that the donor promised an amount of dollar value. In scenario 1, the donor promised a number of shares.

Contribution of Services

Contributed services should be **reported as revenue** when the services create or enhance a nonfinancial asset or when the services require specialized skills or would have had to have been purchased by the entity if they were not donated. Examples of specialized skills are carpenters, teachers, electricians, attorneys, physicians, accountants, investment advisors and other professionals. Contributions of services should be recorded at fair value.

Note that ASC 958-605 specifically states that if the contributed services **create or enhance a nonfinancial asset** then the services do not need to be performed by someone with a specialized skill.

EXAMPLE 1

An NFP organization nursery school was in the process of building a new building to expand it's after school program. Although the majority of construction was being performed by an outside company, the painting and inside finishing work was being performed by volunteers in order to keep the cost of the building down. The organization maintained records of volunteer hours and computed the fair value of the work performed using competitive market rates for those types of services. The value of the services was capitalized as part of the building with the credit to donated services increasing net assets without donor restrictions. Management evaluated the total cost of the building to determine whether the amounts capitalized would exceed the amount at which the building would be appraised.

EXAMPLE 2

An NFP organization builds houses and sells them to economically disadvantaged people at approximately ½ their fair value. The majority of the construction is performed by a construction company that is paid for its services. The organization also receives contributed services from volunteers. The volunteers are not skilled homebuilders. They perform a variety of unskilled home building tasks but also prepare and serve food and other "nonbuilding" tasks. The volunteers generally come with civic or church groups. NFP personnel have observed that the volunteers also spend a portion of their time talking with their colleagues. Due to the difficulty in determining what tasks the volunteers are performing and how many hours they actually work, the organization believes that it is not possible to determine the amount of the contributed services that qualify for recognition as contributions.

EXAMPLE 3

A legal aid organization received thousands of hours in donated services each year. Among the volunteers were accountants who completed the organization's payroll and informational tax returns and consulted with the organization on revenue recognition issues, attorneys who provided legal assistance to low income families in one of the organization's programs and other volunteers who assisted with fund-raising and administrative duties. The organization recognized the services of the accountants and attorneys as donated services with the debit increasing administrative expense (accountants) and program expense (attorneys). The other services were not recorded, as they did not meet the criteria for revenue recognition. Even though certain of the volunteers were professionals, they were not performing tasks in their professional capacities.

Technical Q&A 6140.11 states that the **costs of soliciting donated services should be categorized as fund-raising**, even if the contributed services do not meet the recognition criteria in ASC 958-605.

The auditor should remember that many NFPs, even ones that appear to have knowledgeable personnel, may not remember to record in-kind gifts. It is a good practice to ask if there are such gifts.

Gifts-in-Kind

NFP organizations often receive gifts of noncash assets. Generally, NFP organizations receive noncash assets from donors which they:

- Sell, with the proceeds being used for programs or administrative expenses
- Transfer to other resource providers during fund-raising events
- Use in the programs provided by the organization

Gifts that are sold or used by the organization should be recorded at their fair value. If they are sold within the accounting period, the fair value is easier to determine. If not or if the gift is retained for use in the organization, the NFP organization should consider the quality and quantity of the gifts, as well as any discounts the organization might have received in an exchange transaction. Appraisals may be necessary under certain circumstances.

If gifts are transferred to other resource providers, then the incremental amount received or not received in the transfer would be an **adjustment to the contribution.**

EXAMPLE

The Sacramento Literacy Action Center, an NFP organization with a June 30 year-end, holds a silent auction and cookout every Labor Day. During the six months leading up to the silent auction, the organization's fund-raising team collected donations of goods or services to be auctioned off at the event. The controller recorded the contributions at their estimated fair value at year-end. When the event was held a little over two months later, he calculated the difference between the estimated fair value and the proceeds received at the event for each item where a value had been estimated at the previous year-end. The difference was either added or deducted as an adjustment to contribution revenue since it was the completion of a transaction.

Sometimes gifts-in-kind such as used clothing, furniture or appliances are of **uncertain value**. In the case of gifts of uncertain value that cannot be used by the organization or sold, the item received would not be recognized. If the items have questionable value but will be sold, recognition would take place when the items were sold.

EXAMPLE 1

A church related thrift store receives donations of used clothing, small appliances, furniture, toys and electronics. These items are sold and the proceeds used to support church mission work. It would be impossible to value each individual item since the items may or may not sell. If the items do not sell, they are donated to relief organizations. Contribution revenue is recognized when the items are sold and a value can be determined.

EXAMPLE 2

Note K – Donated Professional Services and Materials

We received donated professional services and materials as follows during the years ended June 30, 20X1:

KIDZ KAMP, Inc.
Statement of Financial Position (in part)
June 30, 20X1

Assets		
Cash and cash equivalents	$	4,874,220
Operating investments		774,223
Accounts receivable, net		502,491
Promises to give, net		941,112
Prepaid expenses and other assets		290,813
Cash restricted to building project		1,500,000
Property and equipment, net		28,957,121
Assets held under split-interest agreements		**977,102**
Beneficial interests in charitable trusts held by others		**812,850**
Beneficial interest in assets held by community foundation		**1,094,842**
Beneficial interests in perpetual trusts		**2,595,059**
Endowment		
Promises to give, net		336,999
Investments		27,027,131
Total assets	$	70,683,963

Excerpt from Liabilities- Statement of Financial Position

Liabilities under split-interest agreements	**1,418,127**

KIDZ KAMP, Inc.
Excerpt from Statement of Activities

	Without Donor Restrictions	***With Donor Restrictions***	***Total***
Change in value of split-interest agreements held by KIDZ KAMP, Inc.		130,406	130,406
Distributions from and change in value of beneficial interests in assets held by others	145,649	90,408	- 236,057

Technical Q&A 6140.24 discusses the contribution of certain nonfinancial assets such as fundraising material, informational material or advertising including media time or space for public service announcements or other purposes. The question was related to how a contribution should be measured and reported. The answer was yes; these items should be recognized as revenue with a corresponding expense at the time the expense is incurred.

Technical Q&A 6140.12 discusses circumstances where the NFP organization has no discretion over the gifts as they have been directed to a specified beneficiary by the donor. In this case, the NFP organization is acting as an intermediary and the receipt of the noncash assets is an **agency transaction**. The NFP organization acting as the intermediary may record an asset and a corresponding liability to the specified beneficiary in their accounting records. However, ASC 958-605 does not require them to be recorded at all. The specified beneficiary should be notified of the gift so that that organization can record the contribution at its fair value.

EXAMPLE 1

Adventures in Learning, an NFP organization, acted as an intermediary for an NFP organization technical school serving disadvantaged youth. In this capacity, they collected and held excess computer equipment which was designated as a contribution to the school by local businesses. The management of Adventures believed it was prudent to record the value of the computer equipment in their accounting records to demonstrate transparency and accountability and recorded it as an asset and a liability.

EXAMPLE 2

Note – Principal Activity and Significant Accounting Policies

Donated Services and In-Kind Contributions

Volunteers contribute significant amounts of time to our program services, administration, and fundraising and development activities; however, the financial statements do not reflect the value of these contributed services because they do not meet recognition criteria prescribed by generally accepted accounting principles. Contributed goods are recorded at fair value at the date of donation. KIDZ KAMP records donated professional services at the respective fair values of the services received.

Contributions of Utilities or Use of Long-Lived Assets

NFPs often receive donations of utilities such as water, electric or natural gas or promises to provide those services from utility companies. The organization should recognize contributions of utilities when they are donated and recognize the expense when they are used. This could result in the organization recording the estimated present value of the contribution for future periods in the donor- restricted net asset class.

With long-lived assets, the NFP organization may receive use of certain facilities, with the donor retaining title to the building. This may or may not be evidenced by a lease. In some cases, the organization may receive a gift in the form of rent that is below fair value. This subsidy would be recorded at the difference between the fair value of the use of the facility and the actual amounts paid. The contribution should not be recorded at more than the fair value of the long-lived asset at the time of donation. The contribution receivable may be described as “contributions receivable” or “building” or some other descriptive term. As in the case of donated utilities, the organization

would record the estimated present value of the contribution at donation and the associated expense at the time of use.

Donor-Imposed Conditions

If a contribution is conditional, it means that the donor has imposed a future and uncertain event that gives them the right of the return of the assets or releases them from the promise to transfer the assets in the future. Examples of conditional gifts are promises of support where certain requirements must be met such as restoring an historic facility, expanding operations or raising matching funds.

EXAMPLE

The Autism Research Foundation of Wisconsin received a conditional pledge of support from a major university. The support was contingent upon its raising $500,000 in matching funds from other donors. At September 30, 20X3, the Foundation's footnotes included the following:

During 20X3, the Foundation received a conditional promise of support in the amount of $500,000. Receipt of this support is contingent upon the Foundation's receiving an equal amount of promises to give from other donors. This condition was not met at September 30, 20X3. Accordingly, the $500,000 promise is not included in fiscal 20X3 revenues or in contributions receivable on the Statement of Financial Position.

The evaluation of whether a donation is conditional may not always be quite so clear. The entity should review the facts and circumstances surrounding the gift and try to resolve any ambiguity with the donor. If the possibility that the condition will not be met is remote, then the promise may be considered unconditional. The AAG-NPE provides an example of where an NFP was required to submit an annual report to receive subsequent annual payments on a multiyear promise to give. The AAG-NPE concludes that the possibility of not following this simple administrative detail is remote. However, the author of this manual is familiar with a situation where an NFP lost $24,000 due to failure to file such a report. Accordingly, the ability of the NFP to properly handle administrative details may be a factor for consideration.

Another example of conditional support is the intention to give set forth in a will. Communications from individuals that indicate the promise to give in a will is conditional because people can alter their wills. The NFP should recognize the contribution when the probate court declares it valid. Even then, it may be a substantial period of time until the NFP receives its share of the estate.

There is diversity in practice as to whether conditional promises in valid wills are considered without donor restrictions or with donor restrictions. Some believe that restrictions can only be imposed by the living and so the amounts are without donor restrictions. Others say that since the contribution will be paid in the future that it is donor restricted.

ASC 958-310-50-4 states that the recipient of a conditional promise to give should disclose the total amount promised and a description and amount of each group of promises having similar characteristics such as amounts of promises conditioned on establishing programs, completing a building and raising matching gifts.

EXAMPLE

From time to time, Charitable Entity is the recipient of bequests, matching grants and other conditional promises to give. At June 30, 2013, Charitable Entity had $350,000 in promises to give conditioned on meeting matching gift targets and $200,000 in intentions to give by individuals who have named Charitable Entity in their wills.

In addition, Charitable Entity is the recipient of a promise to give represented by a will that has been declared valid by the probate court. Accordingly, a receivable in the amount of $250,000 has been recorded as donor restriction revenue due to provisions in the will that Charitable Entity use the funds for scholarships.

Grants and Contributions Literature

While FASB offered a one-year delay of the revenue recognition standards (Topic 606) to nonpublic entities that have not yet issued (or made available for issuance) financial statements reflecting its adoption, the Board opted to retain the effective dates for ASU 2018-08, *Clarifying the Scope and Accounting Guidance for Contributions Received and Contributions Made*. This decision highlights the Board's viewpoint that the guidance in ASU 2018-08 will be helpful to organizations that are accounting for COVID-19–related assistance. Note that the criteria for conditional contributions have changed since the issuance of ASU 2018-08 which is effective for years beginning after June 15, 2018 for conduit obligors and for years beginning after December 15, 2018 for all others. The ASU defines a donor-imposed condition as one where:

- The recipient has to overcome a barrier or hurdle to be entitled to the resources.
- The grantor is released from the obligation to fund or has the right to return advanced funding if the recipient fails to overcome the barrier.

Both requirements must be present for an agreement to be conditional. If the terms of a grant are not clear, then the grant is presumed to be conditional.

One significant change to present literature is that the guidance emphasizes that neither the likelihood that a barrier will be met nor the resources provider's intent to enforce the right of return is to be considered when determining whether funding is conditional. Therefore, the term "probability is remote" has no bearing on these decisions. A conditional contribution can only become unconditional when the condition is substantially met. Donor restrictions, on the other hand, limit the use of the contributions.

Performance Barriers

The FASB identifies three criteria for entities to use when evaluating barriers:

- Does the stipulation require performance by the entity or that some event beyond the recipient's control occurs?
- Does the stipulation limit the discretion of the entity on how the activity is conducted in order for it to be funded?

- Is the stipulation related to the purpose of the grant?

Judgment will be necessary in determining whether there is a barrier. None of these factors is determinative in and of itself. Sometimes conditions have milestones to be reached. Examples might be meals served, people trained, money raised. To be a true barrier, it should be measurable. There is a difference in achieving an objective such as reduce a metric by 10% rather than "strive" to reduce the metric by 10%.

Certain awards may provide the recipient with discretion to conduct the activity in the way they choose. In other cases, the resource provider may have specific requirements. The key here is related to whether the entity is entitled to the resources if they do not comply with the funder's requirements. An example relates to grants that require compliance with the Uniform Guidance. The 12 compliance requirements, activities allowed, allowable cost, cash management, eligibility, procurement and others are very specific stipulations. And they relate to the purpose of the grant.

The FASB added the requirement – must be related to the purpose of the grant in order to avoid "gamesmanship" in the recording of a grant. Administrative requirements such as having an audit under the Uniform Guidance or submitting a report on funds expended are administrative requirements. This is in contrast to the requirement to write a report on findings in a research grant. That is related to the purpose of the grant.

EXAMPLE 1

An NFP receives a grant from a foundation to provide career training to disabled veterans. The grant stipulates that the NFP must serve 7,500 veterans during the year. The grant also stipulates other targets that must be achieved every quarter. The grant is for $400,000 but is to be released ratably over the year if the NFP serves at least 2,000 per quarter. The NFP determines that this grant is conditional because there is a measurable performance barrier.

EXAMPLE 2

An NFP university has a research program. It receives an $800,000 grant to fund thyroid research. The university put together a budget that was approved and the university has to incur qualifying expenses according to the budget. The grant is paid primarily on a reimbursement basis, but under certain circumstances, the entity may draw down on funding. Any unused funds are forfeited including return of funding advanced. An annual single audit is required by the OMB due to the amount. Any funding spent for unallowable items must be returned as well.

This grant is conditional because of the right of return of the unused funding, if any is advanced. The audit requirement is not sufficient to be a barrier. Accordingly, the entity is entitled to funding spent for the qualifying purpose.

EXAMPLE 3

An NFP university has a research program and obtains a grant from a corporate foundation. It is required to adhere to a very general budget, but there is no stipulation related to qualifying expenses. Any deviations from the broad budget must be approved. At the end of the grant period, a report must be filed showing the funding spent. This is considered an unconditional contribution. The general budget allows broad discretion for spending.

Right of Return

The right of return is the second criteria that must be met. It states that if the recipient does not overcome the barrier, the donor/grantor is released from the requirement to provide the funding, and if funds were provided in advance, can demand the return of the resources. Such wording is included in the Uniform Guidance. The right of return must be linked to a specific barrier except the administrative requirement discussed earlier.

Step 3: If the grant is unconditional, is it donor restricted?

The guidance related to donor restrictions for timing, purpose or both has not changed. However, the question has bearing on NFP reporting. Conditional contributions may or may not be restricted.

In the case of a matching grant where the condition is to raise a certain amount of money to receive a match, there may be no restrictions on what to do with the funding once the condition is met. On the other hand, if a federal award is provided for nutrition for the elderly, this grant has conditions but also has restrictions as to the program for which the funds are used. There is, therefore, a simultaneous release of the condition and the restriction when the funds are spent for the restricted purpose and satisfy the conditions.

The FASB provides entities with the ability to make an election to bypass recording the funding as donor restricted and then releasing it from restriction. The entity would record the funding as without donor restriction when the conditions were met.

General Financial Statement Presentation and Disclosure

Contribution revenue should be reported as a separate line item under *Revenue and Support.* If the organization chooses, it can report more than one line to separately state items such as bequests, grants that meet the definition of contributions or transactions that that include a component of contribution revenue such as membership dues or special events (discussed later).

The notes to the financial statements should include accounting policies adopted by the organization, including implied timing restrictions on the use of contributed long-lived assets (or cash/investments donated to purchase these items), whether the organization classifies donor-restricted contributions as without donor restrictions or as restricted support if the restrictions are satisfied in the same time period, and whether the organization recognizes contributions of collection items.

If contribution receivables are pledged as collateral, this must be disclosed. Notes to the financial statements should contain a schedule of promises to give due in less than one year, one to five years and in more than five years along with the related allowance for uncollectable arising from subsequent evaluations and the unamortized discount.

If unconditional promises to give are subsequently measured at fair value, then the disclosures required by ASC 820 are required. Also required would be disclosures required by ASC 825, if the organization elects the fair value option for reporting.

DISCLOSURE EXAMPLE

Note 3: Promises to Give

Contributions receivable represent unconditional promises to give by donors. They are classified as current and noncurrent depending on when they are expected to be collected. Current receivables are recorded at net realizable value. Noncurrent contributions are expected to be collected in greater than one year and have been discounted at 3%.

At September 30, 20X3, unconditional promises to give consisted of the following:

Without donor restrictions contributions	$350,350
United Way commitments	45,035
Restricted contributions	705,500
Gross unconditional promises to give	1,100,885
Less unamortized discount	(65,000)
Net unconditional promises to give	$1,035,885
Amounts due in:	
Less than one year	$935,500
One to five years	165,385

At September 30, 20X3, the organization had a conditional promise to give in the form of a $100,000 grant from a private foundation. To receive the grant, the organization must raise an equivalent amount for its elder care program from other sources.

Receivables and Credit Policies

Accounts receivable consist primarily of noninterest-bearing amounts due for advisory services. We determine the allowance for uncollectable accounts receivable based on historical experience, an assessment of economic conditions, and a review of subsequent collections. Accounts receivable are written off when deemed uncollectable. At June 30, 20X1, the allowance for doubtful accounts was $15,300.

Promises to Give

KIDZ KAMP records unconditional promises to give that are expected to be collected within one year at net realizable value. Unconditional promises to give expected to be collected in future years are initially recorded at fair value using present value techniques incorporating risk-adjusted discount rates designed to reflect the assumptions market participants would use in pricing the asset. In subsequent years, amortization of the discounts is included in contribution revenue in the statement of activities. We determine the allowance for uncollectable promises to give based on historical experience, an assessment of economic conditions, and a review of subsequent collections. Promises to give are written off when deemed uncollectable. At June 30, 20X1 the allowance was $145,539.

Note 6: Contributed Services

The Legal Aid Society recognizes contribution revenue for services donated by attorneys and accountants acting in a professional capacity that meet the revenue recognition criteria for contributions. The services were recorded at their fair value as a contribution and as program and administrative expenses. During the years ended December 31, 20X3 and 20X2 the organization received the following:

	20X3	20X2
Attorneys providing program services	$49,900	$54,000
Accountants providing administrative services	14,000	14,000
Total salaries	$63,900	$68,000

In addition, approximately 1,000 hours, for which no value has been assigned, were volunteered by individuals performing fund-raising and administrative activities.

Note 3: Donated Facilities

During 20X3, the Charitable Organization received an unconditional promise to provide office space for 10 years at no cost from the City of Atlanta. Management has estimated the approximate fair value of the rental over the 10-year period to be $92,660. A risk-free rate of 5% was used to determine the fair value. This amount has been recognized as with donor restrictions revenue. Rent expense in the amount of $12,000 was recognized for the year ended March 31, 20X3.

REVENUE FROM CONTRACTS WITH CUSTOMERS

In June 2020, FASB issued ASU No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842), Effective Dates for Certain Entities*, which delays the effective dates of ASC 606 for private companies and private NFP entities. The deferrals apply only if those entities have not yet issued their financial statements (or made their financial statements available for issuance) as of June 2020. ASU 2020-05 permits private entities to adopt ASC 606 for annual reporting periods beginning after December 15, 2019, and for interim reporting periods within annual reporting periods beginning after December 15, 2020. However, since the deferral is not compulsory, private entities may still elect to adopt ASC 606 in accordance with previous guidance (i.e., for annual reporting periods beginning after December 15, 2018, and for interim reporting periods within annual reporting periods beginning after December 15, 2019). The deferral is intended to give immediate relief to certain entities as a result of the widespread adverse economic effects and business disruptions caused by COVID-19. Although some NFPs will choose to take advantage of COVID-19–related effective date delay, many NFPs are already well underway with their implementation of Topic 606. Consequently, it is important to make sure you know the all-encompassing requirements under the new standard.

ASC 2014-09, *Revenue from Contracts with Customers (Topic 606),* was initially effective for nonpublic entities, including most NFP entities for fiscal years beginning after December 15, 2018. An NFP entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market is required to implement one year earlier. This guidance is principles based and, therefore, specific revenue guidance that is in current professional literature will no longer be GAAP. Not all revenue sources of an NFP entity will be affected by the guidance.

ASC 606 is the codification section for revenue recognition guidance. The pronouncement uses a principles-based five-step model approach to revenue recognition. Because of the complexities in certain industries, the AICPA created transition task forces to develop example applications. One of these was the NFP industry. The FASB carved contributions out of ASC 606 since the ASC deals with reciprocal transactions. In addition, the FASB recently issued an ASU related to accounting for grants and contributions. This segment of the program discusses the two areas: 1)

tuition and housing for educational entities, and 2) membership organizations. For a complete discussion of the revenue recognition standard, participants may want to attend our revenue recognition course, Deceptive Revenue Recognition and Other Accounting Techniques – Recognizing the Warning Signs (DRR).

The five steps to revenue recognition are:

Step 1: Identify the contract with the customer

Step 2: Identify the performance obligations in the contract

Step 3: Determine the transaction price

Step 4: Allocate the transaction price to the performance obligations in the contract

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation

Tuition and Housing Revenue

Step 1: Identify the contract. Institutions of higher education (IHE) will need to consider the practices and processes including the admission and registration processes, in determining whether and when an agreement with a student has enforceable rights and obligations between the parties.

A contract does not exist if each party has the unilateral, enforceable right to terminate an underperformed contract without compensating the other party. There are two circumstances where a contract would be underperformed.

- The entity has not transferred promised goods or services
- The entity has not received, and is not yet entitled to receive, consideration in exchange for the goods or services.

IHEs will need to determine whether consideration has been received from or on behalf of the student, whether the entity is entitled to receive consideration in exchange for promised services or if the IHE has begun to perform the services. Any of these circumstances would indicate that the contract is not wholly underperformed.

EXAMPLE

A university received cash for a nonrefundable deposit for tuition and housing. It has not transferred any services. ASC 606 states that when a prepayment is received from a customer, that the seller should record a contract liability as it is standing ready to perform under the contract and transfer goods or services in the future. The customer, or in this case, the student, has a right to receive a service in the future. The FinREC believes that even if the student chooses not to attend the university and the deposit is forfeited, that he/she is entitled to the service. Revenue would not be recognized until the student's right to enroll or be provided with housing expires.

Collectability

In order for a contract to exist, it has to be probable that the entity will collect the consideration it is entitled to under the contract. The entity will look at the customer's ability and intention to pay the consideration when due. The ASC states that the amount of consideration to which the entity is entitled to could be less than the price in the contract if the consideration is variable because the entity could offer a price concession.

EXAMPLE

A university needed to determine whether it was probable that it would collect the consideration to which it was entitled to for tuition. In making that analysis, the university incorporated not only the student but his/her family as well as financial aid packages for a combined collectability assessment. If in the combined collectability assessment, the University believed that the probability of collection was not there, then revenue would not be recognized. Collectability is continually reassessed.

If the customer meets the collectability requirements at the beginning of the contract, then the contract is not reassessed for collectability unless there is a change in circumstances.

EXAMPLE

A university evaluated the probability of collection at the beginning of a contract with a student and believed it was probable that the consideration to which it was entitled would be collected. The student's circumstances changed during the term and collection was no longer probable. The university ceased to recognize revenue including any related to partial consideration received. The university waited until collectability became probable again to recognize further revenue.

If collectability is not probable and there is no contract and an entity receives consideration from the customer, the consideration is recognized only when one of the following events occurs.

- Entity has no remaining obligations to transfer goods or services to the customer and substantially all of the consideration promised by the customer has been received by the entity and is nonrefundable.
- The contract has been terminated and the consideration received from the customer is nonrefundable.
- The entity transferred control of the goods or services for which consideration has been received and the entity stopped transferring goods or services to the customer and has no further obligation under the contract to transfer goods or services and the consideration received is nonrefundable.

Note that the reassessment only relates to the remaining services so any receivables, revenue or contract assets already recognized would not be reassessed. However, the entity would evaluate any contract assets or receivables for impairment.

Combining Contracts

The IHE will need to determine if it has one or more contracts. For example, tuition and housing could be one contract or might be two. ASC 606 states that an entity shall combine two or more contracts entered into at or near the same time with the same customer and account for it as one contract if one or more criteria are met.

- Contracts are negotiated as a package with single commercial objective.
- The consideration paid depends on the price or performance of the other.
- If the services performed are a single performance obligation.

The IHE would need to consider whether a discount, such as financial aid was provided in a bundled arrangement. But if none of the criteria are met, then there is a single performance obligation.

Portfolio Approach

ASC 606 is generally applied on a contract-by-contract basis, but as a practical expedient, performance obligations with similar characteristics can be evaluated together if the entity believes that applying the guidance to a portfolio of transactions would not differ greatly from a contract-by-contract approach.

EXAMPLE

A university was evaluating tuition contracts and determined that it was beneficial to apply the portfolio approach to these contacts because they were practically identical performance obligations. It used the portfolio approach to evaluate collectability in Step 1 and to estimate refunds in Step 3.

Step 2: Identify the performance obligations. IHEs need to determine if tuition and housing are separate performance obligations. If those services are distinct, then the performance obligations are separate. A good or service is distinct if the customer can benefit from the service on its own or together with other resources that are readily available to the customer and the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

IHEs need to determine the promises included in the contract(s) entered into with students and whether the promises are performance obligations that should be accounted for separately. The FinREC believes that, in most cases, these services are distinct performance obligations.

Step 3: Determine the transaction price. The IHE will need to determine the transaction price. To do this, they will consider the terms of the contract as well as their business practices. The transaction price is the amount of consideration the entity expects to be entitled to for the good or service delivered. It excludes amounts collected on behalf of their parties. It includes fixed amounts as well as variable amounts.

EXAMPLE

A college was determining the transaction price for tuition and housing. It included all the consideration it was entitled to for tuition and housing based on the type of student, in-state vs. out-of-state, veterans, etc. It grouped these into separate portfolios based on type of student. The amount of the consideration can be paid by the student, parents, federal or state governments or other parties, so the college evaluated all these sources when assessing the probability of collection.

There is the likelihood that some customers may have consideration payable to them by the entity. Examples of consideration payable could be discounts, vouchers or other credits which can be applied to the transaction price. Consideration payable is a reduction of the transaction price unless the consideration payable is for a specific good or service that the customer transfers to the entity.

EXAMPLE

A college routinely provides $500,000 in financial aid to students that meet certain criteria. The aid may be applied to either tuition or housing. Generally, this aid would be a reduction of the transaction price. However, some aid may be provided to work-study students. These reductions are reported as expenses.

The college, in accordance with ASC 606, recognizes the reduction in revenue when either the transfer of the services occurs or when the college pays or promises to pay the consideration. Since the college knows of these arrangements with the student before the revenue is recognized, they are simultaneously recognized with the revenue.

Right to Withdraw

If a contract includes variable consideration (rebates, discounts, refunds, price concessions, incentives, penalties, etc.), then the amount must be estimated in accordance with ASC 606.

EXAMPLE

A university provides a period of time where students can withdraw from classes without obligation and receive a total or partial refund of the amount paid. It will recognize a refund liability for the amount of consideration for which it does not expect to be entitled. It does not keep enough detail to use the expected value method to compute the estimate so it uses the most likely amount. Since it is not possible to know whether specific students will withdraw, it uses an aggregate method based on passed history and other information known to it at the time.

Collectability is assessed at Step 1 as discussed above. The amount of consideration, including variable consideration, is determined at Step 3. Therefore, the transaction price is not adjusted for credit risk in Step 3 unless the contract has a significant financing component. Then the IHE would use a rate commensurate with the credit risk involved. The IHE needs to evaluate all contract assets and receivables or impairments. Judgment is required in evaluating whether the contract is impaired or whether the student has been given a price concession. If the IHE has a

history or customary business practice of accepting the risk of default, then this is a price concession and therefore variable consideration. The IHE would need to determine the transaction price (Step 3) before assessing collectability (Step 1).

Step 4: Allocate the transaction price to performance obligations. In cases where there is a contract with more than one performance obligation (tuition and housing), the IHE will need to allocate the amount to each performance obligation in an amount that represents the consideration that represents the standalone selling price. This is the observable price that the entity sells the service for separately.

EXAMPLE

A college sells tuition and housing together, but they also sell tuition separately to students that do not need housing. The standalone price for tuition is observable. Since the IHE does not sell housing to those students that are not enrolled, housing does not have standalone selling price. That means that the transaction price for the housing is what is left once the standalone price of the tuition is factored in. Where there are reductions in amounts charged for tuition or housing because of financial aid, the college determines to which the reduction belongs.

Step 5: Recognize revenue when (or as) the entity satisfied a performance obligation. A performance obligation is satisfied either at a point in time or over a period of time based on the transfer of the good or service.

The FinREC believes that, in the case of tuition and housing, the IHE satisfies the obligation over the academic period so recognizing revenue over time is appropriate. The student is simultaneously receiving and consuming the benefits provided under the contract.

The IHE should derecognize the contract liability related to nonrefundable prepayment from the customer and recognize revenue when it transfers the goods or services and satisfies the performance obligation (i.e., over time).

If a student does not enroll or move into the housing and has paid a nonrefundable deposit, then at that point the IHE recognizes the amount as revenue. This would happen when the right to enroll or commit to housing expire.

The IHE will need to decide how to measure progress under the contract. ASC 606 describes input and output methods that can be used to measure progress. The objective is to depict the IHE's performance in transferring control of the good or service the entity has promised to transfer. When using the output method, the output must be observable. If the output is not observable, the input method should be used.

The input method is based on the entity's efforts or inputs into the satisfaction of the obligation. This could include labor hours, costs incurred or time elapsed. The FinREC believes it is appropriate for IHEs to use the input method and recognize revenue ratably over the academic period based on time elapsed.

Presentation

The IHE should present the contract in the statement of financial position as a contract asset or liability depending on the circumstances. Unconditional rights to consideration are presented separately as a receivable. This would be appropriate if the only condition to satisfying the obligation was the passage of time. Even though ASC 606 discusses contract assets and liabilities as terms in the literature, alternative terms are acceptable.

Advance cash payments represent contract liabilities. Amounts that represent consideration to which the entity has a right are receivables. These would be shown separately. If the entity provides services before payment, then this is a contract asset. As noted earlier, it is important to review these assets for impairment.

Although it is not permissible to show revenue as gross when there are discounts and allowances, the FinREC believes it is acceptable for the IHE to disclose the amounts of the reductions incorporated in the revenue line. This could be done on the face of the statement or in the footnotes.

IHEs should follow the other disclosure requirements in ASC 606.

Additional Examples

EXAMPLE 1

A college has a fiscal year end of June 30. The semester begins May 1 and goes through August. A student pays a nonrefundable deposit of $1,000 to accept the college's offer of enrollment. The IHE generates an invoice to the student for the remaining tuition, $9,000. The semester is 100 days long. The student is permitted to drop his/her classes in the first 2 weeks of the semester. They are not able to recoup the nonrefundable portion of $1,000. The student decides to drop a class which would generate a refund of $900. The college is using the portfolio approach for calculating refunds and uses 10% of tuition less deposits to estimate refunds. They made the following journal entries:

1. The student enrolls and the deposit is included in the transaction price. But since the IHE is not entitled to it, the payment is reflected as a contract liability or deferred revenue.

DR Cash	$1,000	
CR Contract liability (deferred revenue)		$1,000

   To reflect payment to the IHE of the deposit.

2. Revenue is recognized over time (academic period). The invoice is sent to the student. No entry is made because the semester has not started so the entity has no right to the revenue yet.

3. Payment is due 2 weeks before class begins. No entry is made because the student may cancel the contract during the withdrawal period.

4. Classes start. Student has made no payment except the deposit.

DR Contract liability (deferred revenue)	$91	
CR Revenue		$91

   To reflect recognition of the revenue less refund estimate ($10,000/100 days less ($9,000/100 days) X 10%). This occurs for the 10 days during the withdrawal period.

5. Student drops one class and the reduction of the transaction price is $900. But the only revenue that has been recognized is due the entity anyway because it is the nonrefundable deposit. The remainder has been billed but not recorded. The new tuition bill is $8,100. No additional entry.

6. The withdrawal period ends.

DR Receivable $	8,100	
CR Contract Liability (deferred revenue)		$8,100

To reflect the receivable for the unpaid balance.

7. The semester continues and revenue is recognized ratably over the period at $91 per day X 90 days remaining.

DR Contract liability (deferred revenue)	$8,190	
CR Revenue		$8,190

To reflect the receivable for the unpaid balance.

8. The student pays the bill.

DR Cash	$8,100	
CR Receivable		$8,100

To reflect the receivable for the unpaid balance.

EXAMPLE 2

1. Assume the facts in the previous example that the student pays the bill before the IHE performs.

DR Cash	$1,000	
CR Contract liability (deferred revenue)		$1,000

To reflect payment to the IHE of the deposit.

2. Revenue is recognized over time (academic period). The invoice is sent to the student. No entry is made because the semester has not started so the entity has no right to the revenue yet.

3. Payment is due 2 weeks before class. But this time the student pays. There is a refund liability because the student may cancel the contract during the withdrawal period.

DR Cash	$9,000	
CR Contract liability (deferred revenue)		$8,100
CR Refund liability		$900

To reflect payment to the IHE of the tuition. There is no revenue. No services have been performed at this time.

4. Classes start. This entry recognizes a portion of the deposit as revenue for the first 10 days.

DR Contract liability (deferred revenue)	$91	
CR Revenue		$91

To reflect recognition of the revenue less refund estimate ($10,000/100 days less ($9,000/100 days) X 10%). This occurs for the 10 days during the withdrawal period.

Student drops one class and the reduction of the transaction price is $900.

DR Refund liability (deferred revenue)	$900	
CR Cash		$900

5. The semester continues and revenue is recognized ratably over the period at $91 per day X 90 days remaining.

DR Contract liability (deferred revenue)	$8,190	
CR Revenue		$8,190

To reflect the receivable for the unpaid balance.

Determining Whether a Transaction is a Contribution or an Exchange Transaction

It is not always easy to determine whether a transaction is a **contribution or an exchange transaction**. Following are considerations for auditors to use in distinguishing exchange transactions from contributions.

Question	Contribution	Exchange
What was the NFP's intent when they requested the revenue source?	The NFP was seeking a donation and would use it for the benefit of the organization with no reciprocal benefit to the donor.	The NFP was willing to provide services/goods in exchange for the revenue
What was the resource provider's intent?	The provider acknowledges that there is no direct benefit due to them but that they are making a contribution.	The resource provider acknowledges that there will be a benefit to the entity in exchange for payment to the NFP.
How are the goods/services delivered?	The NFP decides how to deliver the benefits. With a contribution, the benefits go to the constituents of the NFP.	The resource provider states how and when the goods/services to them will be delivered. Note that the goods/services could be delivered to the constituents of the resource provider instead.
How much will the NFP receive for the services?	The resource provider decides how much to give the NFP.	The NFP will receive payment commensurate with the value of the goods/services the NFP provides.
Will penalties be assessed if the NFP organization fails to deliver the goods/services on a timely basis?	The NFP is not penalized per se for nonperformance. However, if the funds are not spent according to the donor's purpose, they may need to be returned.	The NFP could receive penalties for nonperformance, just like any other organization, if the resource provider so chose.

Exchange transactions are defined in ASC 958-605 as **reciprocal transfers** in which each party receives and sacrifices approximately equal value. Exchange transactions in NFP organizations usually involve their efforts in providing goods **or services to members, clients, students, customers and other beneficiaries for a fee.** Another significant type of exchange transaction for NFP organizations involves **services performed for federal, state and local governments, generally under the terms of grant agreements.** Revenue from exchange transactions will always be recorded in the net asset class without donor restrictions.

The ASC 958-225, *Income Statement*, distinguishes revenues from gains. Gains are increases in net assets arising from peripheral transactions.

EXAMPLE

An NFP organization university sells laptop computers in its bookstore. The sale of these computers is part of the ongoing operations of the bookstore and as such would be considered revenue. The university also purchases laptops for the use of the faculty. When the laptops are 3 years old, they are sold as surplus equipment and new laptops are purchased. The proceeds from the sale of these laptops are peripheral to the operations of the university.

Unlike contribution revenue, revenue from exchange transactions is recognized when earned. If cash is paid to the entity in advance and the services are not performed, the entity will have deferred revenue. Revenue should be reported gross of related expenses. In the case of special events such as golf tournaments or fundraising dinners, there are options on how the information is presented in the statement of activities.

Receivables from exchange transactions should be reported at net realizable value. If they are expected to be collected in greater than one year, then they should be discounted and reported in accordance with ASC 835, *Interest.*

EXAMPLE 1

An NFP research organization has a diabetes research center. The center regularly performs research on the newest treatment options. It receives contributions from donors to support its research efforts. The donations, which are designated specifically for research programs, are recorded as with donor restrictions until they are used for the intended purpose. The donors may specify that the donations are used for research but they receive no direct benefit from the research.

The research organization also receives resources from pharmaceutical companies. These companies will pay for the costs of clinical trials using diabetes medication that they developed. The pharmaceutical company dictates the drug testing protocol. They require a detailed report. These services have commercial value to the pharmaceutical company. Therefore, this revenue is not a contribution.

EXAMPLE 2

An NFP research organization obtains a grant from the National Institutes of Health (NIH) to study diabetes treatments. The grant specifies the eligible participants to the study, as well as costs that are allowable under the terms of the grant. The research organization is required to produce a report on how the monies were spent.

The controller of the research organization was evaluating whether this transaction was a contribution or an exchange transaction. He considered the following indicators of a contribution currently under discussion by the FASB.

Proprietary rights retained by resource provider	The resource provider reserves no proprietary rights, although the resource provider may ask for acknowledgment of its support.
Benefits resulting from assets to be provided to the recipient NFP	The benefits resulting from the assets provided are made available to the general public. The recipient NFP determines the specific beneficiaries or recipients.

He knew that the FASB's current position, was that government agencies do not directly benefit from the activities; it is the general public or a specific group of constituents that benefit from the activity. Therefore, it would be rare that a government grant would be considered an exchange transaction.

The controller determined that this activity would be considered a contribution.

Memberships

NFP entities often enter into transactions that are in part a contribution and in part an exchange transaction. Professional literature also refers to them as bargain purchases. These transactions include an inherent contribution which according to the FASB codification glossary is a contribution that results if an entity voluntarily transfers assets (or net assets) or performs services for another entity in exchange for either no assets or those with substantially lower value and there is no commensurate compensation. "Memberships" is one such category of transaction. Other transactions that may be in part a contribution and in part an exchange transaction include grants, awards, and sponsorships, naming opportunities and gifts-in-kind.

The accounting and reporting of membership dues are determined by the underlying substance of the transaction. A membership may be entirely a contribution, entirely an exchange, or a combination of the two. Therefore, it is important to analyze them carefully and look at the membership agreement. The distinction is the benefit that the member receives with his/her membership.

For example, the exchange portion of member benefits may include a journal subscription, discounted or free continuing professional education (CPE) classes, conferences and seminars, discounted or free tickets to seats at performing arts events, discounted services, access to locked website contents or a library, networking opportunities, and/or career qualifications.

The determination of whether membership dues are contributions rests on whether the value received by the member is commensurate with the dues paid. For example, if an NFP has annual dues of $200 and the only benefit members receive is a monthly newsletter with a fair value of $25 per quarter, $100 of the dues are received in an exchange transaction and $100 of the dues are a contribution. Rarely, however, is it that straight-forward.

The following table identifies several indicators from ASC 958-605 that could be used to determine whether memberships are contributions, exchange transactions, or a combination of both. No indicator will carry more weight than another. However, a guiding principle is that indicators of a contribution point toward little or no direct benefit to the resource provider whereas exchange transactions are reciprocal and provide proprietary benefits to the resource provider.

Indicators to Assist in Allocating Membership Dues		
Indicator	**Contribution**	**Exchange**
Trade association's expressed intent concerning purpose of payment	Request describes dues as used to provide services to general public	Request describes dues as used to provide services to members or those related to members
Extent of member benefits	Negligible	Substantial
Trade association's service efforts	Service provided to members and nonmembers	Service provided to members only
Duration of benefits	Not specified	Defined; additional payment is required to extend benefits
Expressed agreement about refundability of payment	Payment not refundable to the resource provider	Fully or partially refundable if membership is withdrawn
Qualifications for membership	Available to general public	Available to those that meet certain criteria

The FinREC believes that membership dues, excluding any amount determined to be a contribution, generally should be considered an exchange or reciprocal transaction in which the member receives something of value and in return for the benefits of membership.

Applying the Revenue Recognition Model to the Exchange Portion of Membership Dues

Step 1: Identify the Contract with a Customer

In order for the exchange portion of membership dues, a subscription, a life-time subscription, or a life-time membership to be a contract with a customer, it would need to meet the following criteria:

- The contract is approved and the parties are committed to their obligations.
- The NFP can identify each parties' rights to the goods or services being provided.
- The NFP can identify the payment terms for the goods or services to be transferred.
- The contract has commercial substance.
- It is probable that the NFP will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer

Since membership organizations usually require payment in advance for memberships including life-time memberships, and life-time subscriptions, the FinREC believes that the criteria of a contract are generally going to be met when the order is placed.

However, when a membership organization bills a member for a renewal in advance, prior to the beginning of the service period, this would not be the case. But even if the criteria were met, the organization still needs to consider whether either party to the contract has performed. ASC 606 states that an entity would only recognize a receivable if it has a right to payment even though that amount may be subject to refund in the future.

If cash has changed hands but performance has not occurred, then there is a contract liability. However, if payment has not changed hands, then it is inappropriate to record a contract asset and a contract liability. Therefore, a receivable would not be recorded until the earliest of meeting the performance obligation or, under a noncancelable contract, when the entity has an unconditional right to consideration.

Step 2: Identify the Performance Obligations in the Contract

A performance obligation is defined in ASC 606 as a promise in a contract with a customer to transfer to the customer either:

- A good or service (or a bundle of goods or services) that is distinct.
- A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

If the membership organization promises to transfer more than one good or service to the customer, then identification is made of each performance obligation. A performance obligation must be distinct or be in a series of distinct goods or services that are substantially the same and have the same pattern of transfer. Since membership dues entitle the member to multiple benefits, the entity would ask, can the customer benefit from the promised good or service either on its own or together with other resources that are readily available to the customer **and** is the promise to transfer the good or service separately identifiable from other promises in the contract?

If the membership organization sells the benefit on a standalone basis, this is a good indicator that the customer can benefit from the good or service on its own or together with other resources that are readily available.

EXAMPLE

A trade association provided multiple benefits to its members. The controller identified them as 1) a monthly magazine, 2) access to information on a special area of the association's website, 3) access to a technical hotline, and 4) advocacy. The journal was identified as a standalone benefit that was sold to others. Access to the website, hotline and advocacy were not distinct and were bundled together.

This step is important because in step 4 the membership organization will be required to allocate the transaction price to each of the identified performance obligations in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised good or service to the customer.

One performance obligation that is often provided to members is the opportunity to receive discounts on future educational opportunities. The membership organization should assess whether discounts provide material rights. ASC 606 discusses material rights. When an entity grants a customer an option to acquire additional goods or services, the option provides a

material right to the customer if that customer would not receive that benefit without entering into that contract. For example, a CPA association providing discounted CPE only to members enters into a transaction that contains a material right.

ASC 606 states that an entity is not required to assess whether promised goods or services are performance obligations if they are immaterial in the context of the contract with the customer, although discounts that provide material rights cannot be deemed immaterial. In effect, an option to purchase a discounted product or service provides a material right to the customer. That is, the customer pays the entity in advance for future goods or services, and the entity recognizes revenue when those future goods or services are transferred or when the option expires.

Step 3: Determine the Transaction Price

The transaction price is the amount of consideration that the membership organization expects to be entitled in exchange for transferring promised goods or services to a member (customer). To determine the transaction price, an entity should consider the effects of:

- Variable consideration
- Constraining estimates of variable consideration
- The existence of a significant financing component
- Noncash consideration
- Consideration payable to the customer

Generally, membership organizations charge for subscriptions, memberships, life-time memberships, and life-time subscriptions in advance and amounts paid are not refundable. ASC 606 discusses the possibility of a financing component. The standard states, "In determining the transaction price, an entity shall adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer".

There are factors that would change this. For example, the ASC specifically discusses a situation where a customer paid for the goods or services in advance, and the timing of the transfer of those goods or services is at the **discretion of the customer**. For example, a customer pays for an online CPE course and it is up to them when they complete it over a two-year period.

ASC 606 provides a practical expedient where the entity does not need to adjust the transaction price for a financing component as long as it expects, at contract inception, that the period between transfer of the goods or services to the customer and payment by the customer will be one year or less.

Step 4: Allocate the Transaction Price to the Performance Obligations in the Contract

If contract with a customer that has more than one performance obligation, then the membership organization should allocate the transaction price to each performance obligation in an amount that depicts the amount of consideration to which the organization expects to be entitled in exchange for transferring the promised goods or services to the customer.

If there are multiple performance obligations, the transaction price is allocated to each performance obligation identified in a contract on a relative standalone selling price basis. If a standalone selling price is not observable, the entity should estimate it. If the transaction price includes a discount or variable consideration that relates entirely to one or more, but not all, performance obligations in a contract, then the entity should allocate the discount or variable consideration to each performance obligation and not to the whole contract.

After determining the transaction price, the membership organization should allocate the transaction price to each separately identifiable performance obligation in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer including the right to obtain a discount on the future educational opportunities if it is a material right.

Step 5: Recognize Revenue When (or as) the Entity Satisfies a Performance Obligation

The membership organization would recognize revenue when (or as) it satisfies the performance obligation by transferring a promised good or service to the customer. For the membership service and/or subscriptions, whether they are annual or life-time, the recognition point will depend on the specific facts and circumstances. A good or service is transferred when (or as) the customer obtains control of that good or service.

ASC 606 provides indicators of when an entity transfers control of a good or service over time.

- The customer simultaneously receives and consumes the benefits provided as the entity performs.
- The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced.
- The entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

The membership organization would use these criteria to evaluate the timing of the satisfaction of the performance obligations. For many benefits, the member will engage in the simultaneous receipt and consumption so the performance obligations would be satisfied over time.

For performance obligations associated with nonrefundable life-time memberships and life-time subscriptions, if the obligation is satisfied over time, exchange transactions would be recognized as revenue over an appropriate time period (such as the life expectancy of the member or subscriber) using an appropriate measure of progress (such as a time-based measure).

If the performance obligation is not satisfied over time, the membership organization should consider at what point in time control transfers, based on the following indicators:

- Present right to payment
- Legal title
- Physical possession
- Risks and rewards of ownership

- Customer acceptance

For a benefit like monthly publications, revenue would be recognized monthly. Since these are separate deliverables, these receive point-in-time recognition. Revenue allocated to the option for discounted CPE would be recognized when the educational opportunity is provided (if exercised) or the option expires. The revenue related to access to an online database or combined benefits of access and advocacy is recognized ratably over the membership period as the customer simultaneously receives and consumes those benefits.

If the member exercises the option to participate in the educational opportunity, this might be accounted for by the membership organization either as a contract modification or a continuation of the existing contract. If the association accounts for the exercise of the option to purchase discounted product as a continuation of the existing contract, it should allocate the additional consideration to the educational opportunity along with the amount previously allocated to the option to participate in the educational opportunity.

EXAMPLE 1

A member enters into a contract with a trade association and receives a benefit that is considered a material right along with other bundled benefits. The fair value of the bundled benefits is $200 which is the contract price. The member gets a 30% discount on continuing education purchases during the membership period. Nonmembers do not get the discount. The controller estimated the average amount of additional purchases members make during the year at $150 and the probability of using discounts at 45%.

Value of incremental purchase	$150.00	Contract Price	$200.00	91%
Likelihood	0.45		$20.25	9%
Discount	0.3		$220.25	
Value of discount	20.25			
		Proportion of discount	0.091941	
		Contract price	200	
		Value of discount	$18.39	
		Value of other services	$181.61	

The material benefit is worth $20.25 over and above the contract price. The proportion of material benefit to the remaining bundled benefits is then multiplied by the contract price to identify the amount of the contract price allocated to the material benefit. The material benefit portion is recognized as the member takes the CPE. If the member does not take the CPE, then revenue is recognized when the obligation expires (the end of the contract). The revenue related to the bundled benefits is recognized over the period of the contract.

EXAMPLE 2

A membership organization provides benefits to members. There are 6 promised goods or services to be evaluated to determine whether they are performance obligations.

- Access to the website during the one-year period
- Promise to provide legislative advocacy services during the one-year period

- The promise to the member of a subscription to provide four quarterly journals (each is a performance obligation)

Step 1 – Identify the Contract: There is a contract between the membership organization and the member related to both membership and the journal subscription.

Step 2 – Identify Performance Obligations: Each promise to deliver the goods and services is distinct. Access to the website and the promise to provide advocacy services are delivered at the same time and have the same measure of progress so they can be accounted for as one performance obligation called member benefits.

Step 3 – Determine the Transaction Price: The transaction price is the contract price of $200 for a one-year membership, which includes the journal.

Step 4 – Allocate the Transaction Price to Performance Obligations: The transaction price should be allocated between the six performance obligations based on the relative standalone selling prices of each performance obligation.

- The standalone selling price for each journal would be the observable price of $20. The membership organization also sells the journal to nonmembers.
- The membership organization does not sell membership separately without including the quarterly journals. There is no standalone observable price for the other benefits because they are not sold separately. However, the entity can use the adjusted market assessment approach to estimate the standalone selling price based on what other membership organizations charge for the service. In this case, the standalone selling price was determined to be $150.

The NFP would then allocate the transaction price to the performance obligations based on the relative standalone selling price as follows:

Performance Obligations (PO)	Value	Proportion
Journal Quarter 1	20	8.70%
Journal Quarter 2	20	8.70%
Journal Quarter 3	20	8.70%
Journal Quarter 4	20	8.70%
Membership benefits	150	65.22%
Observable prices for Pos	230	100.00%

Allocate to POs based on contract price	200
Journal Quarter 1	17.39
Journal Quarter 2	17.39
Journal Quarter 3	17.39
Journal Quarter 4	17.39
Membership benefits	130.43

Revenue is recognized for each journal when delivered. Revenue is recognized for the remaining benefits on a monthly basis.

Naming Opportunities

Some donors are publicly recognized through naming opportunities. Additional rights and privileges may also be part of the transaction. The question that arises is related to whether the transaction is really a gift or if it is really advertising.

Indicators to Assist in Evaluating Naming Opportunities		
Indicator	**Contribution**	**Exchange**
Value of public recognition	Resource provider receives nominal value related to the public recognition and there are no other benefits	Resource provider receives significant value related to the public recognition or there are other benefits
Length of time that naming benefit is provided	Relatively short time or the NFP can change the name at its discretion	Relatively long tie and the name cannot be change by the NFP at its discretion
Control over name and logo use	Resource provider cannot change the name	Resource provider can change the name (e.g., if the company name changes)
Other benefits	None	Other rights and privileges such as an exclusive right to sell, exclusive recruitment opportunities, etc.

The FinREC believes that if public recognition and any accompanying rights and privileges that result are nominal in value, the transaction is a contribution.

Following is an example of how naming opportunities might be analyzed using the new revenue recognition guidance.

EXAMPLE 1

Scenario: An NFP university wants to sell the rights to the name for its sports arena. The arena is located in a place where it can be seen from a major highway. Several corporations bid on the naming rights and the contract was awarded to Better Buys, an electronics distribution company. The agreement called for a five-year period of time. It also covered the right to rename the arena should the entity's name change during the period of the agreement. The agreement was very specific as to the size of the sign with the company's name, its positioning and other specific details.

Step 1: Identify the Contract with the Customer – There is a contract here. This is not merely a contribution to the university but the rights for very visible advertising for a period of time. This is a reciprocal arrangement.

Step 2: Identify the Performance Obligations Under the Contract – The contract in this case is rights to the name of the stadium for a period of time and the prominent display of the company's name.

Step 3: Determine the Transaction Price – The transaction price for the five-year period was $5,000,000. Note that since this is a five-year period, it is necessary to consider a financing component.

Step 4: Allocate the Transaction Price to the Performance Obligations – There is only one performance obligation.

Step 5: Recognize Revenue When (or as) Each Performance Obligation is Satisfied – The next step is to determine whether the obligations are satisfied at a point in time or over time. The performance obligation is to permit the name of the company to be attached to the university's stadium. This reciprocal transaction results in revenue recognized over the five-year period. The transaction is initially recorded as deferred revenue and amortized over time.

EXAMPLE 2

NFP University gives the resource provider the opportunity to name a faculty position or provide scholarships. In exchange, the resource provider receives special recruiting privileges. This would be considered an exchange transaction if the recruiting privileges would be more than a nominal benefit.

EXAMPLE 3

A performing arts entity provides resource providers with the opportunity to have portions of its building including its auditoriums, gift shops and function rooms named after them. The sponsoring entity would have its name and logo prominently placed and would have the opportunity to use the facilities for its corporate functions without charge. The benefits would continue until such time as the entity moved to a new facility. This would be an exchange transaction since it would be difficult to demonstrate that the benefits were nominal. This type of transaction has the appearance of advertising.

Some NFPs have different levels of donors or sponsorship to recognize those that provided substantial resources. These can be classifications such as silver, gold and platinum or carry more creative names. These distinctions may only carry the benefit of having the resource provider's name at the top of a list but it may also carry other benefits analogous to the naming discussion above. For example, in the situation of a dinner, the entity may receive a certain number of tickets. Then this transaction would be considered part exchange and part contribution.

SPECIAL EVENTS

Relevant Literature:

- **ASC 958-605, *Revenue Recognition*, Accounting for Contributions Received and Contributions Made**
- **ASC 958-205, 210, and 225, Financial Statements of Not-for-Profit Organizations**
- **Technical Q&A 6140.07, Functional Category of Costs of Special Events**
- **Technical Q&A 6140.08, Functional Category of the Costs of Direct Donor Benefits**

Professional standards require that revenue and expenses from special events be **reported gross** unless the special event is peripheral to the organization's central activities. For example, a golf tournament that is a regularly held fundraiser would be reported gross. A bowl-a-thon that was held once and was not significant would be considered peripheral and the revenue and expenses would not be segregated. In addition, there are times when a group of people or a separate

organization is interested in the mission of a particular NFP organization. This group may raise money by holding a fundraising activity for the benefit of the NFP organization and then donate the net proceeds to the NFP organization. This would not be considered a special event of the NFP organization but a donation to it.

There are several ways that special events can be reported as illustrated in the following example.

EXAMPLE

A charitable organization holds a polo match each year as its major fundraiser. For the year ended June 30, 2013, the revenue in connection with the special event was $25,000. Approximately $17,500 of the revenue was contributions from sponsors and attendees. The remaining $7,500 was related to donor benefits such as food provided, cost of renting the polo field, cost of referees and parking. The $7,500 represents a fair value for the event itself. The cost of the direct donor benefits was $6,500. The $1,000 difference represents the approximate gross profit that would have been made on the event if held by another party.

During 2013, the charity incurred general and administrative costs of $52,000 which includes $1,500 in connection with the event, as well as $10,000 in fund-raising costs, $750 of which were in connection with the event. Contributions not related to the event were $250,000. Program expenses unrelated to the event were $120,000.

The costs of direct donor benefits can be deducted from special event gross revenue.

Contributions and Net Revenue from Special Event:		
Contributions		$250,000
Special event revenue	$25,000	
Less: Cost of direct benefits to donors	6,500	18,500
Contributions and net revenue from special events		268,500
Expenses:		
Program		120,000
Management and General		52,000
Fund-Raising		10,000
Total Expenses		182,000
Increase in net assets without donor restrictions		$86,500

Special event revenue (gross) can be presented in the revenue section and the costs of direct benefits to donors in the same section as all other expenses

Contributions and Net Revenue from Special Event:	
Contributions	$250,000
Special event revenue	25,000
Total Revenue	275,000
Expenses:	
Program	120,000
Cost of Direct Donor Benefits	6,500
Management and General	52,000
Fund-Raising	10,000
Total Expenses	188,500
Increase in net assets without donor restrictions	$86,500

The contribution and exchange portion of the gross revenues are presented separately, with the cost of direct donor benefits deducted from the exchange portion

Contribution and Net Revenue from Special Event:		
Contributions		$267,500
Polo match sales	$7,500	
Less: Costs of direct benefits to donors	6,500	1,000
Contributions and net revenue from special events		268,500
Expenses:		
Program		120,000
Management and General		52,000
Fund-Raising		10,000
Total Expenses		182,000
Increase in net assets without donor restrictions		$86,500

TPAs 6140.07 and 6140.08 state that if the direct donor benefits, which represent exchange transactions, are **not** program related, they should be reported as a separate supporting activity such as donor benefits (examples 1 and 2) or cost of sales (example 3).

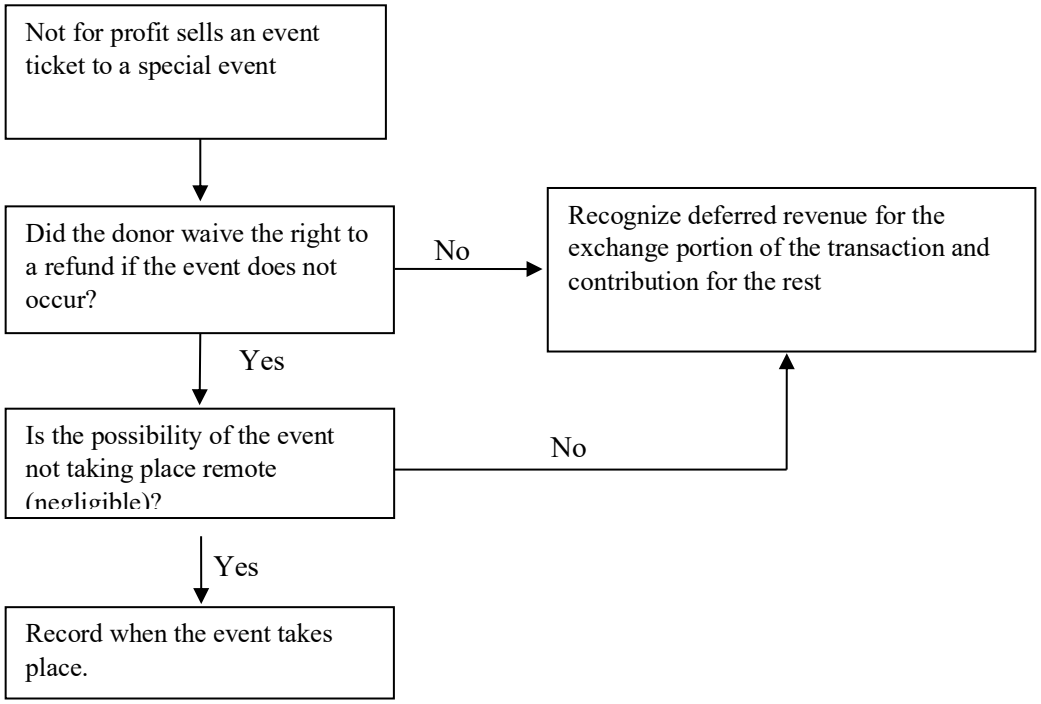
Note that the costs of the event that are in excess of the direct donor benefits are reported as fundraising costs or **management** and general. The $10,000 of **fundraising costs** in the example above consists of $750 in connection with the events and $9,250 general fundraising costs. The same is true for the management and general expenses.

If the costs of **direct donor benefits** are provided in transactions that are not exchange transactions, then they should be reported as fundraising costs. An example would be a fundraising dinner where the participants did not pay to attend.

The portion of the special event payment that is a contribution ($17,500) should be recognized as revenue in accordance with ASC 958-605. If, however, the contribution portion of the special event is really **conditional** in that it is contingent upon the event occurring, then that portion of the special event payment would be recorded as a refundable advance.

The portion of the special event payment that is an exchange transaction ($7,500) would be recorded as deferred revenue since revenue recognition should take place after the benefits are provided to the donor.

Note: The FinREC believes that if the event is supposed to take place after the date of the financial statements, that the contribution portion of the amount received for the event is conditioned on the event taking place. It would ordinarily be recorded as a refundable advance. Following is a flow chart summarizing the FinREC's guidance that can be used to assess the existence of deferred revenue and refundable advances.



Some NFPs hold events and publicize that the proceeds or net proceeds will be used for a specific purpose. When this occurs, the presentation changes because there is a temporarily restricted component to them. The examples in the ASC all assume that the proceeds from the event are without donor restrictions.

EXAMPLE

An NFP dialysis clinic held a golf tournament. The net proceeds of the event were to be restricted to the purchase of dialysis equipment. The statement of operations and a note disclosure are illustrated below.

Horizon Dialysis Clinic
Statement of Operations
For the year ended September 30, 20X1

Revenue, gains and other support	
Net Patient Service Revenue	*$ 1,572,052*
Grants	*27,928*
Net assets released from restrictions	*24,113*
Special events income	*33,032*
Total revenue, gains and other support	*1,657,125*
Expenses	
Program services	
Patient care	*1,212,577*
Supporting services	
General and administrative	*263,509*
Direct expense of special events	*33,032*
Fundraising	*58,557*
Total expenses	*1,567,675*
Operating income	*89,450*
Nonoperating items	
Investment return	*44,504*
Loss on disposal of fixed assets	*(1,370)*
Other income	*87*
	43,221
Excess of expenses (over) revenues and net assets without restriction	*$ 132,671*

Horizon Dialysis Clinic
Statement of Changes in Net Assets
For the year ended September 30, 20X1

Net assets without donor restirction		
Increase in net assets without donor restriction	*$*	*132,671*
Donor restricted net assets		
Contributions		*4,375*
Special events income		*19,738*
Net assets released from restrictions		*(24,113)*
Increase (decrease) in donor restricted net assets		*-*
Increase in net assets		*132,671*
Net assets, beginning of year		*4,123,192*
Net assets, end of year	*$*	*4,255,863*

Note L – Special Event

During the year ended September 30, 20X1, the Clinic held a golf tournament with the net proceeds restricted by the donors to pay for new dialysis equipment. By September 30, 20X1, the net proceeds were spent for dialysis equipment.

Special event revenue - donor restricted	*$*	*19,738*
Special event revenue - without donor restrictions		*33,032*
Less direct donor expenses		*(33,032)*
Net proceeds		*19,738*
Amount released from restriction for charity care		*(19,738)*
Donor restricted amount at year-end	*$*	*-*

As discussed in the section on functional expenses, the cost of the direct donor benefits may be shown as a contra revenue account. In this case, the preparer of the statements will want to ensure that the expenses that are not included in the expense section of the statement of activities are identified in the functional expense presentation.

OTHER ASSETS – COLLECTION ITEMS

Relevant Literature:

- **ASC 958-360, Property, Plant, and Equipment**
- **ASC 820, Fair Value Measurement**

Museums and other NFP organizations frequently receive donations of art or historical objects. These items may or may not qualify as "collections". The ASC Glossary defines **collections as works of art, historical treasures or similar assets that are:**

- Held for public exhibition, education or research to further public service rather than financial gain
- Protected, kept unencumbered, cared for and preserved
- Subject to an organizational policy that requires the proceeds of items that are sold to be used to acquire other items

An **organization may capitalize** collections but is not required to. When organizations initially adopt the pronouncement, they may choose to:

- Capitalize collections including prior period items
- Capitalize those collections that are acquired in future periods
- Not capitalize collections at all

One policy must be applied for all collection items.

If the organization decides to capitalize collections, then it will capitalize items received as assets, regardless of whether they were acquired by contribution or in exchange transactions. If they are acquired in an exchange transaction, they will be capitalized at cost. If donated, then they will be capitalized at fair value in the appropriate net asset class.

If an organization has a policy of not capitalizing collections, then contributions would not be recognized. Purchased collection items would be charged to expense. Any related cash flow that occurs relative to purchases, sales or insurance recoveries would be reported as an investing activity in the Statement of Cash Flows. Proceeds are recognized in the appropriate net asset class as a change in net assets.

If an NFP organization makes a contribution of a collection item to another organization, it will account for the transaction as follows:

- For items that have been capitalized, the donation will be recognized as an expense at fair value. If the fair value is different than the carrying value of the item, then a gain or loss would be recognized
- If the item was not capitalized, then there would be no recognition of the contribution made to the other entity. However, the event would be disclosed in the footnotes

If donated works of art or other historical items are evaluated and do not meet the criteria to be included in the organization's collection, then they would be recognized as support in the appropriate net asset class.

EXAMPLE 1

A museum with a policy of capitalizing collections received a valuable statue from a donor for its collection along with an appraisal obtained by the donor. Museum personnel inspected the statue and determined that it should be added to the collection. There was no evidence to contradict the appraisal obtained by the donor so the statue was capitalized at the appraised value at the date of donation.

EXAMPLE 2

A Historical Society with a policy of capitalizing collections received a painting and collection of writings from a donor for its collection. The painting had recently been appraised and the donor provided the appraisal to the Society. Historical Society personnel examined the painting and decided that it did not meet its criteria for inclusion in its collection. However, it was an appealing painting and the entity decided to hang it in the boardroom. The Historical Society recognized the donation but did not capitalize it as part of its collection. Historical Society personnel evaluated the collection of writings. They did not meet the criteria for inclusion in the Society's collections. It was determined that the writings were of uncertain value so the Historical Society did not recognize that gift in the financial statements.

EXAMPLE 3

A museum received a painting from a donor at the end of its fiscal year with the understanding that it would be sold. The organization recorded the gift at its fair value at the date of donation in the net asset class without donor restrictions. When the painting was sold, the proceeds from the sale were less than the amount recorded at donation. The museum adjusted contribution revenue for the difference.

Disclosure Requirements

If the organization capitalizes collections, the amount of the collections would be shown as a separate line item on the Statement of Financial Position. If there are other works of art or historical items that do not meet the definition of collection items, they would be disclosed on the face of the financial statements or in the notes. The organization should disclose its policy for capitalization of works of art or historical treasures that meet the definition of collections in ASC 958-360, *Property, Plant and Equipment.*

If the organization does not recognize and capitalize its collections or capitalizes items prospectively, the Statement of Activities should present the following:

- A description of the collections, including their relative significance
- A description of the organization's accounting and stewardship policies for collections
- The fair value or a description of collection items that are given away, damaged, destroyed, lost, or otherwise decreased during the period

The following should be reported separately from revenues, expenses, gains, and losses for collections not previously recognized:

- Costs of collection items purchased as a decrease in the appropriate class of net assets
- Proceeds from the sale of collection items as an increase in the appropriate class of net assets
- Proceeds from insurance recoveries of lost or destroyed collection items as an increase in the appropriate class of net assets

Note that this would include proceeds from sales and insurance recoveries from items not previously capitalized.

Organizations that do not capitalize collections or capitalize collections prospectively should have a separate line item on the Statement of Financial Position that refers to the disclosures above (even if there is no balance associated with it). Note that the line item should be dated if collections are capitalized prospectively; for example, "Collections acquired since January 1, 1995 (Note 8)."

DISCLOSURE EXAMPLES

Summary of Significant Accounting Policies (capitalized collections)

Collection items – The Organization has capitalized its collections since inception. If purchased, items are capitalized at cost. If they are donated, they are capitalized at their fair value at the date the Board of Trustees accepts the items. Gains or losses on the deaccession of collection items are classified on the Statement of Activities as without donor restrictions or with donor restrictions support, depending on donor restrictions that are placed on the item.

During the year ended June 30, 20X3, a fire destroyed several items from the collection. Insurance proceeds in the amount of $59,000 were spent on similar items due to a stipulation from the donor that limited future proceeds from deaccessions to acquisitions of items from the same period.

Summary of Significant Accounting Policies (collections capitalized prospectively)

Purchased collection items are recorded in net assets without donor restrictions in the year in which the items are acquired or donor restricted net assets if the assets used to purchase the items are restricted by donors. Gains and losses from deaccession of these items are reflected on the Statement of Activities as changes in the appropriate net asset classes, depending on the existence and type of donor-imposed restrictions.

Summary of Significant Accounting Policies (collections not capitalized)

The Organization's collections, which are appropriately cared for and preserved, were acquired through purchase and contributions since its inception in 1953. They are not recognized as assets on the Statement of Financial Position. Purchases of collection items are recorded as decreases in net assets without donor restrictions when acquired or with donor restricted net assets if contributions made by donors used to purchase the collection items are restricted. Contributed collection items are not reflected in the financial statements. Proceeds from deaccessions or insurance recoveries are reflected as increases in the appropriate net asset class.

NFP ENTITIES – LEASE ACCOUNTING

GASB Lease Accounting

Within the United States, the lease accounting standards for governmental and nongovernmental entities have traditionally been aligned. However, this changed following the issuance of ASU 2016-02, *Leases.* Following the issuance of ASU 2016-02, *Leases*, GASB issued Statement No. 87, *Leases* which more closely resembles the lease accounting standards under the International Accounting Standards Board's (IASB) IFRS 16, *Leases.*

GASB 87 provides for three accounting treatments for lease agreements, as follows:

- Short-term leases
- Lease contracts that transfer ownership
- Lease contracts that do not transfer ownership (catch-all category for leases not falling within the first two categories)

Short-Term Leases

The determination of whether or not a lease is considered short-term depends entirely upon the maximum possible non-cancelable lease term specified in the lease agreement, including possible lease extensions. The likelihood of the lease extension being elected is not relevant to the consideration. If the maximum possible non-cancelable lease term, including extensions, is less than 12 months, the lease is classified as short-term. As such, the lease is accounted for in the same manner as operating leases under FASB 13. There is no additional financial statement note disclosures required for short-term leases.

Contracts That Transfer Ownership

Lease contracts that explicitly state that ownership of the asset will transfer to the lessee at the end of the lease term and do not contain contract termination provisions fall within this category. In this case, the lease is treated as a sale of the asset by the lessor and a purchase of the asset by the lessee. If the contract contains a termination provision, GASB lease accounting still permits sale treatment as long as it is reasonably certain the cancellation provisions will not be exercised.

Contracts That Do Not Transfer Ownership (All Others)

If a lease does not fall into the short-term lease category or the contracts transfer ownership category, it by default falls into this category. Under GASB 87, the lessee is required to record a right-of-use asset and the related lease liability. Consistent with FASB 13, the lease liability is measured at the present value of the fixed minimum lease payments, and the asset's initial value will equal the liability plus additional payments for indirect costs made to the lessor on or before the start of the lease term. The right-to-use asset is considered an intangible asset and is amortized over the shorter of the lease term or the useful life of the asset. The lessee will also recognize interest expense over time on the current balance of the lease at the implicit interest rate charged to the lessee.

GASB 87 requires retrospective application by restating the financial statements for all periods presented in the financial statements, unless it is not practicable to do so. In situations where it is

not practicable to restate the prior period financial statements, a note disclosure must be included explaining the reason. Additionally, where full restatement is not practicable, GASB 87 provides a practical expedient whereby fund net position, fund balance, or beginning net position (whichever is applicable) is adjusted for the cumulative effect of applying the new standard for the earliest year presented within the financial statements.

GASB 87 was initially effective for reporting periods beginning after December 15, 2019. GASB 95, *Postponement of the Effective Dates of Certain Authoritative Guidance*, deferred the effective date of GASB 87 to fiscal years beginning after June 15, 2021, and all reporting periods thereafter.

FASB LEASE ACCOUNTING

In November 2019, FASB issued ASU 2019-10, *Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842), Effective Dates,* which amended ASC 842 on leases to give implementation relief to certain entities. Subsequently, in June 2020, FASB issued ASU No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842), Effective Dates for Certain Entities*, which delays the effective dates of ASC 842 for private companies, private NFP entities, and public NFP entities. The following chart highlights ASC 842's effective dates (a) as originally issued, (b) as amended by ASU 2019-10, and (c) as amended by ASU 2020-05.

	Public Entities	**Public NFP Entities**	**All Other Entities**
(a) Originally Issued in ASU 2016-02	Fiscal years beginning after December 15, 2018, and interim periods within those fiscal years	Fiscal years beginning after December 15, 2018, and interim periods within those fiscal years	Fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020
(b) Amended by ASU 2019-10	N/A – no change	N/A – no change	Fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021
(c) Amended by ASU 2020-05	N/A – no change	Fiscal years beginning after December 15, 2019, and interim periods within those fiscal years	Fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022

The deferrals are not compulsory. Early adoption continues to be permitted in any interim or annual period. If an entity adopts ASC 842 in an interim period, it should reflect such early adoption as of the beginning of the annual period. The deferral is intended to give immediate relief to certain entities as a result of the widespread adverse economic effects and business disruptions caused by COVID-19. Although some NFPs will choose to take advantage of COVID-19–related effective date delay, many NFPs are already well underway with their implementation of Topic 842. Consequently, it is important to make sure you know the all-encompassing requirements under the new standards.

The ASU on leasing was initially to take effect for entities that are conduit bond obligors for years beginning after December 15, 2018. For all others, the guidance was initially effective a year later. The leasing guidance, contained in ASC 842, is principles-based like the guidance for revenue recognition, and applies to all entities. Unlike the revenue recognition guidance, the AICPA did not create industry specific task forces to provide practitioners with further assistance. During 2018, the AICPA issued a white paper discussing an issue that is particular to NFPs regarding right-of-use assets that either have no rent or below market rent. This segment provides a brief overview of the changes in the leasing standard as well as a discussion of the accounting for leases that contain an inherent contribution.

Following are the main requirements related to leases as it relates to lessees and lessors:

- Lessees will recognize most leases on the statement of financial position. The only exception is leases that have a term of 12 months or less. A right-of-use asset will be recorded along with a lease liability.

- Lease origination costs are not as likely to be capitalized. ASC 842 changed the requirements so that only incremental costs incurred in connection with the execution of the lease would be capitalized. This leaves out the type of costs of arranging and negotiating the lease.

- There will be more disclosures for lessees (and lessors). ASC 842 provides numerous disclosure examples.

- The definition of a lease has changed to include a new requirement to determine whether the customer has the right to direct the use of the identified asset. This could require judgment.

- Criteria to determine financing vs. operating lease are similar yet not as specific. If one or more criteria is met at commencement, the lease is considered financing. ASC 842-10-55 says that the following would be a reasonable approach to classification:

  - 75% or more of the remaining economic life of the underlying asset is considered a major part of its remaining economic life.

  - A commencement date that falls at or near the end of the economic life of the underlying asset refers to a commencement date that falls within the last 25% of the asset's total economic life.

  - 90% or more of the fair value of the underlying asset amounts to substantially all the fair value of the underlying asset.

    The other criteria are (1) the ownership of the underlying asset transfers to the lessee by the end of the lease term, (2) the lessee has an option to purchase the underlying asset that it is reasonably certain to exercise, and (3) the underlying asset is of such a specialized nature that it is not expected to have an alternative use to the lessor at the end of the lease term.

Leases with the government – There are often provisions related to space in airport facilities, bus terminals, or ports owned by the government. It may be very difficult to determine the fair value of the underlying asset. If it is impracticable to do so and leases do not provide for a transfer of ownership or purchase option that the lessee is reasonably certain to exercise, they are considered operating leases. This guidance applies when the following conditions are met: (1) The asset is owned by a government unit or authority and is part of a larger facility such as an airport operated by or on behalf of the lessor; (2) The asset is a permanent structure such as a building that cannot be moved; (3) The lessor has the explicit right under the lease or other regulations to terminate the lease during the lease term by closing the facility or taking possession of the facility; and (4) The lease does not transfer ownership of the underlying asset to the lessee or allow them to acquire ownership of it.

- The discount will be the rate implicit in the lease unless it is not determinable. The lessee can use the incremental borrowing rate based on collateralized borrowings with similar maturities. Non-public business entities (includes all NFPs) can make an election to use a risk-free rate but should realize that the lower the rate, the higher the liability.

- The lease term will include the non-cancelable lease term plus renewal periods that are reasonably certain of exercise by the lessee or under the control of the lessor.

- Service arrangements may contain embedded leases. These leases will be recorded on the statement of financial position where service arrangements are not.

- Lessees may need to remeasure the liability when there is significant change in lessee controlled circumstances even when it is not a lease modification.

- Fixed payments made by the lessee cover lessor costs related to the underlying asset, such as property taxes, or insurance are considered part of the lease payments. However, if these same payments were variable, they would be excluded from the lease payments.

- When collectability of lease payments is not probable, lessors may have to recognize some of the payments as deposit liabilities. Leases that have significant variable payments will no longer be able to be classified as operating leases. This could result in the imputed interest rate for the lease being zero or a loss at commencement.

- Fewer build to suit arrangements will be subject to sale-leaseback accounting requirements under the new standard. The new process for determining when a lessee controls an underlying asset before lease commencement will result in fewer transactions where the lessee is considered the owner of an asset during the construction period. The changes in the sale-leaseback guidance will also make it easier for the lessee to remove real estate assets recognized during the construction period from their statement of financial position. Entities may need to derecognize build to suit assets and liabilities that remained on the statement of financial position after the end of the construction period during the transition to ASC 842.

Accounting for Donated Rent and Below Market Leases

NFPs sometimes receive promises to give the use of long-lived assets such as buildings and facilities where the donor retains legal title. These arrangements may look like leases but have no lease payments. ASU 842 defines a lease as a contract that provides the use of identified property and equipment for a period of time in exchange for consideration. With these arrangements, there

is no consideration so they are not in the scope of ASU 842. There are other times when some rent is paid but it is below market. Consideration includes cash or other assets and so the lease payments will only reflect these amounts. The amount of the contract that is less than fair value is a contribution and accounted for by ASC 958-605.

When the time is a certain number of periods, the NFP would record the fair value of the use of the property as a donor restricted (time) contribution and contribution receivable. With each period, the restriction is released and the net assets become without donor restrictions. The entity may call this "building" rather than contributions receivable. The rate that will be used for the examples that follow is 5%. The numbers are the same in each scenario to illustrate the differences.

EXAMPLE 1 – LEASE IS 100% DONATED RENT

A social service agency (SSA) received the use of donated office space from a governmental entity. SSA is not required to pay rent, insurance, taxes or other consideration. Since there is no consideration, this is not considered a lease.

The undiscounted value for the free rent is $69,000 which is computed at $20,000 Y1, $23,000 Y2 and $26,000 Y3. This is because the location is growing in popularity and rents are increasing. The space is usable in future periods so the contribution is donor restricted.

The computations for the three years follow:

Calculating the Contribution and Receivable

Payments	**$ 20,000**	**$ 23,000**	**$ 26,000**
	Year 1	**Year 2**	**Year 3**
Contribution rec. beginning of year	$ 69,000	$ 45,490	$ 24,760
Beginning of year discount	(6,630)	NA	NA
Amortization of discount (5%)	3,120	2,270	1,240
Fair value of donated lease rental	(20,000)	(23,000)	(26,000)
Contribution rec. end of year	$ 45,490	$ 24,760	$ -

Initial Entry to record the donated asset		
Contribution receivable	62,370	
Contribution revenue - donor restricted		62,370
($69,000- $6,630)		

Impact on net assets with donor restrictions	**Year 1**	**Year 2**	**Year 3**
Net assets with donor restrictions, beginning	62,370	45,490	24,760
Amortization of discount	3,120	2,270	1,240
Release from restriction	(20,000)	(23,000)	(26,000)
Net assets with donor restrictions, ending	$ 45,490	$ 24,760	$ -

Annual Journal Entry 1	**Year 1**		**Year 2**		**Year 3**	
Occupancy expense	20,000		23,000		26,000	
Contributions receivable		20,000		23,000		26,000
To record the expense related to donated space						
Annual Journal Entry 2						
Net assets released from restriction - with donor restriction	20,000		23,000		26,000	
Net assets released from restriction - without donor restriction		20,000		23,000		26,000
To release amounts from restriction						
Annual Journal Entry 3						
Contribution receivable	3,120		2,270		1,240	
Amortization - contribution with donor restriction		3,120		2,270		1,240
To amortize the discount						

EXAMPLE 2 – LEASE IS BELOW MARKET (FINANCING LEASE)

A social service agency (SSA) received the use of space from a business entity. The undiscounted value for the annual rental is $69,000 which is computed at $20,000 Y1, $23,000 Y2 and $26,000 Y3. This is because the location is growing in popularity and rents are increasing. Consideration paid each year is $5,000 each year so there is a lease component. The remainder is considered an unconditional promise to give which has been assessed as fully collectible. The space is usable in future periods so the contribution is donor restricted.

Management evaluated the lease and determined it should be classified as a financing lease. They do not know the rate implicit in the lease so SSA used its incremental borrowing rate of 5% to discount.

The computations for the three years follow:

Below Market Financing Lease

Calculating the ROU asset and lease liability	
Value of Lease	
Fair value of rental - 3 X $5,000	15,000
Discount at 5%	(1,380)
Discounted value of rental	13,620
Value of contribution	
Total fair value of arrangement	69,000
Less fair value rents to be paid	(15,000)
Amount attributable to contribution	54,000
Discount on contribution receivable	(5,250)
Discounted value of contribution	48,750

Contribution Receivable	**Year 1**	**Year 2**	**Year 3**
Contribution rec. beginning of year	$ 54,000	$ 36,190	$ 20,000
Beginning of year discount	(5,250)	NA	NA
Amortization of discount (5%)	2,440	1,810	1,000
Fair value of donated lease rental	(15,000)	(18,000)	(21,000)
Contribution Rec.-End of Year	$ 36,190	$ 20,000	$ -

Journal Entries

Contribution Portion		
Contribution receivable	48,750	
Contribution revenue with donor restrictions		48,750
To record the initial contribution		

Annual Journal Entry 1	**Year 1**		**Year 2**		**Year 3**	
Lease expense	15,000		18,000		21,000	
Contributions receivable		20,000		18,000		21,000
To record the expense related to donated space						
Annual Journal Entry 2						
Net assets released from restriction - with donor restriction	15,000		18,000		21,000	
Net assets released from restriction - without donor restriction		15,000		18,000		21,000
To release amounts from restriction						
Annual Journal Entry 3						
Contribution receivable	2,440		1,810		1,000	
Amortization - contribution with donor restriction		2,440		1,810		1,000
To amortize the discount						

	Year 1	Year 2	Year 3
Accounting for the Lease Component			
Lease liability			
Lease liability beginning of year)	13,620	9,290	4,750
Add amortization (lease expense)	670	460	250
Less lease payment	(5,000)	(5,000)	(5,000)
Lease liability end of year)	9,290	4,750	-
Right of Use Asset			
ROU asset, beginning of year	13,620	9,080	4,540
Less amortization (lease expense)	(4,540)	(4,540)	(4,540)
ROU asset,end of year	9,080	4,540	-

Journal Entries						
Initial entry to record the Lease Portion						
Lease Portion						
ROU Asset, net of discount	13,620					
Lease liability		13,620				
To record the initial lease entry						
	Year 1		**Year 2**		**Year 3**	
Annual Journal Entry 1						
Lease expense	670		460		250	
Lease liability	4,330		4,540		4,750	
Cash		5,000		5,000		5,000
To record the payment of the rent						
Annual Journal Entry 2						
Amortization of ROU Asset	4,540		4,540		4,540	
ROU Asset		4,540		4,540		4,540
To record amortization of the ROU asset						

EXAMPLE 3 – LEASE IS BELOW MARKET (OPERATING LEASE)

A social service agency (SSA) received the use of donated equipment from a business entity. The undiscounted value for the annual rental is $69,000 which is computed at $20,000 Y1, $23,000 Y2 and $26,000 Y3. Consideration paid is $5,000 each year so there is a lease component. The remainder is considered an unconditional promise to give which has been assessed as fully collectible. The equipment is usable in future periods so the contribution is donor restricted.

Management evaluated the lease and determined it should be classified as operating. They do not know the rate implicit in the lease so SSA used its incremental borrowing rate of 5% to discount.

The computations for the three years follow:

Calculating the ROU asset and lease liability	
Value of Lease	
Fair value of rental - 3 X $5,000	15,000
Discount at 5%	(1,380)
Discounted value of rental	13,620
Value of contribution	
Total fair value of arrangement	69,000
Less fair value rents to be paid	(15,000)
Amount attributable to contribution	54,000
Discount on contribution receivable	(5,250)
Discounted value of contribution	48,750

Contribution Receivable	Year 1	Year 2	Year 3
Contribution rec. beginning of year	$ 54,000	$ 36,190	$ 20,000
Beginning of year discount	(5,250)	NA	NA
Amortization of discount (5%)	2,440	1,810	1,000
Fair value of donated lease rental	(15,000)	(18,000)	(21,000)
Contribution rec. end of year	$ 36,190	$ 20,000	$ -

Journal Entries

Contribution Portion						
Contribution receivable	48,750					
Contribution revenue with donor restrictions		48,750				
To record the initial contribution						
Annual Journal Entry 1	**Year 1**		**Year 2**		**Year 3**	
Lease expense	15,000		18,000		21,000	
Contributions receivable		15,000		18,000		21,000
To record the expense related to donated space						
Annual Journal Entry 2						
Net assets released from restriction - with donor restriction	15,000		18,000		21,000	
Net assets released from restriction - without donor restriction		15,000		18,000		21,000
To release amounts from restriction						
Annual Journal Entry 3						
Contribution receivable	2,440		1,810		1,000	
Amortization - Contribution with donor restriction		2,440		1,810		1,000
To amortize the discount						

	Year 1	Year 2	Year 3
Accounting for the Lease Component			
Lease liability			
Lease liability beginning of year)	13,620	9,290	4,750
Add amortization (lease expense)	670	460	250
Less lease payment	(5,000)	(5,000)	(5,000)
Lease liability end of year)	9,290	4,750	-
Right of Use Asset			
ROU asset, beginning of year	13,620	9,290	4,750
Less amortization (lease expense)	(4,330)	(4,540)	(4,750)
ROU asset,end of year	9,290	4,750	-
Total lease expense - components			
Lease liability amortization	670	460	250
ROU asset amortization	4,330	4,540	4,750
Total lease payment	5,000	5,000	5,000

AGENCY TRANSACTIONS

Relevant Literature

- **ASC 958-605, Revenue Recognition, Transfers of Assets to a Not-for-Profit Entity or Charitable Trust that Raises or Holds Contributions for Others**
- **ASC 958-205, 210, and 225, Financial Statements of Not-for-Profit Entities**
- **ASC 820, Fair Value Measurement**
- **Technical Q&A 6140.13-.19, Series Related to Financially Interrelated Entities**
- **Technical Q&A 6140.21, Should a Not-for-Profit Entity Report Amounts Charged to the Not-for-Profit Entity by a Professional Fund-Raiser Gross, as Fund-Raising Expenses, or Net, as a Reduction of Contributions?**
- **Technical Q&A 6140.22, Circumstances Where the Reporting Not-for-Profit Entity Undertakes a Transaction in Which Another Not-for-Profit Entity Raises Contributions on Behalf of the Reporting Not-for-Profit Entity and the Reporting Not-for-Profit Entity Compensates the Fund-Raising Not-for-Profit Entity for Raising the Contributions**

There are times when an NFP organization will act as an agent, trustee, or intermediary for another organization rather than acting as a donor or donee. Some NFP organizations, as a part of their charitable purpose, collect cash and other assets and, in turn, distribute the assets, or return on the investment of those assets to other organizations as part of their charitable purpose. Although we tend to think of these transfers as transfers of cash, sometimes the transfers can take the form of other assets, including assets such as securities, land, buildings, use of facilities or utilities, materials and supplies, intangible assets, services and unconditional promises to give those items in the future.

ASC 958-605 applies to:

- Transactions where a **donor makes a contribution by transferring assets to a not-for-profit organization or charitable trust** that agrees to use the assets on behalf of, or transfer the assets, or the return on investment of those assets to an entity specified by the donor.
- Transactions where an entity that transfers assets to recipient (resource provider) is related to the beneficiary so that the transaction is deemed to be reciprocal.
- **Transactions where conditions imposed by the resource provider or relationships between the parties make the transfer of the assets revocable or repayable.**

The three parties to the majority of the transactions covered by the guidance on agency transactions are the donor or resource provider, the recipient organization and the beneficiary. The term resource provider is used when the entity that initiates the transaction transfers resources to another entity and the transaction is not a contribution. The recipient is the party that receives the assets in a transfer. The beneficiary is the party for whom the assets are intended.

Transfers of Noncash Assets

When transfers to an NFP organization for a specified beneficiary are in the form of non-cash assets, the organization may record an asset and a liability for the amount as they would in the case of cash assets. However, ASC 958-605 gives the option of not recording noncash agency transactions on the books and records. NFP organizations are under intense scrutiny from donors and other interested parties so this may not be the best course of action.

EXAMPLE

Frequently schools, churches, service groups and individuals donate food that they have collected to various shelters and soup kitchens that have no room to store it. We Care, an NFP food bank, provides storage for these items for the shelters and soup kitchens. We Care maintains detailed records to ensure accountability for these donations. As these are noncash agency transactions, We Care does not include them in their financial statements.

Transactions with Intermediaries

In the context of ASC 958-605 intermediary describes a situation where a recipient organization facilitates the transfer of assets between a resource provider and beneficiary but is **not** an agent or trustee. Moreover, the intermediary is not a donor or donee itself since it does not receive or make a gift.

EXAMPLE

A local church wants to pay for the education of a parishioner who wants to attend seminary. The local church specifies the parishioner and transfers funds to the seminary. The seminary is an intermediary because it facilitates the cash transfer from the church to the individual. The seminary recognizes an asset and a liability.

There may be times when a family will provide resources to a religious organization or school that are intended to benefit a specific party. In this case, the NFP organization is acting as an intermediary. It might be wise to advise these organizations that the family is not making a donation since there is a specifically designated party. Families might erroneously decide that these transfers are tax deductible.

Transactions with Trustees

A **trustee** holds and manages assets for the benefit of a specified beneficiary in accordance with a charitable trust document. This type of transfer will be discussed in the section on split interest agreements.

Main Applications of ASC 958-605 as it Relates to Agency Transactions

There are three main scenarios where this guidance is applicable:

- Organizations (such as United Way) receive assets from donors where a beneficiary is designated by that donor
- Organizations unrelated to the NFP organization (such as Community Foundations) receive assets from NFP organizations (resource providers) to hold and manage. These organizations may also raise money on behalf of NFP organizations
- A recipient and a specified beneficiary may be financially interrelated. For example, a Foundation may exist in order to raise, hold and invest assets for a related NFP organization or group of affiliated NFP organizations

The literature contains numerous examples of applications of the standard. Due to time constraints, this section will only discuss those most frequently found in practice.

Unrelated Fundraising Organization with Variance Power

The United Way is an excellent example of an entity that raises money and then provides contributions to other NFPs. A donor can give to United Way or another similar fundraising organization, and if there is not a specified beneficiary, the fundraising organization will pay its own operating expenses and then give contributions to charities that meet its criteria. When this scenario occurs, the donors have given variance power to the fundraising organization. The contribution to the fundraising organization is recognized as a contribution and revenue is recorded. Variance power is defined as the unilateral power to redirect the use of the transferred assets to another beneficiary.

Donors can also specify beneficiaries when they give money to these fundraising organizations. If they do and the beneficiaries are unrelated to the fundraising organization, then the fundraising organization would recognize the fair value of the assets, as well as the liability to the beneficiary. In this case, the fundraising organization is acting as an **agent**. In this case, the donors have not granted variance power.

EXAMPLE

A donor transferred resources to Friendly Fund-Raising Entity and did not specify a beneficiary. Friendly Fund-Raising recorded contribution revenue and then allocated the contributions from various sources to the various organizations it has chosen as beneficiaries. The beneficiaries recorded contribution revenue when it was promised or transferred to them by Friendly Fund-Raising Organization, whichever came first.

Friendly Fund-Raising Entity also received resources from donors who specified beneficiaries. Friendly took an administrative fee off the top of the resources before passing them down to the specified beneficiaries. Friendly did not record contribution revenue for the amounts passed through to the beneficiaries because the beneficiaries were specified by the donor. Until the resources were passed to the beneficiaries, they were recorded as assets and liabilities to the beneficiaries on Friendly's books. Friendly could record revenue for the administrative fee. The beneficiaries were required to record revenue at the gross amount and fundraising expense for the amount deducted by Friendly.

In some cases, an agent will raise contributions for the NFP entity. Technical Q&A 6140.21 states that the NFP entity should record the revenue as the gross amount and record an expense for the fundraising costs.

EXAMPLE

Charitable Entity hired a fundraising entity to solicit donations on its behalf. The compensation to the fundraiser was 20% of the amounts raised. Charitable Entity records the full amount of contribution and fundraising expenses to represent the fee. Friendly Fund-Raising must tell them about the contribution.

It is not surprising that this guidance is not particularly popular with organizations that have a significant amount of agency transactions. Although they incur fund-raising expenses, the donations are not there to show for it. The guidance permits these organizations to demonstrate their service efforts on the Statement of Activities as follows:

Total amounts raised	$100,000
Less: amounts designated by donors for specific organizations	(40,000)
Contributions revenue	60,000
Other revenue	20,000
Administrative fees retained on amounts designed by donors for specific organizations	4,000
Total support and revenue	$84,000

Community Foundation

A community foundation can be found in almost every city. It serves several purposes for NFPs and donors in the community. Among other things, it raises money for NFPs; it makes grants to NFPs; guarantees the debt of NFPs; and also manages money for NFPs. Note that other entities may perform many of the same functions as a community foundation. The key to the accounting treatment is the relationship between the recipient entity and the unrelated beneficiary and whether or not there was true variance power.

The following examples are illustrations that are typical of NFP organizations that use other entities such as a Community Foundation to hold and manage resources. In the first example, an

NFP organization establishes a fund at a Community Foundation. The NFP organization solicits the donations but they are sent by the donors to the Community Foundation subject to the spending policy of the Community Foundation. In addition, the Community Foundation has variance power because the campaign materials clearly give it the right to redirect the assets under certain circumstances.

In the second example, the NFP transferred a sum of money to the Community Foundation to manage. Here, although the document may provide for variance power, the FASB has specified that it would not truly be variance power because the evidence supports that when the entity transferred the assets it was counting on the return on those assets as distributions.

EXAMPLE 1

Scenario 1: Social Service Agency, an NFP organization, establishes a fund at Community Foundation (CF). Donors are solicited by Social Service but the pledge materials specify that gifts will be sent to CF and will be used to establish a fund for the NFP. The return on the gifts is intended to be used for the NFP. However, CF has the right to redirect the assets if it chooses to. In subsequent periods, when assets are transferred to the beneficiary from CF, CF recognizes expense and a decrease in cash. Social Service does nothing, until it is notified of the contribution from CF.

Scenario 2: In this example, an NFP organization transfers assets previously donated to it to a Community Foundation to invest. The difference between this example and the previous one is that the assets reflected amounts that were donated or earned by the NFP organization and transferred to the Community Foundation. The agreement states that the Community Foundation will not ever return the assets to the NFP organization but it will give the NFP organization the return on the assets. Even though the agreement goes on to say that the Community Foundation has the right to redirect the assets, the FASB determined that this was a reciprocal transaction. The NFP organization is transferring the assets in exchange for future distributions. At the time of the transfer, the Community Foundation is stating that it has the ability to fulfill the obligation and that the transfer of the investment return to the NFP organization is consistent with its mission.

EXAMPLE 2

In the initial transaction, the resource provider (the NFP) will record the following:[20]

Beneficial interest in assets held by Community Foundation	XX	
Investments		XX

The recipient (Community Foundation) will record the following:

Investments	XX	
Liability to resource provider		XX

In subsequent periods, the resource provider will increase cash when there are transfers to the organization. It will adjust the beneficial interest for changes in asset valuation. The recipient will account for the change in the value of the investments and investment income. It will also decrease the investments for any amounts transferred to the resource provider.

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[20] Note that present value techniques are one valuation technique for measuring the fair value of the contribution and the beneficial interest. Other valuation techniques are also available as described in ASC 820 *Fair Value Measurement*. If present value techniques are used, the contribution revenue and the beneficial interest should be measured as the present value of the future cash inflows over the expected term of the agreement.

Financially Interrelated Foundations

Some NFP organizations are financially interrelated with foundations that exist to raise, hold and invest assets for them. It is important to distinguish which transactions are contributions and which are equity transactions. Both will be discussed here. There is also a series of *technical practice aids* dealing with various scenarios and when the amounts are considered with donor restrictions and without donor restrictions. They will not all be discussed here but can be accessed in the AICPA's Technical Practice Aids as 6140.13-.1*8*.

Entities are **financially interrelated** when the following two conditions are met:

- One must have the ability to influence the operating and financial decisions of the other. For example:
  - Organizations are affiliates
  - One has considerable representation on the board of the other
  - Charter or bylaws of one limit its activities to those that benefit the other
  - An agreement between the two allows one to participate in policymaking processes for the other
- One organization has an ongoing economic interest in the net assets of the other. In this case, one organization's interest either increases or decreases as a result of the fund-raising and operating activities of the other.

If the two organizations are financially interrelated, then the amounts become contributions to the recipient. An example follows:

EXAMPLE

A donor makes a contribution to a Foundation. The bylaws of the foundation state that it is organized to support a private school. The Foundation records contribution income. The private school will recognize its interest in the net assets of the Foundation.

In the initial transaction, the recipient (Foundation) will record the following:

Asset	XX	
Contribution revenue		XX

The Beneficiary (private school) will record the following:[21]

Interest in net assets of the recipient	XX	
Change in interest in net assets of Foundation		XX

[21] Note that present value techniques are one valuation technique for measuring the fair value of the contribution and the beneficial interest. Other valuation techniques are also available as described in ASC 820 *Fair Value Measurement*. If present value techniques are used, the contribution revenue and the beneficial interest should be measured as the present value of the future cash inflows over the expected term of the agreement.

In subsequent periods, anytime cash comes into the Foundation from a donor, it will be a contribution. There will also be appreciation/depreciation and investment income from interest/dividends. The private school periodically records a change in its interest in the net assets of the Foundation.

There may be times when foundations and financially interrelated NFP organizations have transactions that are not characterized as contributions but are equity transactions. A transaction is an **equity transaction** if all of the following conditions are present:

- The resource provider specifies itself or an affiliate as the beneficiary
- The resource provider and the recipient are financially interrelated
- Neither the resource provider or affiliate expects payment of the transferred assets although they may expect the investment return to be paid

If the resource provider specifies itself or an affiliate as its beneficiary, then the equity transaction is an interest (or increase) in the net assets of the recipient. If the resource provider specifies an affiliate as the beneficiary, the beneficiary reports an interest in the net assets of the recipient. Both the recipient and the resource provider would report an equity transaction as a separate line in the Statement of Activities. An example follows:

EXAMPLE

A Foundation is created to hold and manage the investments of a private school. The portfolio is transferred from the school to the Foundation. The school requests that the return on the investments be distributed to them, subject to approval from the governing board. However, the school does not expect the principal to be returned.

The school would record the initial transaction as follows:

Interest in net assets of Foundation	XX	
Investments		XX

The Foundation would record the initial transactions as follows:

Investments	XX	
Equity transaction		XX

In subsequent periods, the private school would record a change in the interest in the net assets of the Foundation. The Foundation would record any increase/decrease in the investments due to changes in market value or additions of investment income. It would also record any cash sent to the private school.

If a resource provider specifies itself or its affiliate as the beneficiary and the transfer is not an equity transaction, then the resource provider would account for the transaction as follows:

DR	Asset	
	CR	Refundable advance

The recipient would account for the transaction as follows:

DR	Asset	
	CR	Liability to resource provider

Other Transfers of Assets That Are Not Contributions

ASC 958-605 states that a transfer of assets to a recipient organization is not a contribution when:

- The transfer is subject to the resource provider's unilateral right to redirect the use of assets to another beneficiary
- It is accompanied by a resource provider's conditional promise to give or is revocable or repayable
- The resource provider controls the recipient organization and specifies an **unaffiliated** beneficiary

In these cases, the resource provider would record the following:

DR Refundable advance
CR Asset or payable

The recipient would record the following:

DR Asset
CR Refundable advance

Disclosures

The following disclosures must be made for each period in which a Statement of Financial Position is presented, if an organization transfers assets to a recipient and specifies that it or its affiliate is the beneficiary.

- The identity of the recipient organization
- If variance power was granted to the recipient organization, and a description of those terms
- Terms under which amounts would be distributed to resource provider and affiliates
- Aggregate amounts recognized in the Statement of Financial Position for those transfers and whether it would be recorded as an interest in the net assets of the recipient organization or another asset

As might be expected, organizations that have relatively large amounts of agency transactions (i.e., beneficiaries were specified by the donor), are unhappy about not being able to recognize revenue for the transactions. This is particularly true since their fund-raising expenses are high and donors want to know the percentage of fund-raising expenses to amounts donated. The literature addresses the risk of misleading information by requiring that if an NFP organization discloses in its financial statements a ratio of fund-raising expenses to amounts raised, it must disclose how the ratio is computed.

DISCLOSURE EXAMPLES

Note A: Significant Accounting Policies (in part)

Beneficial Interest in Assets Held by Community Foundation

During 20X4, KIDZ KAMP established an endowment fund that is perpetual in nature (the fund) under a community foundation's (the CF) Non-Profit Preservation Endowment Challenge Grant Program. KIDZ KAMP granted variance power to the CF, which allows the CF to modify any condition or restriction on its distributions for any specified charitable purpose or to any specified organization if, in the sole judgment of the CF's Board of Directors, such restriction or condition becomes unnecessary, incapable of fulfillment, or inconsistent with the charitable needs of the community. The fund is held and invested by the CF for our benefit and is reported at fair value in the statement of financial position, with distributions and changes in fair value recognized in the statement of activities.

Note 5: Funds Held on Behalf of Charitable Association (not an equity transaction)

The sole purpose of the Charitable Foundation is to provide support for Charity, a financially interrelated organization. In accordance with professional standards, the Foundation has recorded as an asset and contribution those contributions being held on behalf of Charity.

On the books of the Charity is the following:

Note 4: Interest in Net Assets of Charitable Foundation (not an equity transaction)

The Charity is supported, in part, by Charitable Foundation whose purpose is to provide support for Charity, a financially interrelated organization. In accordance with professional standards, the Charity has recorded an interest in the net assets of the Foundation.

Note 6: Related-party Transactions

During 2013, the Organization transferred investments totaling $180,000 to Wellness Foundation to be distributed to Children's Clinic, an affiliate of the organization. The Organization retains the unilateral right to redirect the use of the assets transferred. Assets will be distributed monthly based on patients under the age of 5 who are treated for cancer.

Note 1: Summary of Significant Accounting Policies

Fund-Raising Performance Measure

The Organization calculates its fund-raising performance ratio by dividing total fund-raising costs by total amounts raised. Amounts designated by donors for specific organizations are included in total amounts raised.

Note 8: Fund-Raising Expense Ratio

The Organization's fund-raising expense ratio for the year ended December 31, 2013 is calculated as follows:

Total support reported on the statement of activities	$1,000,000
Plus, donor designated gifts	450,000
Total	1,450,000
Fund-raising expenses	108,750
Fund-raising expense ratio	7.5%

INVENTORY

Relevant Literature:

- **ASC 330, *Inventory***
- **ASC 958-605, Revenue Recognition (section on contributed inventory)**
- **Technical Q&A 6140.01, Inventory Valuation for a Not-for-Profit Scientific Organization**
- **Technical Q&A 6140.06, Functional Category of Cost of Sales of Contributed Inventory**

Inventory is held by certain NFPs. It may be incidental to the purpose of the organization such as a bookstore that sells books to promote the NFP's mission. It may also be the main focus of the organization such as a thrift shop that sells donated merchandise as a service to the community or to raise money to give to other organizations. Inventory may be acquired through purchase or through donation.

Contributions of inventory should be recognized when received. Estimates of the value could be obtained by appraisal, estimated selling prices from catalogues and other sources. As noted earlier, it is possible that the gifts may not have an estimable value. This happens frequently with **thrift stores** as they receive used clothing and furniture. Revenue is recognized if the item is sold. The FASB makes an exception for those items where there is uncertain value. Revenue would not be recognized until the item was sold.

ASC 330 and Technical Q&A 6140.01 states that when there is **evidence that the utility of the goods is no longer as great as cost**, then there should be a departure from the cost basis of accounting. Reasons for this could be due to physical deterioration, obsolescence, changes in price level or other causes. Accordingly, inventories should be valued at the lower of cost or market and not at an arbitrary amount. The fact that the difference between sales proceeds and the costs is covered by contributions does not change the accounting requirements.

EXAMPLE

Note 3: Sales of Donated Goods

The Synagogue operates a thrift store where donations of used clothing, appliances and furniture are solicited from its members and the public. The Synagogue sells the donated items to generate cash to fund the Synagogue's outreach programs. For the year ended June 30, 20X3, the Organization recorded contribution revenue of approximately $420,000. This represented only the items that historically the thrift store's management knew would sell at prices that were management's best estimate of "market." The used clothing was not considered because the value was uncertain. Sales and cash and the relief of inventory and cost of sales were recorded when the items sold for $405,000. The remaining $15,000 was recorded as a reduction of the contribution revenue and a relief of inventory. The cost of sales is shown as a separate supporting service as illustrated in the example financial statements found in the appendix.

ASC 958-605 illustrates an example of inventory sold at auction. It states that "the difference between the amount received for those items from the ultimate resource providers (NFPs in

developing countries purchasing goods) and the fair value of the gifts-in-kind when originally contributed (by pharmaceutical companies) to the organization should be recognized as adjustments to the original contributions when the items are transferred to the ultimate resource providers.

Contributed Inventory

Technical Q&A 6140.06 states that the cost of sales of contributed inventory should be reported as the cost of a separate supporting service unless the item sold is related to a program activity. Cost of sales of contributed inventory would never be considered a fund-raising expense.

EXAMPLE 1

An NFP organization serves developing countries where certain diseases are prevalent. The organization's mission is to help prevent the spread of disease and in doing so they provide various NFP organizations in these communities with certain medical and hygienic supplies. The organization receives the supplies from pharmaceutical companies in the United States and USAID, a federal agency. It also purchases supplies for distribution. The organization sells the supplies donated by the pharmaceutical companies and those it purchases to the various NFPs in developing countries at a charge that would be significantly less than the items would sell for in the United States. The items received from USAID are donated to the various NFPs as a requirement of the federal award.

The organization values the supplies in inventory from USAID at the amount stated in the grant since it is used for a federal program.

Inventory	3,000,000	
Grant Revenue		3,000,000

Amount in inventory is amount stated in the grant. Amount per case is $300 X 10,000 cases. When the inventory is shipped overseas to developing countries, the organization records the following:

Program expense – cost of sales	3,000,000	
Inventory		3,000,000

Note that the amount of program expense equals the amount in inventory since it is a federal award.

The inventory from the pharmaceutical company is valued at the amount for which it could be sold. Since the sales price varies, depending on the country, an historical average is used to value the inventory at year-end. Any difference between the value in inventory for contributed items and the sales price would be accounted for as a reduction or addition to contribution revenue as noted in ASC 605. As further noted in Technical Q&A 6140.01, the fact that the sales price for the items is lower than cost and the difference is covered by contributions does not change the requirements of ASC 330.

Inventory	1,500,000	
Contribution revenue – without donor restrictions		1,500,000

The pharmaceutical company donates 10,000 cases. The average amount that the organization believes they will be able to sell it for is $150 a case (based on historical information).

Cash	1,400,000	
Contribution revenue – without donor restrictions	100,000	
Inventory		1,500,000

If the organization is not able to get $150 a case for it, the contribution is reduced. If the organization gets more than $150 a case, then additional contribution is added.

In this case, the cost of sales is shown as a program expense.

EXAMPLE 2

Note 2: Inventory

Supplies inventories purchased for use in programs and supporting services are carried at the lower of cost or market on a first-in first-out basis.

SPLIT-INTEREST AGREEMENTS

Relevant Literature

- **ASC 958-30, Split-Interest Agreements, Embedded Derivatives: Application of Statement 133 to a Not-for-Profit Organization's Obligation Arising from an Irrevocable Split-Interest Agreement**
- **ASC 820, Fair Value Measurement**

Certain donors may give NFP organizations donations in which the NFP organization receives benefits but they are shared with other parties. There may or may not be trusts involved. In addition, some trusts are held by a third party over whom the NFP organization has no control.

Under the split-interest agreement, the donor makes the initial gift to a trust or to the NFP organization. As noted above, there is a shared interest. The arrangement will specify an event or a period of time under which it is effective. For example, the time period could be the remaining life of the donor or some other individual. The arrangement could also span a certain number of years. Generally, the arrangement will be irrevocable.

If a split-interest agreement is revocable, then the NFP organization should treat it as an intention to give. If the NFP organization is acting as a trustee, then the accounting is similar except that the element of contribution is recorded as refundable advance. When the agreement becomes irrevocable before the time that the NFP organization gets a distribution of the assets for its unconditional use, then contribution revenue should be recognized.

The accounting and valuation treatment varies depending on the type of split-interest agreement and whether the entity holds the assets and liabilities in its own accounts (gift annuity), is the trustee (lead or remainder trusts), is not the trustee (lead or remainder trusts where the trustee is a third party) and whether it is considered a perpetual trust (the corpus is never distributed). A summary follows:

Creation of the Agreement

	Creation of the Agreement		
	Debit	Credit	Credit
Assets Held by a Third Party			
Charitable lead trust	Beneficial interest in lead trust		Contribution revenue (1)
Charitable remainder trust	Beneficial interest in remainder trust		Contribution revenue (1)
Assets Held by the NFP			Contribution revenue (1)
Charitable lead trust	Assets held in charitable lead trust	Liability for amounts held for others	Contribution revenue (1)
Charitable remainder trust	Assets held in charitable remainder trust	Liability under trust agreement	Contribution revenue (1)
Charitable gift annuity	Assets	Annuity payment liability	Contribution revenue (1)
Pooled income fund	Assets of pooled income fund	Discount for future interest (Deferred revenue)	Contribution revenue (1)

(1) See Section 958-30-45 for classification of contribution revenue and change in the value of split-interest agreements.

Distribution to Holder of Lead Interest

	Distribution to Holder of Lead Interest	
	Debit	Credit
Assets Held by a Third Party		
Charitable lead trust	Cash	Beneficial interest in lead trust
Charitable remainder trust	No entry	No entry
Assets Held by the NFP		
Charitable lead trust	Cash	Assets held in charitable lead trust
Charitable remainder trust	Liability under trust agreement	Assets held in charitable remainder trust
Charitable gift annuity	Annuity payment liability	Cash
Pooled income fund	Liability to life beneficiary	Assets of pooled income fund

Reclassification of Amounts Distributed When Restrictions are Met

Reclassification of Amounts Distributed to Holder of Lead Interest When All Restrictions Are Met		
	Debit	Credit
Assets Held by a Third Party		
Charitable lead trust	Temporarily restricted net assets - Reclassifications out	Unrestricted net assets - Reclassifications in
Charitable remainder trust	Not applicable	Not applicable
Assets Held by the NFP		
Charitable lead trust	Unrestricted net assets - Reclassifications out	Unrestricted net assets - Reclassifications in
Charitable remainder trust	Not applicable	Not applicable
Charitable gift annuity	Not applicable	Not applicable
Pooled income fund	Not applicable	Not applicable

Investment Income and Changes in Fair Value

Investment Income and Changes in the Fair Value of Assets Held Under the Agreement (2)	Debit	Credit
Assets Held by a Third Party		
Charitable lead trust	No entry	No entry
Charitable remainder trust	No entry	No entry
Assets Held by the NFP		
Charitable lead trust	Assets held in charitable lead trust	Liability for amounts held for others
Charitable remainder trust	Assets held in charitable remainder trust	Liability under trust agreement
Charitable gift annuity	Assets	Investment return (1)
Pooled income fund	Assets of pooled income fund	Liability to life beneficiary

- Alternatively, the annuity payment liability could be credited, resulting in the netting of investment return with other changes in the value of split-interest agreements.
- Debit and credit could be reversed depending on whether the change in fair value of the assets held under the agreement is a gain or a loss.

Revaluation of Obligation to Beneficiaries

	Revaluation of Obligation to Other Beneficiaries	
	Debit	Credit
Assets Held by a Third Party		
Charitable lead trust	Not applicable	Not applicable
Charitable remainder trust	Not applicable	Not applicable
Assets Held by the NFP		
Charitable lead trust	Liability for amounts held for others (2)	Change in value of split-interest agreements (1) (2)
Charitable remainder trust	Liability under trust agreement (2)	Change in value of split-interest agreements (1) (2)
Charitable gift annuity	Annuity payment liability (2)	Change in value of split-interest agreements (1) (2)

Adjustment of Deferred Revenue – including Amortization of Discount and Changes in Life Expectancy

Adjustment of Deferred Revenue - including Amortization of Discount and Changes in Life Expectancy	Debit	Credit
Pooled income fund	Discount for future interest (deferred revenue)	Change in value of split-interest agreements

	Change in Fair Value of Beneficial Interest	
	Debit	Credit
Assets Held by a Third Party		
Charitable lead trust	Beneficial interest in lead trust	Change in value of split-interest agreements (1) (2)
Charitable remainder trust	Beneficial interest in remainder trust	Change in value of split-interest agreements (1) (2)
Assets Held by the NFP		
Charitable lead trust	Not applicable	Not applicable
Charitable remainder trust	Not applicable	Not applicable
Charitable gift annuity	Not applicable	Not applicable
Pooled income fund	Not applicable	Not applicable

- See Section 958-30-45 for classification of contribution revenue and change in the value of split-interest agreements.
- Debit or credit could be reversed depending upon whether the adjustment increases or decreases the liability.

Termination of the Trust

	Termination of the Trust		
	Debit	Credit	Credit
Assets Held by a Third Party			
Charitable lead trust	Change in value of split-interest agreements (1) (2)	Beneficial interest in lead trust	Change in value of split-interest agreements (1) (2)
Charitable remainder trust	Assets (for example, endowment or other investments)	Beneficial interest in remainder trust	Change in value of split-interest agreements (1) (2)
Assets Held by the NFP			
Charitable lead trust	Liability for amounts held for others	Assets held in charitable lead trust	Change in value of split-interest agreements (1) (2)
Charitable remainder trust	Liability under trust agreement		Change in value of split-interest agreements (1)
Charitable remainder trust	Assets (for example, endowment or other investments)	Assets held in charitable remainder trust	
Charitable gift annuity	Annuity payment liability		Change in value of split-interest agreements (1)
Pooled income fund	Discount for future interest (deferred revenue)		Change in value of split-interest agreements (1)
Pooled income fund	Assets (for example, endowment or other investments)	Assets of pooled income fund	
All Agreements	Additionally, a reclassification may be necessary if net assets are no longer subject to time or purpose restrictions		

- See Section 958-30-45 for classification of contribution revenue and change in the value of split-interest agreements.
- Debit or credit could be reversed depending upon whether the adjustment increases or decreases the liability.

A description of the most common types of split-interest agreements follows:

Charitable Lead Trusts

Description: The NFP organization receives distributions during the life of the donor or another party or some other time period. The remainder goes to the donor or heirs after the period specified by the agreement. The donor may impose restrictions on the assets received. Distributions may be a fixed dollar amount (charitable lead annuity trust – CLAT), or a fixed percentage of the trust's value determined each year – (charitable lead unitrust – CLUT). In the case where the payment is based on a percentage of the trust and the time period involves a certain period (for example 10 years or the lesser of 10 years or the donor's death), then the NFP needs to be concerned about an embedded derivative. The easiest way to deal with an embedded derivative is to mark the liability to fair value. This will only happen where there is not an outside trustee.

Split-Interest Agreements Where the NFP Organization is Not the Trustee

If the assets are in trust and the NFP organization does not exercise control over the asset, it has a beneficial interest in the trust. The NFP organization would recognize its interest in the assets by recording the present value of the expected future benefits to be received once the trust is

terminated. The factors to be considered are the same as those discussed above with one important exception. As stipulated in ASC 958-320, *Investments – Debt and Equity Securities,* the same method must be used to measure the beneficial interest as was used originally and the discount rate would be revised to reflect current market conditions.

Charitable Remainder Trusts

Description: The donor establishes and funds a trust with specified distributions to be made to a designated beneficiary or beneficiaries during the life of the donor or another party or some other time period. The remainder goes to the NFP organization. (Note that the NFP organization may not receive the entire remainder. This would be specified in the agreement). The donor may impose restrictions on the assets received. Distributions may be a fixed dollar amount (charitable remainder annuity trust – CRAT), or a fixed percentage of the trust's value determined each year – (charitable remainder unitrust – CRUT). Some CRUTs will limit the annual payout to the lesser of the stated percentage or actual income earned.

Perpetual Trust Held by a Third Party

In a perpetual trust, the donor enters into an irrevocable perpetual trust agreement with a bank (or other trustee) and gives the bank a sum to be invested in perpetuity. The NFP organization receives the income. Note that the NFP organization may or may not be the only beneficiary of the trust.

The AICPA paper on fair value for NFPs states that NFPs should assume that the trustee stands in the shoes of the NFP in making investment decisions and therefore their control over the investment decisions does not enhance or diminish the NFP. The AICPA paper also affirms the discussion in ASC 820, which is to say that the fair value can be measured using the fair value of the assets contributed to the trust unless facts and circumstances provide other information.

The assets and revenue are measured at fair value. The contribution revenue is with donor restrictions. The subsequent entries will have two parts. Each period the NFP organization receives cash from the payout. There will also be adjustments to the beneficial interest in the trust relative to changes in the value of the assets. The NFP organization will need to obtain this information from the trustee.

The AICPA paper discusses how the beneficial interest in a perpetual trust held by a third party should be valued.

NOTE: The FinREC uses the analogy of investments that are reported at net asset value per share. "If a reporting entity will never have the ability to redeem its investment at the net asset value per share (or equivalent), the fair value measurement of the investment should be categorized as a level III investment.". A perpetual trust would fall into this category.

Charitable Gift Annuity

Description: With a charitable gift annuity, the donor contributes assets to the organization in exchange for its promise to pay a fixed amount for a specified time to the donor or a beneficiary. In this way, it is similar to the charitable remainder trusts. However, there is no trust. The assets are held as general assets of the NFP organization and the obligation to the donor is a general obligation. The accounting is the same as the charitable remainder trust.

Pooled Life Income Fund

Description: A pooled life income fund is a fund where contributions of numerous donors' life income gifts are pooled and invested as a group. The donors are assigned shares or units in the fund based on the proportion of the value of their gift to the fund on the date their donation was placed in the fund. The life beneficiary (which could be the donor) is paid the actual income (as specified in the agreement) that is earned on his/her units. When the life beneficiary dies, the units revert to the NFP organization.

Derecognition of Liability

When the NFP organization has control over the assets in a split-interest agreement, they also have a liability to the donor or donor's heirs representing either the lead or the remainder interest. In cases where the liability represents the present value of payments to be made to the donor and the NFP organization has the lead interest, it may appear reasonable to purchase an annuity to make the payments to the donor or donor's heirs. The NFP organization may choose this course of action but it cannot remove the liability from its books. ASC 405, *Liabilities,* states that a debtor can derecognize a liability if and only if it has been extinguished. A liability has been extinguished if either of the following conditions is met:

- The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds

- The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor

Following are disclosure examples for several types of split interest agreements.

DISCLOSURE EXAMPLES

KIDZ KAMP, Inc.
Statement of Financial Position (in part)
June 30, 20X1

Assets		
Cash and cash equivalents	*$*	*4,874,220*
Operating investments		*774,223*
Accounts receivable, net		*502,491*
Promises to give, net		*941,112*
Prepaid expenses and other assets		*290,813*
Cash restricted to building project		*1,500,000*
Property and equipment, net		*28,957,121*
Assets held under split-interest agreements		***977,102***
Beneficial interests in charitable trusts held by others		***812,850***
Beneficial interest in assets held by community foundation		***1,094,842***
Beneficial interests in perpetual trusts		***2,595,059***
Endowment		
Promises to give, net		*336,999*
Investments		*27,027,131*
Total assets	*$*	*70,683,963*

Excerpt from Liabilities- Statement of Financial Position

Liabilities under split-interest agreements	***1,418,127***

KIDZ KAMP, Inc.
Excerpt from Statement of Activities

	Without Donor Restrictions	***With Donor Restrictions***	***Total***
Change in value of split-interest agreements held by KIDZ KAMP, Inc.		*130,406*	*130,406*
Distributions from and change in value of beneficial interests in assets held by others	*145,649*	*90,408*	*-236,057*

EXAMPLE 1

Note A: Principal Activity Significant Accounting Policies (in part)

Beneficial Interests in Perpetual Trusts

We have been named as an irrevocable beneficiary of several perpetual trusts held and administered by independent trustees. Perpetual trusts provide for the distribution of the net income of the trusts to us; however, KIDZ KAMP will never receive the assets of the trusts. At the date KIDZ KAMP receives notice of a beneficial interest, a contribution with donor restrictions of a perpetual nature is recorded in the statement of activities, and a beneficial interest in perpetual trust is recorded in the statement of financial position at the fair value of the underlying trust assets. Thereafter, beneficial interests in the trusts are reported at the fair value of the trusts' assets in the statement of financial position, with trust distributions and changes in fair value recognized in the statement of activities.

Beneficial Interest in Assets Held by Community Foundation

During 20X4, KIDZ KAMP established an endowment fund that is perpetual in nature (the fund) under a community foundation's (the CF) Non-Profit Preservation Endowment Challenge Grant Program. KIDZ KAMP granted variance power to the CF, which allows the CF to modify any condition or restriction on its distributions for any specified charitable purpose or to any specified organization if, in the sole judgment of the CF's Board of Directors, such restriction or condition becomes unnecessary, incapable of fulfillment, or inconsistent with the charitable needs of the community. The fund is held and invested by the CF for our benefit and is reported at fair value in the statement of financial position, with distributions and changes in fair value recognized in the statement of activities.

EXAMPLE 2

Note 3: Receivables from Split-Interest Agreements

Receivables from split-interest agreements represent the estimated net present value of the Organization's irrevocable remainder interests in various trusts held by third-party trustees. The net present value of these receivables was determined using investment returns consistent with the composition of the asset portfolios of the trusts, the single life expectancy from mortality tables published by the IRS, and discount rates determined in the years when the trusts were established.

EXAMPLE 3

Note 4: Split-Interest Agreements

During the year ended June 30, 20X3, the Organization entered into a charitable remainder unitrust agreement. The Organization serves as trustee. Assets held in these trusts are included in investments and are reported at fair value. Contribution revenue was recognized at the date the trust was established after recording a liability for the present value of the estimated future payments to be made to the donor. The liability will be adjusted during the term of the trust for changes in the value of the assets, accretion of the discount, and other changes in the estimates of future benefits. The discount rate on the Organization's split-interest agreement is 6%.

Note that the changes in value of split-interest agreements could also be in the "with donor restrictions" category if the donor had not specified that the remainder was to be used as an endowment.

INVESTMENTS

Relevant Literature

- **ASC 958-320, Investments – Debt and Equity Securities**
- **ASC 958-321, Investments – Equity Securities**[22]
- **ASC 820, Fair Value Measurement**

NFP organizations account for investment activity under the provisions of ASC 958-320. The Statement requires investments in equity securities with **readily determinable fair values** and all investments in debt securities initially to be recorded at acquisition cost, if purchased, and to be recorded at fair value at the date of donation, if donated. Subsequent to acquisition, securities covered by the Statement are reported at fair value.

Investments not included in ASC 958-320 include derivatives and related entities. With regard to derivatives, if a security has an embedded derivative, as discussed in the section on split-interest agreements, then the host instrument would be subject to the provisions of ASC 958-320, even though the derivative is subject to the provisions of ASC 815. Derivative instruments are not discussed in this manual. Related entities are covered within the provisions of ASC 958-810 that is also discussed in this section.

Other investments that an NFP organization may own include real estate, mortgage notes, venture capital funds, partnership interests, oil and gas interests, certain equity securities where fair value is not readily determinable and investments accounted for by the equity method.

Measurement

Equity investments are measured at fair value with changes in fair value running through net income. NFPs do not have other comprehensive income so this is not a change for them.

Effective with calendar year-ends in 2019, ASC 321 permits entities to use a measurement exception for those equity investments without a readily determinable fair value and do not qualify for the use of the practical expedient, net asset value per share (NAV) from the fair value literature, ASC 820. This exception allows these investments to be measured at cost minus impairment.

To evaluate impairment, qualitative criteria are examined first to see if a quantitative measurement is necessary. Criteria that should be considered are:

- Significant deterioration in earnings, credit rating, asset quality or business prospects
- Significant adverse change in the regulatory or technology environment

[22] Section 321 is a new section that was created to address ASU 2016-01. The ASU changed the accounting for equity securities so that all investment return gains and losses are run through the statement of activities. Previously, certain NFPs and for-profit entities categorized these securities as trading and available for sale with the unrealized gains and losses running through other comprehensive income. In addition, this standard provides a measurement exception for investments without readily determinable fair values.

- Significant adverse change in general market condition of the geographic area or industry
- Bona fide offer to purchase, offer to sell or completed auction process for the same or similar investment that is lower than the carrying amount
- Factors that raise questions about the entity's ability to remain a going concern

Where an impairment exists based on the qualitative assessment, the entity would perform a quantitative analysis to determine the difference between carrying value and fair value which would be recorded as the impairment.

Unrealized and Realized Gains and Losses

Unrealized gains and losses result when investments are adjusted to their fair value. Unrealized and realized gains and losses would be classified as without donor restrictions or with donor restrictions, depending on whether the donor stipulations. Realized gains and losses result when the organization disposes of securities. These gains and losses would generally be recorded as increases or decreases in the net asset class without donor restrictions, unless otherwise specified by the donor. Note that as it relates to endowment funds, state law may require gains and losses to be treated in a different manner.

When calculating gains and losses, if a previously recognized unrealized gain or loss is represented in the investment balance, then the amount of gain or loss already reported in the Statement of Activities would be excluded from the calculation of realized gain or loss. However, for reporting purposes, the organization could report the realized gain less the unrealized gain previously recognized as illustrated below.

DISCLOSURE EXAMPLES

An NFP organization purchased shares of an equity security which was actively traded for $300,000 during 2012. At the end of the year, the fair value was $320,000. During 2013, the securities were sold for $350,000. The realized gain was $30,000.

Disclosure requirements for investment return include:

- Investment income (interest and dividends)
- Net realized and unrealized gains or losses on investments reported at fair value
- Net realized gains or losses reported at other than fair value

Investments and return should be disclosed by net asset class.

	2013	2012
Option 1		
Investment return:		
Interest and dividends	$15,000	$15,000
Net realized and unrealized gains on investments reported at fair value	30,000	20,000
Realized gains (losses) on investments reported at other than fair value	(16,000)	40,000
Total investment return	$29,000	$75,000
Option 2:		
Investment return:		
Interest and dividends	$15,000	$15,000

Unrealized gains on investments		20,000
Realized gains on investments reported at fair value	50,000	
Less unrealized gain previously recognized	(20,000)	
Realized gains (losses) on investments reported at other than fair value	(16,000)	40,000
Total invested return	$29,000	$75,000

Investment income includes interest and dividends as well as royalties, rents and other payments and is recognized as earned. Generally, investment income would be recorded in net assets without donor restrictions unless otherwise specified by the donor (if the investments were a result of donations). Investment revenues may be reported net of related investment expenses. However, the expenses should be disclosed in the notes to the financial statements.

Decline in Fair Value after the Date of the Financial Statements

Changes in the fair value of assets or liabilities that occur after the date of the statement of financial position but before the statements are issued are not recognized as of the financial statement reporting date.

Investment Expenses

ASU 2016-14 requires that an entity include direct internal investment expenses in its investment expenses and net them with the investment return. Some entities may already be doing this but others may not have ever considered it. The FASB defines direct internal investment expenses as those that involve the direct conduct or direct supervision of the strategic and tactical activities involved in generating investment return. These include, but are not limited to, both of the following:

- Salaries, benefits, travel, and other costs associated with the officer and staff responsible for the development and execution of investment strategy
- Allocable costs associated with internal investment management
- Supervising, selecting, and monitoring of external investment management firms

Direct internal investment expenses do not include items that are not associated with generating investment return. For example, the costs associated with unitization and other such aspects of endowment management would not be allocated.

There have been implementation questions related to whether a person who reconciles investment report information to purchase and sales and performs analytical procedures are included in direct internal investment expenses. The entity should determine whether these costs are associated with management of investment firms that are instrumental in carrying out the investment activity.

EXAMPLE

The CFO of an NFP performed various activities related to investments. She managed the investment strategy of not only the general portfolio but the endowment portfolio. She performed analytical procedures to understand the investment return and how it relates to accomplishing the investment strategy. She supervised accounting for the investments. In this case, the work related to the strategy is considered investment expenses. The supervisory activity would not be since it is related to accounting. That would be a management and general activity.

The FASB also:

- Eliminated the requirement to disclose the composition of investment return
- Eliminated the requirement to disclose the amount of investment expenses
- For NFPs with endowment funds, the roll-forward schedule in the endowment disclosure now only needs to present net investment return and not the components

The NFP may choose to present the information. Note that expenses related to programmatic investments are not included.

Following is an excerpt from KIDZ KAMP, Inc.'s Summary of Significant Accounting Policies:

Note A: Significant Accounting Policies

Investments

KIDZ KAMP records investment purchases at cost, or if donated, at fair value on the date of donation. Thereafter, investments are reported at their fair values in the statement of financial position. Net investment return/(loss) is reported in the statement of activities and consists of interest and dividend income, realized and unrealized capital gains and losses, less external and direct internal investment expenses.

ENDOWMENT FUNDS

Definitions

An endowment fund is an established fund of cash, securities, or other assets to provide income for the maintenance of an NFP entity and may be with or without donor-imposed restrictions. Endowment funds generally are established by donor-restricted gifts and bequests to provide either of the following:

- A permanent endowment, which is to provide a permanent source of income.
- A term endowment, which is to provide income for a specified period.

In the truest sense, an endowment is a fund that provides a stream of funding for a purpose. Accordingly, an NFP entity's governing board may earmark a portion of its unrestricted net assets as a board-designated endowment fund.

One other important distinction is the term institutional funds. UPMIFA defines the term institutional fund as a fund held by an institution exclusively for charitable purposes. The term does not include:

- Program-related assets
- A fund held for an institution by a trustee that is not an institution or a fund in which a beneficiary that is not an institution has an interest, other than an interest that could arise upon violation or failure of the purposes of the fund

A perpetual fund, although an endowment, would not be considered an endowment subject to UPMIFA.

Accounting

Until ASU 2016-14 is implemented, a permanent endowment will be referred to as permanently restricted net assets. A term endowment would be considered temporarily restricted. The return on the endowment is presently considered temporarily restricted until appropriated for expenditure by the entity's board. If there are further restrictions on how the return can be spent, the amount would be considered donor restricted until such time as the restrictions have been met, even though appropriated for expenditure. Approval for expenditure may occur through different means. For example, expenditures could be approved as part of a formal annual budget. Expenditures also could be approved during the year as unexpected needs arise.

Laws concerning use of net appreciation of endowment funds that are donor restricted may vary from jurisdiction to jurisdiction. For example, some jurisdictions follow trust law, but most jurisdictions follow an enacted version of the Uniform Prudent Management of Institutional Funds Act of 2006 (UPMIFA) or similar legal guidance. This includes interpretations of laws issued by state Attorneys General. Other states, such as Pennsylvania, follow trust law.

Since donor stipulations and laws vary, NFP entities need to assess the facts and circumstances related to their endowments and applicable laws to determine the classification of endowment funds within the financial reporting model to see if some or all of the investment return is available for spending. Investment return includes the dividends and interest, as well as the appreciation/depreciation. For donor-restricted endowment funds that are subject to trust law, typically at least, the amount of the original gift(s) and any gains or net appreciation of the fund are **not** considered to be available for expenditure. Generally, interest, dividends, rents, or other forms of ordinary income are available for spending and are classified as net assets without donor restrictions unless a purpose or other donor restriction exists on use of the investment income.

ASU 2016-14 did not change the accounting for endowment funds except in one instance. If any of the funds has declined past the original gift (referred to as an **underwater endowment fund**), whether due to appropriations of return greater than that accumulated by the fund or through investment decline, the amount will no longer be reclassified to net assets without donor restriction but will remain within the donor restricted category. The update requires additional disclosures as discussed below.

Reporting Under ASU 2016-14

The NFP entity will report endowments based on the existence or absence of donor-imposed restrictions. After the implementation of ASU 2016-14, the classifications are with donor restrictions and without donor restrictions. Board-designated endowment funds generally arise from an internal designation of net assets without donor restrictions so would be classified as net assets without donor restrictions. There are rare circumstances where a board-designated endowment fund also can include a portion of net assets with donor restrictions. For example, if an entity is unable to spend donor-restricted contributions in the near term, then the board sometimes considers the long-term investment of these funds.

The entity must disclose information to enable users of financial statements to understand all of the following about its **endowment funds** (both donor restricted and board designated):

- Net asset classification (for example, **net assets with donor restrictions or net assets without donor restrictions**)
- Net asset composition by type (for example, **board-designated endowment funds or donor-restricted endowment funds**)
- Changes in net asset composition
- Spending policies
- Related investment policies.

Disclosures

At a minimum, the entity must disclose all of the following information for each period for which it presents financial statements:

- A description of the governing board's interpretation of the law or laws that underlie the entity's net asset classification of donor-restricted endowment funds, including its interpretation of the ability to spend from **underwater endowment funds**.
- A description of the entity's policy or policies for the appropriation of endowment assets for expenditure (its endowment spending policy or policies), **including its policy, and any actions taken during the period, concerning appropriation from underwater endowment funds (bolded portion indicates new disclosure – ASU 2016-14)**
- A description of the NFP's endowment investment policies, including all of the following:
  - Return objectives and risk parameters
  - How return objectives relate to the entity's endowment spending policy or policies
  - The strategies employed for achieving return objectives
- A reconciliation of the beginning and ending balance of the entity's endowment, in total and by net asset class, including, at a minimum, all that apply:

- Investment return (net)
- Contributions
- Amounts appropriated for expenditure that contain no purpose
- Restrictions
- Other changes

If the entity is subject to a donor restriction or applicable law or regulation that its governing board interprets as requiring the maintenance of purchasing power for donor-restricted endowment funds, then the entity must periodically adjust the disclosed amount that is required to be maintained either by the donor or by law in permanently restricted net assets to reflect that interpretation to maintain the purchasing power of the endowment fund in perpetuity. Under those circumstances, unless a donor provides an amount or an index, the entity would use the inflation/deflation index(s) that it deems most relevant for adjusting the net assets of the funds (i.e., Consumer Price Index or the Higher Education Price Index).

The entity must disclose each of the following, in the aggregate, for all underwater endowment funds:

- The fair value of the underwater endowment funds
- The original endowment gift amount or level required to be maintained by donor stipulations or by law that extends donor restrictions
- The amount of the deficiencies of the underwater endowment funds

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EXAMPLE

Note I: Endowment

KIDZ KAMP's endowment (the Endowment) consists of approximately 45 individual funds established by donors to provide annual funding for specific activities and general operations. The Endowment also includes certain net assets without donor restrictions that have been designated for endowment by the Board of Directors.

The Board of Directors has interpreted the Georgia Uniform Prudent Management of Institutional Funds Act (UPMIFA) as requiring the preservation of the fair value of the original gift as of the date of the donor-restricted endowment funds, unless there are explicit donor stipulations to the contrary. At June 30, 20X1, there were no such donor stipulations. As a result of this interpretation, we retain in perpetuity (a) the original value of initial and subsequent gift amounts (including promises to give net of discount and allowance for doubtful accounts donated to the Endowment and (b) any accumulations to the endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is added. Donor-restricted amounts not retained in perpetuity are subject to appropriation for expenditure by us in a manner consistent with the standard of prudence prescribed by UPMIFA.

We consider the following factors in making a determination to appropriate or accumulate donor-restricted endowment funds:

- The duration and preservation of the fund

- The purposes of the organization and the donor-restricted endowment fund
- General economic conditions
- The possible effect of inflation and deflation
- The expected total return from income and the appreciation of investments
- Other resources of the organization
- The investment policies of the organization

As of June 30, 20X1, KIDZ KAMP had the following endowment net asset composition by type of fund:

	Without Donor Restriction	With Donor Restriction	Total
Board-designated endowment funds	$ 6,511,186	$ -	$ 6,511,186
Donor-restricted endowment funds			
Original donor-restricted gift amount and amounts required to be maintained in perpetuity by donor	-	19,864,750	19,864,750
Accumulated investment gains	-	988,194	988,194
	$ 6,511,186	$ 20,852,944	$ 27,364,130

From time to time, certain donor-restricted endowment funds may have fair values less than the amount required to be maintained by donors or by law (underwater endowments). We have interpreted UPMIFA to permit spending from underwater endowments in accordance with prudent measures required under law. At June 30, 20X1, funds with original gift values of $19,883,738, fair values of $19,841,061, and deficiencies of $42,677 were reported in net assets with donor restrictions.

Investment and Spending Policies

We have adopted investment and spending policies for the Endowment that attempt to provide a predictable stream of funding for operations while seeking to maintain the purchasing power of the endowment assets. Over time, long-term rates of return should be equal to an amount sufficient to maintain the purchasing power of the Endowment assets, to provide the necessary capital to fund the spending policy, and to cover the costs of managing the Endowment investments. The target minimum rate of return is the Consumer Price Index plus 5% on an annual basis. Actual returns in any given year may vary from this amount. To satisfy this long-term rate-of-return objective, the investment portfolio is structured on a total-return approach through which investment returns are achieved through both capital appreciation (realized and unrealized) and current yield (interest and dividends). A significant portion of the funds are invested to seek growth of principal over time.

We use an endowment spending-rate formula to determine the maximum amount to spend from the Endowment, including those endowments deemed to be underwater, each year. The rate, determined and adjusted from time to time by the Board of Directors, is applied to the average fair value of the Endowment investments for the prior 12 quarters at June 30 of each year to determine the spending amount for the upcoming year. During 20X1, the spending rate maximum was 4.5%. In establishing this policy, we considered the long-term expected return on the Endowment and set the rate with the objective of maintaining the purchasing power of the Endowment over time.

Changes in Endowment net assets for the year ended June 30, 20X1 are as follows:

	Without Donor Restriction	With Donor Restriction	Total
Endowment net assets, beginning of year	$ 5,912,222	$ 19,839,035	$ 25,751,257
Investment return, net	1,143,669	1,412,392	2,556,061
Contributions	-	330,409	330,409
Appropriation of endowment assets pursuant to spending-rate policy	-	(728,892)	(728,892)
Other changes:			
Distribution from board-designated endowment pursuant to distribution policy	(544,705)	-	(544,705)
Endowment net assets, end of year	$ 6,511,186	$ 20,852,944	$ 27,364,130

Spending Formulas

UPMIFA identifies characteristics that constitute prudency and one of them deals with a spending formula.

- The duration and preservation of the endowment fund
- The purposes of the organization and the endowment fund
- General economic conditions
- The possible effect of inflation or deflation
- The average expected total return from income and the appreciation of investments
- Other resources of the organization

The investment policy of the organization

A common way to accomplish this is to separate the investment return into operating and non-operating amounts based on a total return formula. The concept of total return takes the components of investment return – net appreciation (depreciation) and investment income and breaks it down into spendable and non-spendable components. The non-spendable portion would be considered non-operating. Note that certain states have laws requiring this type of calculation and the non-spendable portion of the total return is required to be added to donor-restricted net assets.

Governing boards would be wise to ensure that the spending rate results in a spendable portion that is less than the actual return on investment. However, if the formula uses, for example, a three-year average in its computation, the amount considered spendable could exceed the actual return in years where the markets are sharply down. Governing boards can set a cap on the spendable portion. UPMIFA, as a model law, suggests a 7% spending cap although not all states have enacted that provision.

An example of a spending rate formula follows.

Spending Formula Example

Illustration 1:

Total expected return per year over the life of the assets (debt and equities)	–	Anticipated inflation per year over the life of the assets (debt and equities)	=	Spending rate
4.5%		**2.5%**		**2.0%**

3-year Average Investment Balance:	**$450,000**
	× 2.0%
Spendable Portion:	**$9,000**

Investment return, YE 9/30/2012:

$12,000	**interest**
12,625	**appreciation**
$24,625	**total return**

$9,000	**$15,625**
Spendable	**Not Spendable**

Illustration 2:

The Fund shall use a spending rate based on assumed future rates of return and assumed future rates of inflation. Based on the asset mix selected in our Investment Policy, we make the following assumptions:

Assumed long-term future net investment returns	_____ %
Less: Assumed long-term rate of inflation	_____ %
Net available to spend	_____ %
Based on these assumptions, we hereby establish our annual spending rate at	_____ %

Illustration 3:

The Fund shall use a spending rate based on actual past rates of return and actual past rates of inflation, as follows:

For the purpose of calculating income available for grants and distributions, the rate of return shall be based on a 5-year average net rate of return earned by the respective endowment account.

If the endowment account has been in existence for less than _____ years, a _____ year rate of return shall be calculated using the actual return of the Fund or Funds in which the account assets are currently invested.

The _____ year average rate of return determined in *a.* above shall be reduced by the average rate of change in the Consumer Price Index (inflation) for the previous _____ years.

The 'spending rate' shall be calculated by subtracting the _____ year average inflation rate from the _____ year average rate of return.

Formula:

Past: _____ year actual net rate of return _____ %
Less: _____ year actual rate of inflation _____ %
Net = Spending Rate _____ %

Investment Pools

NFP organizations may pool investments in order to manage the portfolios. These **investments may or may not arise from contributions**. When they arise from contributions, they are typically with donor-restricted endowment funds. When a pool is established, the value of the investments in the pool is divided into units and each pool category or participant is given an initial number of units. The pool is marked to market and a new unit value established each time additional assets are added to the pool or when there are withdrawals. Investment income is allocated to each pool category or participant based on the number of units held. The income is reported in net assets with or without donor restrictions depending on the stipulations of the donor.

Some investment pools may hold term endowments and quasi endowments in addition to donor restricted endowment funds. Accordingly, it is important to address how not only the gains but also the losses on the investment pool should be classified.

In **comingled pooled endowment funds**, the organization should look at the restrictions on each of the donor funds in the pool to make classifications on losses, not the aggregate of the pool.

EXPENSES

Contributions Made

Programmatic Investments

An NFP may make investments in other NFPs or other constituents that are not financial instruments. Examples are:

- Low interest or interest free loans to students with demonstrated need
- Student loans that are forgiven after graduation when a specified amount of community service is provided
- Investments in nonprofit, low income housing projects
- Loans to small for-profit business that are owned by members of an economically disadvantaged group where loans are not available commercially
- Investments in blighted urban areas to provide jobs or job training to residents
- Guarantees of an NFP's debt

These investments must meet two criteria:

1. Further the tax-exempt mission of the NFP

2. The production of income or appreciation is not the reason for conducting the activity

Programmatic loans are discussed below. Guarantees are discussed later in this section.

Loans

Loans are a very common programmatic investment. There is diversity in how entities handle them. Some account for them in the method that will be illustrated in the discussion on debt later in this section and impute interest at a market rate that incorporates the risk the NFP takes in making the loan (Scenario 1). Some look at this transaction entirely as a contribution or part contribution and part loan receivable (Scenario 2).

EXAMPLE

Scenario 1: A community foundation makes a loan to an entity that assists unemployed people in finding work. The entity is not particularly credit worthy so the five-year $100,000 loan is discounted at 15% with the contribution expense equaling the discount on loan receivable.

The discount then is amortized into interest income. The loan is also carefully watched for impairment.

Scenario 2: A community foundation makes a loan to an entity that assists unemployed people in finding work. The note is noninterest bearing and is unsecured and a balloon payment is due at the end of the five-year term. The community foundation believes that when the balloon payment is due that it will receive $58,000. When computing the present value of the most likely cash flow at a rate commensurate with the risk is 3% for a total of $50,000.

The community foundation would record the following:

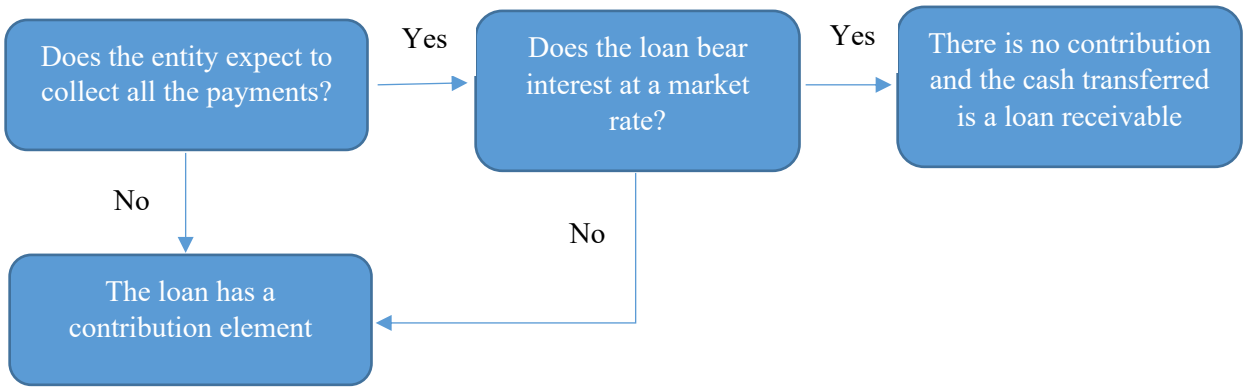
Cash transferred – $100,000

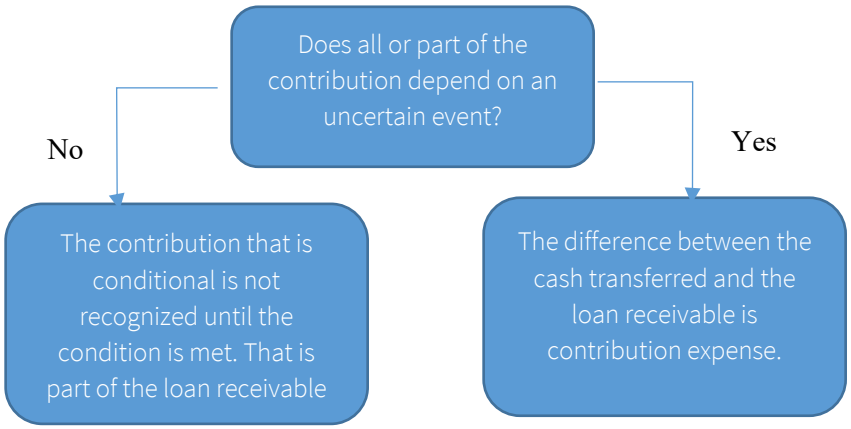
Loan receivable (most likely cash flow) – $58,000

Contribution expense – $50,000 = ($58,000 X .86261) rounded

Discount on loan receivable – $8,000 ($50,000 +$58,000 – $100,000)

The discount on the loan receivable would be amortized over the loan.





Sometimes programmatic loans come with a promise of forgiveness. These are conditional promises to give.

Sometimes these loans do not include forgiveness, but the investor decides to forgive the loan or part of it. The investor should determine whether this is a loan impairment or a decision to forgive. If there is an impairment, then this may be bad debt expense and a valuation allowance is appropriate. If it is simply a decision to forgive the loan for other reasons, it is a programmatic expense.

The NFP should make all the required disclosures in accordance with ASC 310-10 as well as the following:

- Number of loans outstanding
- Average face amount and average carrying amount at origination and the reason for the difference
- Program purpose being accomplished
- Total impairment losses in total and by program expense line item

NOTE: The FinREC believes that if a donor provides resources with a restriction that calls for the entity to make a programmatic investment, then the net assets are with donor restrictions until the investment is made. But if the donor specifies that a revolving loan fund be created, the net assets are subject to permanent restriction. This is true even if the loan fund is down due to losses or if it is eventually depleted.

Relevant Literature: ASC 460 - Guarantees

The guidance requires that organizations that guarantee the debt of others recognize a liability for guarantees, even when it is not probable that payments will need to be made under the guarantee. Certain NFP organizations such as community foundations guarantee the debt of other NFP organizations so that they can obtain more favorable interest rates. The guarantee is part conditional – that is the willingness to make payments if the other organization defaults. It is also unconditional – the gift of the guarantor's support. If there is no commensurate return, then this guarantee would be a contribution on the part of the guarantor.

The liability to be recorded on the books of the guarantor is illustrated below.

EXAMPLE

Contributions Made	
Community Foundation (Guarantor)	Part conditional – Foundation stands ready to make payment on default Part unconditional – Foundation gifts its credit rating to assist charity in obtaining lower interest rate
Guarantees $200,000 note for a charitable organization for 10 years 10% probability of default based on history of guarantees to other NFPs	Record at the greater of the guarantee's fair value or contingent liability amount Use amount of premium guarantor would need to issue to guarantee to unrelated-party or If lack of observable transactions, use expected present value technique
10% X $200,000 = $20,000 $20,000 x .767 (present value of $1 table at 4% risk free rate) = $13,511	Grant expense $13,511 Liability under guarantee of debt $13,511
Subsequent re-measurement is not discussed in ASC 460 but NPO A&A Guide Chapter 10 states that it would be reduced as the guarantor is released from the obligation	

NFPs may also make grants to other organizations. These may be pass-through grants of federal awards or contributions. They are accounted for as an expense by the grantor.

DISCLOSURE EXAMPLES

Note 10: Commitments and Contingencies

The Foundation guarantees the debt of certain local NFP organizations in order to assist them in obtaining bank financing at a reasonable cost. Guarantees, which range from 5-10 years, are recognized at fair value using the estimated discounted cash flow method at the risk-free rate represented by U.S. Treasury securities of similar duration. The interest rate on guarantees outstanding at June 30, 2013 is 4%. The Foundation's liability at June 30, 2013 for guarantees of debt was $43,500.

Note 5: Grant Expenditures and Designations

Expenditures for grants made to NFP organizations are considered incurred at the time they are approved by the Board of Trustees of the Foundation for payment to a specific organization and the beneficiary is notified. The Board of Trustees designates amounts of net assets without donor restrictions for grants to NFPs when the amounts have been approved but the beneficiary has not yet been identified.

Uncertainty in Income Taxes – ASC 740 (Uncertain Tax Positions)

This guidance deals with uncertain tax positions and is applicable to tax-exempt, as well as taxable entities. Under the guidance, NFP organizations are required to assess the certainty of their tax positions and could be required to record liabilities arising from uncertain tax positions for interest, penalties and potential taxes. There are also new disclosures. The Form 990 requires that the footnote on uncertain tax positions be included on Schedule D.

Tax positions for an NFP could be:

- Tax-exempt status – the organization could jeopardize its tax-exempt qualification by private inurement, substantial private benefit, excessive lobbying or political activity, excessive unrelated business income (UBI) and noncompliance such as failing to file Form 990. Health care organizations are under a particular focus as it relates to community benefit. Schedule H of the Form 990 highlights those aspects of a hospital where the IRS has concern.

- Unrelated business income – incorrectly identifying revenue streams that are subject to UBIT and expense methodologies for allocating expenses to UBI streams.

- Other issues such as transactions between related entities, NOL carry-forwards use, lobbying expenditures and the proxy tax, open years under the statute of limitations.

Regulatory authorities can always disagree with the tax-exempt entity so it is critical that the entity perform the analysis and document the analysis for its open tax years.

EXAMPLE

An NFP college was performing an evaluation of its tax positions for purposes of applying the guidance relative to uncertain tax positions. In evaluating its bookstore revenue, it considered the types of products sold: direct educational materials, non-educational (under the convenience exception) and other merchandise sales. They evaluated the amount of benefit to be recognized. The amount should be the largest benefit that has a greater than 50% likelihood of being realized upon effective settlement.

Possible Estimated Outcome	Individual Probability	Cumulative Probability
$200,000 (represents complete success in litigation or settlement with IRS)	5%	5%
$150,000 (represents a very favorable compromise)	25%	30%
$100,000 (fair compromise)	30%	60%
$75,000 (represents unfavorable compromise)	20%	80%
$50,000 (represents total loss)	20%	100%

Management determined that because $100,000 is the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement, the organization would realize that benefit in its financial statements.

A tax position that did not meet the “more likely than not” threshold could be recognized later if the organization reevaluates and determines the threshold has been met, if the statute of limitations expires or if the organization reaches a resolution with the taxing authority.

If the organization determines that it is no longer "more likely than not" that the position will not be sustained on audit, a change should be recognized in the statements in the period in which the change occurs.

An example disclosure follows.

EXAMPLE

Income taxes – The Museum is an NFP corporation and has been recognized as exempt from federal income taxes on related income under Section 501(c)(3) of the Internal Revenue Code (IRC). The Museum engages in certain activities unrelated to the mission of the organization for which it is responsible for payment of unrelated business income tax. Deferred tax assets and liabilities are measured based on enacted tax laws and rates expected to apply to taxable income in the years in which temporary differences are expected to be recorded or settled. Income taxes did not have a material impact on the financial position or results of operations of the Museum as of and for the years ended June 30, 2012 and 2013.

The Museum's policy is to record a liability for any tax position taken that is by the organization including any interest and penalties, when it is more likely than not that the position taken will be overturned by a taxing authority upon examination. Management believes there is no such position as of December 31, 2013 and 2012, and accordingly, no liability has been accrued.

The NFP entity must have a "more likely than not" level of certainty that its tax position would be sustained based on its technical merits. This means it should be supported by statutes, rulings, court cases, etc. The "more likely than not" level is a 50% or more chance that the position will be sustained by the IRS. The analysis should be performed by the "unit of account". Therefore, all revenue streams should be analyzed.

Note that disclosures about uncertain positions are only necessary if there are uncertain positions such as the one discussed in the example footnote.

Fundraising Expenses

Fundraising costs are defined in the glossary of the ASC as activities undertaken to induce potential donors to contribute money, securities, services, materials, facilities, other assets or time. The costs of soliciting exchange transactions are considered management and general costs. Costs of fundraising events should be expensed as incurred.

Sometimes fundraising costs will be incurred in one period where the benefit is in future periods. For example, if an entity compiles a mailing list of potential donors or solicits contributions in a direct response activity. No contributions have been received, but ASC 958-720 requires them to be expensed at the time they are incurred anyway.

NOTE: The FinREC believes that the costs of tangible fundraising assets such as brochures or promotional items may be recorded as an asset when purchased and expensed when used. Since this is similar to inventory, the entity should determine whether the value of the items has been impaired.

ALLOCATION OF JOINT COSTS

Relevant Literature

- **ASC 958-720, *Other Expenses,* Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities that Include Fund-Raising**

NFPs are under pressure from donors and other interested parties to maintain supporting expenses at a reasonable level. Accordingly, when certain fund-raising activities include components that are program related or related to management and general activities, some NFP organizations have found it beneficial to allocate the costs among the activities. To prevent abuse and help ensure accurate financial reporting in this area, professional literature sets forth specific criteria that must be met in order to allocate some expenses that would otherwise be considered fund-raising to program or management and general categories.

These criteria are so stringent that many NFP organizations have determined that it is too much work to go through all the strategy and documentation necessary to be able to reclassify some costs that would otherwise be considered fund-raising as program or management and general. There are others, though, that believe the benefits outweigh the cost.

In order to be able to qualify for joint cost treatment, the activity must meet three very specific criteria:

1. Purpose

   The activity must accomplish program goals in addition to a fund-raising appeal. If it meets that test, it should call for a specific action other than making the contribution. Note that it is not enough to simply educate the audience about the cause; there must be a specific call to action. Other things to be considered are:

   – If the majority of compensation for any party performing part of the activity varies based on contributions raised, the purpose criteria is **not met**

   – If the organization conducts a similar type program or activity that doesn't include a fund-raising component in the same fashion and on a similar or larger scale, then the purpose criterion **is met**

   – Even if the organization does not conduct similar activities, if there is other available evidence that indicates that the purpose criterion is met, that is permissible. Other evidence might include program results of the activity being measured, how employees contributing to the event are measured, how the organization evaluates the results of the event or the qualifications of third parties or employees performing the activity

2. Audience

   The audience should be selected based on their need or reasonable potential need for the information. There is a rebuttable presumption that if the audience includes prior donors or is based on ability to donate, this criterion is not met.

- The audience must have the ability to take specific action to help the organization meet its program goals
- The organization must meet a requirement to direct the management and general activity to the audience (like an annual meeting or annual report sent by mail) or the audience must have the potential need for the management or general activity

3. Content

   The content criterion is met if the content of the joint activity supports the program or management and general functions as follows:

   - It calls for specific action by the recipient to help accomplish the organization's mission
   - It fulfills one or more of the organization's management and general responsibilities

The organization should allocate the costs in a systematic and rational manner. One example would be to determine the costs of the joint activity and then determine the amount of the costs that would have been incurred if the activity were only held as a program or management and general activity. The ratio of program/management to total would be the amount allocated to that activity.

EXAMPLE

An NFP organization runs a summer camp for children with diabetes who are on insulin. Education is not a part of the organization's mission. The NFP organization solicits contributions from individuals in local shopping malls. The volunteers explain to the people who they encounter in the mall about the benefits of the camp. They distribute brochures explaining the camp activities, who can attend and the benefits to the children. Requests for contributions are also included in the brochure.

Purpose: The activity does not include a specific call to action. There is an educational component but this does not constitute a call to action.

Audience: The audience criterion is met because it is not based on the audience's ability to contribute. All mall-goers are solicited.

Content: The content criterion is not met because there is not a call for action. Mall-goers are educated about the benefits of this camp for children, but they are not asked to do anything.

Conclusion: Do not allocate joint costs. The costs are strictly fund-raising.

An NFP organization runs a summer camp for children with diabetes who are on insulin. The organization's position is that the quality of life of these children will be improved and that some diabetes conditions can be avoided by proper diet and exercise. The NFP organization mails a brochure on the importance of diet and exercise to residents of its service area that have children. The last page of the three-page brochure includes a form to remit contributions to the organizations. The content of the brochure is primarily educational and talks about how diabetes can be prevented and encourages parents to watch the diet and activity level of their children and to take action. In addition, the NFP organization also sends residents of the area with children a separate brochure that contains nutritional information and ways that children might exercise in the vicinity. The audience is not based on whether or not the recipients have the ability to contribute or have ever contributed to the NFP organization.

Purpose: The activity calls for specific action on the part of the recipient on behalf of their children. In addition, the purpose criterion is met based on other evidence. It conducts a similar type program or activity that doesn't include a fund-raising component in the same fashion and on a similar scale.

Audience: Criterion is met because the audience is based on its need to use or reasonable potential for use of the action called for by the program components.

Content: The activity calls for specific action by the recipient on behalf of their children.

Conclusion: Allocate the costs of the first brochure as joint costs. The second brochure should be charged to program.

Allocating Joint Costs

There are numerous ways in which costs can be allocated. The most frequently used methods are:

- Physical units method – costs are allocated to materials and activities in proportion to the number of units that can be attributed to the output
- Relative direct cost method – costs are allocated to the activities (fund-raising, program and general and administrative) based on the direct costs incurred for each
- Standalone joint cost method – costs are allocated to the activities (fund-raising, program and general and administrative) based on the costs that would have been incurred if the activity had been conducted by itself.

EXAMPLE 1

An NFP produced a brochure discussing the value of exercise and diet to children to prevent diabetes that also included a fund-raising appeal. When evaluated, this activity met the criteria to enable the costs to be recorded as joint costs.

There were $10,000 of costs in the form of personnel time, stationery, postage and envelopes. The finance officer evaluated three different ways that the costs could be allocated.

Allocation of Joint Costs

Components – personnel time, stationery, postage and envelopes = $10,000.

	Physical Units
Activity	Costs allocated on basis of proportion of entire mailing.
Brochure discussing value of exercise and diet to children to prevent diabetes. Also	(1/3 of space) X 10,000 = 3,333 (2/3 of space) X 10,000 = 6,667
	Relative Direct Cost

includes fund-raising request	Costs that can be separately identified with program are more expensive because of the time involved in putting together the materials. The fund-raising section is very inexpensive to produce. It would cost about the same to mail them (5,000/6,000) X 10,000 = 8,333 (1,000/6,000) X 10,000 = 1,666
	Standalone Joint Cost If materials and personnel time were costed out for two separate mailings, the amounts would have been $9,000 for program and $7,000 for fund-raising. Allocate as follows: (9,000/16,000) X 10,000 = 5,625 (7,000/16,000) X 10,000 = 4,375

EXAMPLE 2

In 2012, the Symphony conducted activities that included requests for contributions, as well as program and management and general components. Those activities included direct mail campaigns, special events and a telethon. The costs of conducting those activities included a total of $150,000 of joint costs which are not specifically attributable to particular components of the activities. Joint costs for each activity were $30,000, $50,000 and $70,000, respectively. The joint costs were allocated as follows:

Note 6: Allocation of joint costs

Fund-Raising	$80,000
Youth Enrichment Program	40,000
Masters Series	20,000
Management and General	10,000
	$150,000

LIABILITIES

Relevant Literature

- **ASC 835, Interest**
- **AAG-NPE, Chapter 5 (5.172-5.174)**
- **ASC 450, Contingencies**

Most NFP organizations are exempt from federal income tax under provisions of the Internal Revenue Code, although an NFP organization may be responsible for other forms of taxes, including state taxes in some states, property taxes and unrelated business income taxes. If an NFP organization has unrelated business income, it will be taxed at the regular corporate rate and will need to follow the requirements set forth in ASC 740, *Income Taxes.* Accordingly, the

organization may have income tax expense, income taxes payable or refundable, as well as deferred tax liabilities or assets representing the effect of temporary differences.

NFPs have the same types of liabilities that are associated with for-profit entities so these will not be addressed here. Liabilities that are specific to NFP organizations follow:

- Liabilities to third parties such as government agencies. These may be the result of cash received where services have not been performed. This is deferred revenue and was discussed earlier in this section
- Costs that have been disallowed resulting in a liability to return money to the government
- Environmental liabilities as a result of EPA issues identified on a piece of donated land
- Returns of contributions to donors when restrictions cannot be met
- Annuity obligations (covered above in the discussion of split-interest agreements)
- Amounts held for others in agency transactions (covered above in connection with ASC 958-605)
- Guarantees of indebtedness of others (covered above in connection with ASC 460) and contingencies

Municipal Bond Financing and Other Long-Term Debt

NFPs may issue **tax-exempt debt** that requires compliance with various covenants. Tax-exempt debt is a benefit for an NFP organization in that they get to pay a **lower rate of interest** since the interest on the debt is not taxable to the bondholder. They are not required to recognize the difference between the market rate for similar debt and the stated rate on the tax-exempt debt. **ASC 835**, *Interest*, provides several exceptions to the rule requiring imputation of an interest rate. **Exception E** applies when transactions are affected by the tax attributes or legal restrictions prescribed by a governmental agency. Examples given in that guidance are industrial revenue bonds, tax-exempt obligations, government guaranteed obligations and income tax settlements.

NFPs also receive loans from third parties at “interest free” or reduced interest rates. Loans from governmental agencies should be evaluated to see if the exception provided by the guidance discussed above, applies. The AAG-NPE provides guidance for accounting for these loans.

The AAG-NPE states that if an organization enters into a loan that allows it to pay a below market rate of interest or no interest at all, then the organization should record the difference between (a) the fair value of the loan based on the market rate and (b) the value of the loan based on the stated rate as a donor restricted contribution. No adjustments would be made for fluctuations in the market rate after the date of donation.

Each year the organization would record interest expense during the loan period, as well as a corresponding reclassification between with donor restricted net assets and net assets without donor restrictions for an amount equal to the interest expense.

EXAMPLE

On January 1, 20X1, the client receives an interest-free loan of $200,000, payable on December 31, 20X3. The purpose of the loan is to pay operating expenses. The appropriate imputed rate of interest is 6%.

1/1/X1:

Cash	200,000	
Loan payable		167,730
Contribution revenue with donor restrictions		32,270

The liability is reported at the fair value of the loan, using the present value of $200,000 due in three years, discounted at 6%.

12/31/X1:

Interest expense	10,080	
Loan payable		10,080
(Accretion of loan using the effective interest method)		
Net Assets with donor restrictions	10,080	
Net Assets without donor restrictions		10,080
(Reclassification due to lapse of restriction)		

Using the effective interest method, in the years ended December 31, 20X2 and 20X3, the client would record interest expense and a reclassification to net assets without donor restrictions of $10,864 and $11,326, respectively.

At the end of the period, if the loan was not repaid, then the terms of the transaction would dictate the accounting at that time. If the loan was forgiven, then a contribution would be recorded. If the loan was repaid, then the loan payable, which had accreted to $200,000, would be relieved and outgoing cash in that amount would be recorded.

DISCLOSURE EXAMPLES

Note 6: Note Payable

The Food Bank has an unsecured non-interest bearing note payable to the Town of Middleburg. The note is payable in equal monthly installments over five years. The note was recorded at fair value at the date of inception with interest imputed at 5% per year. At December 31, 2013, the carrying value of the note was as follows:

Note payable	$250,000
Unamortized discount on note payable	(30,000)
Carrying value	$220,000

During the year ended December 31, 2013, $10,500 was reclassified from contributions with donor restrictions to without donor restrictions with a corresponding amount charged to interest expense.

Note 7: Uncertainties

A major project of the Organization has been funded with grants from the USAID, the United States Agency for International Development. A portion of those funds were used to pay for operating expenses and the Organization may be liable for repayment of up to $500,525 in disallowed costs. In addition, the Organization borrowed $150,000 from the endowment fund to pay for operating expenses. These conditions create an uncertainty about its ability to continue as a going concern. Management is currently

negotiating an agreement with USAID relating to the disallowed costs and is expecting an infusion of cash through contributions from two members of the Board of Directors. The successful outcome of these events will allow the Organization time to expand its program revenues. The financial statements do not include any adjustments that might be necessary if the Organization is unable to continue as a going concern.

Conduit Debt Securities

An NFP entity may finance its activities from contributions, its cash flows from operations, proceeds of debt from a bank or from proceeds from the issuance of tax-exempt bonds or other obligations that are issued through state and local financing authorities. The NFP is responsible for the payment even though they may be issued through a conduit. These are referred to as municipal bonds.

In conduit arrangements, the authority (e.g., housing authority, hospital authority, etc.) issues the securities such as limited obligation revenue bonds and certificates of participation. Then it lends the proceeds to the obligor that is the NFP. The NFP is responsible for the interest and principal repayment to the bondholder and will generally post collateral. The collateral may be a revenue stream or it could be a mortgage on the property that is being financed. There are also generally debt covenants.

Municipal bonds can have fixed or variable interest rates. A common financing technique is to initially issue a lower variable rate debt and a floating-to-fixed interest rate swap. The economics will be very similar to fixed rate debt.

The bonds may or may not be tax exempt. Tax-exempt bonds are issued to finance services or facilities for the public good. Interest is often exempt from federal and sometimes state and local taxes.

Some conduit bonds trade in the public market. In addition, when conduit bonds trade in the public market or are widely distributed, the entity is required to provide disclosures such as those for the fair value of financial instruments.

This is not to be confused with the guidance in ASU 2013-12, *Definition of a Public Business Entity.* This amendment does not include NFP entities in its scope. Its purpose is to define public business entities for purposes of the FASB's Private Company Guidance.

Credit Enhancement

Credit enhancement uses the credit standing of another party to be able to secure a lower rate. Bond insurance, bank letters of credit and other facilities such as guarantees are a form of credit enhancement. As noted earlier, foundations may provide guarantees on bank borrowings of NFP and members of the governing board may also guarantee the debt of an NFP.

When the credit enhancement is provided through a letter of credit, the debt would bear the rating of the issuing bank that is promising to pay in the event the NFP defaults. These are available for a specific time period. Bond insurance provides the unconditional, irrevocable commitment from a bond insurance company to make payments in the event of default and the bonds would carry the rating of the municipal bond insurer. These commitments last for the life of the bonds.

The downgrade of the bond insurer or the bank (or other entity) can have implications for triggering instances of default under the bond agreement and derivative contracts.

Extinguishment

NFPs follow ASC 405-20 as it relates to accounting and financial reporting standards for extinguishment and modification of debt. A liability is extinguished when the debtor pays the creditor or is legally released by the creditor or judicially. One way to pay the creditor could be reacquiring the securities. This may happen if the NFP reacquires the bonds in a secondary market purchase. They may be held in treasury or canceled. Even if the NFP intends to remarket them, they would never be considered assets of the entity.

Bonds may also be repurchased in a failed debt remarketing of its variable rate debt. If another investor cannot be found, then the NFP will need to pay the bondholder. If the entity has a liquidity facility, then that provider will advance the money and the bonds belong to the facility provider. The liquidity facility contains a rate for this type of event and that rate becomes the new rate. If a new bondholder can be found, then the proceeds are used to pay off the facility and the bonds revert to their normal rate.

Refunding

An NFP may decide to issue new debt to pay off the old debt. This is referred to as a refunding. The new debt could be held by the same creditor and so the refunding may really be a modification of the terms rather than an extinguishment. There are three types of refunding – current refunding, advance refunding and crossover refunding.

Current	New debt proceeds are used to repay old debt within 90 days of the first call date or maturity of the debt to be refunded.
Advance	New debt proceeds are placed in escrow and invested until repayment occurs in the future. This would be greater than 90 days from the first call date or maturity of the debt to be refunded.
Crossover	Debt is issued to pay off existing debt. The bonds are collateralized initially by an escrow of investments purchases with the crossover bond proceeds and the refunded bonds are secured by the original collateral or revue stream. On a specific date, the investments in escrow are sold and the refunded bonds redeemed. Then the crossover bonds are collateralized by the ordinal collateral or revenue stream

With these situations, the bonds have a call option that allows the entity to repay the bonds prior to their maturity date.

Defeasance

If the entity wants to retire the debt early but there is not a call option, then the bonds could be defeased. Here, the entity purchases government securities and places them in escrow. They irrevocably pledge the securities to the payment of debt. The securities and the retained earnings are enough to pay both the principal and the interest when due.

The defeasance can be in-substance or legal. The NFP has not paid the creditor so the liability is considered extinguished only if the entity is legally released either judicially or by the creditor. If the defeasance is legal, then the creditor releases the entity from being the primary obligor. With an in-substance defeasance, the liability is not extinguished and the NFP is not released from the debt.

A full discussion of the accounting is beyond the scope of this manual. Participants should see ASC 405-20-55 for implementation guidance.

Bond Modifications and Exchanges

NFPs may also replace one debt instrument with another one and the creditor is the same. Then it may be necessary to determine if the transaction is a modification or an extinguishment.

With a conduit bond offering that involves a governmental financing agency, it is important to determine whether the financing agency is really a principal or an agent. If the financing agency is an agent, then the analysis looks through the intermediary. But if it acts as principal, then the intermediary is considered a third-party creditor.

ASC 470-50-40 states that an exchange of debt instruments with substantially different terms is a debt extinguishment and the liability should be derecognized. When the debt situation is untroubled, then an exchange of debt instruments is accomplished with terms that are substantially different if the present value of the cash flows under the terms of the new debt is at least 10% different from the present value of the remaining cash flows under the original debt. If not, it is a modification.

The unit of account is on a bondholder-by-bondholder basis so if there are many holders then this would very likely be an extinguishment.

A gain or loss on the debt extinguishment is measured as the difference between the reacquisition price and the net carrying amount of the extinguished debt. It would be recognized in the income in the period of extinguishment and not be amortized to future periods. The reacquisition price includes the amount paid on the extinguishment including call premium and costs of reacquisition. If the extinguishment is a direct exchange of securities, then the reacquisition prices is the fair value of the new securities. The net carrying amount of the extinguished debt is the amount due at maturity as adjusted for unamortized premium, discount, and cost of issuance.

Debt Issue Costs

The NFP will incur costs to exchange or modify its debt. The accounting depends on the party who receives the fees and is summarized below.

Method	Debt issue costs between debtor and creditor	Third party costs (e.g., legal fees)	Old debt issuance costs
Extinguishment-new debt recorded at fair value	Associate with the extinguishment and include in determination of gain/loss	Amortize over the term of the new debt	Net carrying amount of debt is the amount due at maturity, adjusted for unamortized premium, discount and cost of issuance. This is incorporated into the loss/gain.
Modification	Associate fess with the replacement or modified debt along with any existing unamortized premium/discount and amortize as an adjustment of interest expense over term of replacement debt	Expense as incurred	No action needed

ASU 2015-03, *Simplifying the Presentation of Debt Issuance Costs*, was issued by the FASB to simplify the presentation of costs incurred upon debt issuance. This ASU was effective for all financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within fiscal years beginning after December 15, 2016. Retrospective application is required.

The debt issuance costs incurred do not meet the requirement of being recorded as an asset, as they do not provide any future benefit. However, GAAP requires that these costs be recorded on the balance sheet as a deferred charge and be amortized over the financing term. FASB Concepts Statement No. 6, *Elements of Financial Statements*, states that debt issuance costs are similar to debt discounts and, therefore, would increase the effective interest rate.

This ASU simplifies the presentation of debt issuance costs by requiring debt issuance costs related to a debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that liability, consistent with debt discounts. The recognition and measurement (effective interest method) of these costs are not changed by this amendment. Remember that these amounts are amortized into interest expense, not with depreciation and amortization.

EXAMPLE

An NFP school issued bonds in 20X2 to pay for an expansion of the gymnasium and locker rooms for its high school. At June 30, 20X5, it had the following presentation in the notes to its financial statements.

Prior to ASU 2015-03:

Long-Term Debt:

Principal Amount	$24,000,000
Less unamortized discount	(2,070,000)
Long-term debt less unamortized discount	$21,930,000

The CFO reclassified the debt issue costs from an asset to a contra-liability account resulting in a net lower debt item on the statement of financial position. The new footnote for 2016 follows.

After Adoption of ASU 2015-03:

Long-Term Debt:

Principal Amount	$23,542,350
Less unamortized discount	(1,750,000)
Less unamortized debt issue costs	(365,000)
Long-term debt less unamortized discount and debt issuance costs	$21,427,350

TECHNICAL QUESTIONS RELATED TO TAX EXEMPT OFFERINGS (CONDUIT DEBT)

NFP entities with conduit bonds that meet certain characteristics are subject to the same effective dates and expanded disclosure requirements that certain FASB standards require for public business entities. It is important to note that not all conduit bonds fit those characteristics, so some NFPs may not be subject to these requirements.

NFP entities are specifically scoped out of the definition of public business entity (PBE) in FASB's Master Glossary. But they are subject to the same requirements imposed on PBEs by some FASB standards. Several FASB standards state that an NFP that has "issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market" to the same accelerated effective dates and expanded disclosure requirements imposed on PBEs. Examples are the new revenue, leases, and grant accounting standards. NFPs are referred to as public entities.

There was enough confusion around the PBE definition that the AICPA issued five Technical Questions and Answers (TQA) to clarify certain terms in the definition. The reason this is important is that NFPs need to determine where they may take advantage of delayed effective dates and scaled back disclosures.

TQA 7100.01 provides guidance on how entities should evaluate whether their financing instruments are securities. The definition of security in the PBE is now linked to the definition of a security in FASB ASC 320, *Investments – Debt and Equity Securities*, as follows:

Security – A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:

- It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.
- It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.
- It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

TQA 7100.02 clarifies that securities may be in the form of equity or debt instruments. For NFPs, the financing instruments are generally in the form of debt instruments or obligations, for example municipal and economic development bonds.

TQA 7100.03 states that a conduit bond obligor is an entity that is obligated for the repayment of conduit debt securities. Conduit debt securities are municipal securities issued by state or local governments, agencies or instrumentalities on behalf of a third-party—for example, an NFP.

An over-the-counter (OTC) market includes an interdealer quotation or trading system for securities that are not listed on an exchange. Markets that are not generally accessible by the public or that do not publish such data points are not OTC markets for the purpose of the PBE definition. This would also be true for deciding whether the NFP is considered public.

TQA 7100.04 states that municipal bonds issued in public offerings, such as when an underwriter purchases municipal securities from an issuer for reoffering to the public, trade thereafter in the public OTC market. But if municipal securities issued in private placements generally are sold directly to qualified investors such as institutional investors, they are not deemed to trade in public OTC markets. This is because the markets in which they are available are limited to only certain investors. The investors are also typically subject to restrictions on resale.

TQA 7100.05 clarifies that the Municipal Securities Rulemaking Board (MSRB) Electronic Municipal Market Access (EMMA) is not itself an OTC market. EMMA is the official SEC designated repository for disclosure documents related to public offerings of municipal securities. EMMA provides historical trade prices, credit ratings, and other information related to those securities, but does not allow execution of trades. NFPs that have issued conduit bonds that trade in public markets are required to provide continuing disclosures on EMMA.

It is important that each financing instrument be assessed through this decision tree. So, if the NFP is a conduit bond obligor of municipal securities, then it should determine whether these securities are traded in the public OTC market. And if so, the NFP would be subject to the accelerated effective dates and/or expanded disclosures imposed on PBEs in the new standards.

CAPITALIZATION OF INTEREST WHEN THERE IS TAX-EXEMPT DEBT

Tax-exempt entities often ask questions about the need to capitalize interest cost when there is no specific borrowing for them. However, interest should be capitalized for all assets that take a period of time to prepare them for use even if the entity is paying for construction costs with cash or grant proceeds. Of course, in some cases, where the amount of time or expenditure is not material, such as the installation of cubicles in office space, capitalization of interest would not be required.

The theory related to the capitalization of interest is that it represents interest that could have been avoided during the assets' acquisition period. This means that the money used to construct the building would not have needed to be borrowed (i.e., and interest not incurred), or could have been used to pay down existing debt if the expenditures had never been made. Interest is seen as an avoidable cost.

The only time that interest would not be capitalized is if there were no other borrowings outstanding. It would not be possible to capitalize interest if the interest did not exist.

There are, however, special rules for interest on tax-exempt bonds as discussed below.

Capitalization Period

The capitalization period begins when expenditures are incurred, when the activities are in progress and when interest cost is present. In addition, as long as those three circumstances continue, interest is capitalized. If part of the asset is placed in service, then the capitalization stops on that asset.

There is an exception related to tax-exempt borrowings. Capitalization begins at the date of the borrowing for qualifying assets financed with the proceeds of tax-exempt borrowings that are restricted for that purpose regardless of when the expenditures are incurred.

Capitalization Rate

The average qualifying expenditures for the period are multiplied by a capitalization rate. If an entity has more than one source of borrowings, it would essentially use more than one rate in the calculation because the capitalization rates are based on the rates applicable to borrowings during the period. If the project was financed solely with one source of debt, then that specific rate would be used. In some cases, there may be a combination. For example, if the bonds represented only a portion of the funding, a weighted average of the rates applicable to the entity's other borrowings would be used, up to the amount of the expenditures for the building. The entity would not capitalize more interest than was incurred.

If the entity was a consolidated entity, then the limitation would be that of the consolidated interest. However, when statements are separately issued, the limitation is to the interest costs incurred by that entity.

Tax-Exempt Borrowings, Gifts, and Grants

If the building is financed with the proceeds of tax-exempt borrowings and those funds are externally designated for the acquisition of specified qualifying assets or to service the related debt, the amount of interest cost capitalized is computed differently than if the debt were from a financial institution or if taxable bonds were issued. Interest earned on the proceeds of the tax-exempt borrowings is offset against the cost of the borrowings.

This is the case because the FASB believes that when an entity considers financing with tax-exempt borrowings, the interest it earns is considered significant to the initial decision to acquire the asset. Therefore, the funds flow from borrowing, temporary investment, and construction expenditures are all considered a part of the decision process.

The amount of the interest cost that is capitalized would be the interest cost of the borrowing less any interest earned on related interest-bearing investments acquired with proceeds of the related tax-exempt borrowings from the **date of the borrowing** until the asset is ready for its intended use. However, if the entity financed the construction with tax-exempt debt but the proceeds were not designated for the acquisition of the asset or its debt service, this would not apply.

The following example illustrates how interest would be capitalized when tax-exempt debt was used to finance a portion of the expenditures.

EXAMPLE

A university is preparing to construct a new fine arts center (Center). The project costs are budgeted at $10 million. The financing for the Center follows:

- $4 million government grant which must be used for this construction project. It is payable $1 million per year.
- $4 million tax-exempt borrowing at an interest rate of 4% (interest expense is $160,000 per year).
- $2 million from operations.

The Center has $10 million in other borrowings that are outstanding throughout the construction of the project. The interest rate on those borrowings is 6%. Other qualifying assets of the entity never exceed $5 million during the construction of the project.

The proceeds from the borrowing and the initial phase of the grant are received one year in advance of starting construction on the project and are temporarily invested in interest-bearing investments yielding 2%. Interest income earned from temporary investments is not reinvested.

The Center believes that the project will take four years after start of construction to complete.

The numbers below describe the steps performed on each line item in the calculation.

(000's omitted)			***20X1***	***20X2***	***20X3***	***20X4***	***20X5***
(1)	*Average qualifying assets*		*-*	*2,000*	*5,000*	*8,000*	*9,000*
(2)	*Average funding received*						
a.	*Tax-exempt borrowing ($4 million)*		*4,000*	*4,000*	*4,000*	*4,000*	*4,000*
b.	*Government Grant ($4 million)*		*1,000*	*2,000*	*3,000*	*4,000*	*4,000*

(3)	*Average temporary investments, not less than zero*	*(1-2)*					
a.	*Tax-exempt borrowing ($4 million)*		*4,000*	*3,000*	*1,000*		
b.	*Government Grant ($4 million)*		*1,000*	*1,000*	*1,000*		
(4)	*Interest earned (at 2%)*						
a.	*Tax-exempt borrowing ($4 million)*		*80*	*60*	*20*		
b.	*Government Grant ($4 million)*		*20*	*20*	*20*		
(5)	*Average qualifying assets in excess of borrowing, **LESS** interest earned on grant*	*((1)-(2a, b)-60)*					*940*
(6)	*Interest cost capitalized – other borrowings*	*((5)*6%)*					*56*
(7)	*Interest capitalized – tax exempt borrowings*	*((2)*4%)*	*160*	*160*	*160*	*160*	*160*
(8)	*Interest capitalized*	*((7)-(4a))*	***80***	***100***	***140***	***160***	***216***
(9)	*Amount of capitalized interest added to construction*		***696***				

Interest rate on the bonds is 4%
Interest rate on other borrowings is 6%
Interest rate for earnings on qualifying assets is 2%

(3) a. & b. Note that the entity may choose to use the grant funds first or the borrowings first. This grant is a federal award. This is the amount over the average qualifying assets that is assumed to earn interest at 2%.80

(5) Note that the average qualifying assets in excess of borrowing is the sum of the average qualifying assets (1) less the average funding received (2) less the interest on the grant (9,000-8,000-60).

(6) Interest cost on other borrowings is line (5) times 6%, the assumed interest cost on the other borrowings.

(7) Interest earned on tax-exempt borrowings is line 2 times 4%, the bond rate.

(8) Interest capitalized is the interest capitalized from the tax-exempt borrowings (7) and other borrowings (6) less interest earned on tax-exempt borrowings in temporary investments (4a).

A step-by-step explanation by line number follows:

1. As noted in the calculation above, the construction began in 20X2, which was one year after the tax-exempt borrowing occurred. The amounts in line 1 are cumulative because they represent the amounts upon which the capitalization rate is applied.

2. Line 2 represents the average funding received. Note that the tax-exempt borrowing occurs one year earlier than the construction. So therefore, the amount of interest income earned begins at that point. This is illustrated on line 4.

3. Line 3 represents the average temporary investments. Note that the temporary investments only last until the construction reaches the point where the money is spent.

4. Line 4 represents the interest earned not only on the tax-exempt borrowing but the grant. ASC 835-20 calls for the interest that would be earned on the amounts restricted for the project to be charged with the interest in just the same way as the borrowings.

5. Line 5 represents the calculation of the amount of qualifying assets remaining where interest will need to be capitalized. These are the "other borrowings" after subtracting the cumulative interest earned on the grant. In this case, the $1,000 represents the $9,000 of construction costs to date less the $8,000 in tax-exempt bonds issued for the purpose and the grant money restricted for the construction. The amount of interest earned on the grant money is subtracted from that leaving the amount of other borrowings subject to interest calculation.

6. Line 6 represents the calculation of interest on line 5.

7. Line 7 represents the interest cost on the tax-exempt borrowings for the period (to date).

8. Line 8 is total interest capitalized. This is the sum of line 6 and 7 but less the interest earned on the tax-exempt borrowing.

The resulting project costs anticipated are the $10 million plus the interest capitalized which is the sum of line 8 for the five years, $696.

GOING CONCERN ISSUES

ASC 205-40, *Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*, requires management to make an assessment to determine whether conditions or events exist that raise substantial doubt about an entity's ability to continue as a going concern for greater than one year after the date the financial statements have been issued or are available to be issued. If management's consideration indicates that it is not probable that the entity will meet its obligations as they become due, then management will evaluate whether it is probable that they would be able to mitigate the conditions or events. If management determines that its plans will mitigate the condition or event, they must disclose the conditions/events that gave rise to the going concern issue and disclose their plans. However, if management believes that their plans will not alleviate the going concern issue, then management will make that statement. The statement must include the wording that there is substantial doubt about the entity's ability to remain a going concern. In addition, some NFPs may use a special purpose framework to prepare their financial statements.

If there is substantial doubt raised and it is alleviated by management's plan, disclose the following:

- Principal conditions or events that raised substantial doubt before consideration of management's plans.
- Management's evaluation of the significance of the conditions or events in relation to the entity's ability to meet its obligations.
- Management's plans that alleviated the substantial doubt about the entity's ability to remain a going concern.

If there is substantial doubt raised but it is **NOT** alleviated by management's plan, disclose the following:

- Principal conditions or events that raised substantial doubt before consideration of management's plans.
- Management's evaluation of the significance of the conditions or events in relation to the entity's ability to meet its obligations.
- Management's plans that are intended to mitigate the substantial doubt about the conditions or events that raised the substantial doubt.
- A statement that there is a substantial doubt about the entity's ability to continue as a going concern.

This disclosure will remain as long as there is substantial doubt. When substantial doubt has been alleviated, then there should be disclosure of how the substantial doubt was resolved.

CONSOLIDATION ISSUES

Relevant Literature:

- **ASC 958-810, Consolidation – Reporting of Related Entities by NFP Organizations**
- **ASC 810, Consolidation**

The guidance used to determine whether or not to consolidate a related entity depends on the type of entity. The reporting entity should use the definition in the FASB ASC glossary to determine whether the related entity is an NFP entity.

NOTE: For purposes of this guidance, the FinREC believes that if an NFP entity has an interest in an entity with nonprofit corporation or nonprofit membership structure, that it would meet the definition. But that if it has a non-corporate structure such as a partnership or LLP, that it would not be an NFP entity either because of the existence of ownership interests or because it provides lower costs or economic benefits to the owners, members or participants or both.

Consolidation with For-Profit Entities

The guidance for determining whether a for-profit entity should be consolidated with an NFP organization is found in ASC 958-810. The major decision point is whether or not the NFP organization has a controlling financial interest in the for-profit organization through direct or indirect ownership of a majority voting interest. This is generally, directly or indirectly, ownership of over 50% of the shares. ASC 810 also says that the power to control could exist with a smaller percentage ownership. For example, contracts, leases, agreements with other stockholders or a court decree may have an impact on control. However, NFP entities are not subject to the guidance for variable interest entities so this would not be considered.

ASC 810 also discusses situations where control does not rest with the majority owner because of bankruptcy, legal reorganization or other factors.

It is possible that minority rights could keep the NFP from having a controlling interest with this level of ownership. NFP organizations are not required to apply the guidance for variable interest entities under ASC 810-10. In these cases, the entity should not be consolidated. If the entity has

a research and development arrangement where all of the funds for those activities are provided by the sponsor, then the entity applies the guidance in ASC 810-30 to determine whether the sponsor should consolidate the arrangement.

If the reporting entity has a contractual management relationship with another entity, then it should apply the guidance in ASC 810-10 to determine whether or not it should be consolidated.

An NFP organization that owns 50% or less of the common stock or in-substance common stock of a for-profit organization and has significant influence would account for the investment using the equity method unless fair value was elected. The determination of whether the entity has significant influence requires judgment. The ASC indicates that there may be instances where there is significant influence but less than 20% ownership could still be sufficient to apply the equity method.

When the ownership is not sufficient for the equity method of accounting and the securities are marketable, the entity would report the fair value of its interest. If the securities do not have a readily determinable fair value, then the entity would report at the lower of cost[23] or fair value. The entity may also elect to report at fair value.

Consolidation – NFP with For-Profit Company		
Consolidate	**Report Under Equity Method**	**Report at Lowe of Cost or Fair Value**
NFP has a majority voting interest in for-profit entity*	NFP has 50% or less ownership of common or in substance common stock but can exert significant influence	All other situations
*If control does not rest with the majority owner (i.e., bankruptcy or legal reorganization), then do not consolidate. Where consolidation is required or permitted based on control through other than a controlling financial interest, the exception to consolidation for a temporarily controlled subsidiary is retained by the NPO and HCO AAG.		

Special Purpose Leasing Entity (SPE)

ASC 958-810-25-8 states that an NFP lessee **should consolidate** an SPE if all of the following conditions exist:

- Substantially all of the activities of the SPE involve assets that are leased to a single lessee
- The substantive risks and substantially all of the residual rewards and the obligation imposed by the debt reside directly or indirectly with the lessee by virtue of:
  - The lease agreement
  - A residual value guarantee through assumption of the first dollar loss provisions
  - A guarantee of the SPE's debt

[23] The entity would report at cost if purchased or fair value at the date of donation if donated.

- An option granting the right to purchase the asset at a fixed price or a defined price that is other than fair value determined at the date of exercise or receive any of the lessor's sales proceeds in excess of a stipulated amount.

- The owner(s) of record of the SPE have not made an initial substantive residual equity capital investment that is at risk during the entire term of the lease. If the owners of record of the SPE are not independent third parties, then the criterion is not met.

NOTE: The FinREC believes that 3% is the minimum acceptable investment to qualify as an initial substantive residual equity capital investment and that even a larger investment may be necessary depending on the facts and circumstances.

Limited Partnerships and Similar Entities

ASC 810 states that an entity that has a general partnership interest in a limited partnership is assumed to control the limited partnership even if the interest is a minority interest. This presumption can be overcome, if the limited partners have participatory or kick-out rights. If the presumption is overcome, the general partner would apply the equity method of accounting or if elected, fair value. ASC 958-810 also permits investments in real estate partnerships, limited liability companies and similar investments to be reported at fair value by NFP organizations.

If the NFP entity is a limited partner, the accounting will depend on the types of activities conducted by the partnership. ASC 970-323-25 discusses the interest in real estate entities. It states that if the entity is engaged in real estate activities, then if the NFP has more than a minor interest it would report its noncontrolling interest using the equity method unless the fair value option was elected. Minor investments may be accounted for using the cost method unless that is prohibited for the NFP.

ASU 2017-02, Clarifying When a Not-for-Profit Entity That Is a General Partner or a Limited Partner Should Consolidate a For-Profit Limited Partnership or Similar Entity

When FASB issued its ASU 2015-02, it inadvertently caused issues for NFPs because it eliminated the presumption that a general partner controls the limited partnership regardless of the size of the ownership interest. The ASU addressed when a general partner should consolidate under the variable interest entity (VIE) model. Since the VIE model does not include NFPs in its scope, this left NFPs without clear guidance for these situations.

ASU 2017-02 reinstates the provisions that the general partner controls the limited partnership regardless of the size of the ownership interest unless the presumption can be overcome due to the limited partners having substantive kick-out or participatory rights. Under ASU 2017-02, kick-out rights are substantive if they can be exercised by a simple majority vote or a lower threshold of the limited partners' voting rights.

The guidance contained in ASU 2017-02 is included in ASC 958-810. The guidance is effective for annual periods beginning after December 15, 2017. If the NFP has not adopted ASU 2015-02, then it adopts both ASUs at the same time using the same transition method.

It is not likely that many NFPs early implemented ASU 2015-02, but in the event they did, the NFP would adopt the latest amendment as of the effective date using a retrospective approach for all periods presented beginning with the fiscal year that ASU 2015-02 was adopted.

In addition, ASU 2017-02 clarifies that amendments in ASU 2016-01, *Recognition of Financial Assets and Financial Liabilities*, were not intended to affect the ability of NFPs, except business-oriented health care entities, with investments in certain for-profit entities to elect to measure them at fair value. This amendment is effective for NFPs for years beginning after December 15, 2018. ASU 2016-01 may be adopted one year earlier.

NOTE: FinREC believes that the guidance in 970-323-25 is appropriate for NFP entities with controlling limited partnership interests in real estate entities. A controlling limited partner would be guided by the principles related to other investments in subsidiaries. As noted above, if the interest is greater than 50%, consolidation is appropriate. The FinREC further believes that even in cases when the limited partnership is engaged in activities **other than real estate**, that 970-323-25-6 be followed which states that the equity method of accounting is generally appropriate for accounting by limited partners for their noncontrolling investments in limited partnerships.

EXAMPLE

Grove Park Health System, an NFP entity (GPHS) had a 45% ownership interest in a joint venture with a physician practice, a for-profit entity. GPHS had significant influence because of the representation on the board of directors and participation in policy-making decisions. Significant influence is defined as the ability to exercise significant influence over operating and financial policies of an investee and may be indicated in several ways, including the following:

- Representation on the board of directors
- Participation in policy-making processes
- Material inter-entity transactions
- Interchange of managerial personnel
- Technological dependency
- Extent of ownership by an investor in relation to the concentration of other shareholdings

Therefore, the equity method of accounting was used to report the physician practice because an investment of 20% or more of the voting stock of an investee causes a presumption that unless there is predominant evidence to the contrary, the investor has the ability to exercise significant influence over an investee.

Real Estate Partnerships and Similar Entities

ASC 958-810 states that an NFP entity with more than a minor interest in a for-profit real estate partnership, a limited liability company or similar entity should report the noncontrolling interest using the equity method of accounting unless fair value is elected. An example provided in the audit guide (AAG-NPE) illustrates the term "minor interest" by analogizing to SEC guidance where 3% to 5% is considered to be more than minor.

If a general partnership, then the noncontrolling partners/members of a real estate entity should apply the equity method unless the presumption of control is overcome by the rights of the limited partners and no single general partner controls the limited partnership. The NFP could also elect to report at fair value.

EXAMPLE

Three NFP entities formed a limited partnership in order to buy a building that they can share for office space. They also believe that they can rent some of the space to other NFPs. NFP A is the general partner. It has a 10% interest. NFPs B and C are limited partners and each one has a 45% interest. B and C do not have substantive kick-out or participating rights. NFP A should consolidate B and C. NFPs B and C should use the equity method of accounting.

If an NFP is a limited partner that holds more than 50% of the total partnership, then it could apply the guidance in ASC 970-323, although it is not required to. This guidance states that the limited partner is in control of the major operating and financial policies of the partnership it should consolidate. Again, NFP entities do not apply VIE guidance.

General Partnerships

The NFP could use the guidance in ASC 970-810 even though it is not required to do so. It states that the general partnership that is directly or indirectly controlled by an investor is, in substance, a subsidiary of the investor. A noncontrolling investor in a general partnership should account for the investment using the equity method of accounting or report at fair value.

EXAMPLE

NFPs D and E formed a partnership that would be used to pay for various office and administrative costs. In this way, each hoped to reduce the amount that it was paying for its accounting, human resources and information technology functions. They both share equally in the decision making. However, NFP D has a 60% ownership and NFP E has a 40% ownership. In this case, neither have control so neither one of the entities would consolidate the other. Each could use the equity method or report at fair value.

Consolidation with Other NFP Organizations

The rules for consolidation in the guidance related to NFP organizations with investments in other NFP organizations state that the organization **should consolidate** when it has a controlling financial interest through direct or indirect ownership of a majority voting interest unless control does not rest with the majority owner. In addition, an NFP organization should consolidate

another NFP organization if the NFP organization has economic interest and control through **majority ownership or a majority voting interest** in the board of the other NFP organization**.** Consolidation is required when one NFP entity is the sole member of another NFP entity.

Note that ownership is not always evidenced by stock ownership since NFP organizations exist in various legal forms such as memberships and joint ventures. More often than not, the trigger for consolidation will be economic interest and control through a majority voting interest.

Economic interest exists if one entity holds or utilizes significant resources that must be used for the without donor restrictions or restricted purposes of the other either directly or indirectly by producing income or providing services. In addition:

- One organization may be responsible for the liabilities of the other
- One organization may guarantee debt of another
- One organization also may assign certain significant functions to another
- One organization may solicit funds in the name of and with the expressed or implied approval of the reporting organization and substantially all of the funds solicited are intended by the contributor or are otherwise required to be transferred to the reporting organization or to be used at its direction
- A reporting organization transfers significant resources to another entity whose resources are held for the benefit of that organization

Control is the direct or indirect ability to determine the direction of management and policies through ownership, contract or otherwise. Other examples of control may be through the organization's charter or bylaws or through an affiliation agreement. Although there may be overlap in the two boards, this may not constitute a majority voting interest.

EXAMPLE

Quality Care has a 5-member board and a simple majority is required to approve board actions. Helping Hand has 3 board members, officers and employees on the board. If Helping Hand does not have the ability to require that those members serve on Quality Care's board, then Helping Hand does not have a majority voting interest in Quality Care.

If there is control and economic interest but there is not a majority ownership or voting interest, e.g., control through contact or affiliation, consolidation is permitted but not required.

If there is only control or economic interest but not both, then consolidation is not permitted but related-party disclosures may be warranted.

A decision tree follows.

Consolidation – NFP with Another NFP

Majority voting interest through stock ownership or economic interest and control through a majority voting interest	Consolidate
Control and economic interest through contact or affiliation	Consolidation permitted but not required
Control or economic interest but not both	Do not consolidate- make related-party disclosures

EXAMPLE

A charitable organization created a Foundation to raise money for it. There is economic interest because the Foundation solicits funds in the name and with the expressed or implied approval of the charity. In addition, substantially all of the funds solicited are intended by the contributor or are otherwise required to be transferred to the reporting organization or to be used at its direction. There is also control as evidenced by a majority voting interest. The charity's bylaws require 4 of the 6 board members of the Charity to be on the Foundation's board. Consolidation is required.

EXAMPLE

The Pediatric Asthma Association of Georgia is affiliated with a National Organization. There is economic interest because the National is responsible for the liabilities of the state chapter. In addition, it guaranteed the debt which was incurred to start the chapter. The National Organization also has control through an affiliation agreement. Consolidation is permitted but not required.

Consolidated Financial Statements

When an entity presents consolidated financial statements, it should look to the industry-specific guidance to ensure that the appropriate disclosure is made relative to its subsidiaries. For example, if an NFP university consolidates a hospital, then the industry-specific disclosure for hospitals must be included in the consolidated financial statements.

When an NFP entity consolidates another, the definitions of with and without restrictions should be applied from the perspective of the reporting entity. This means that the results could be different from the way that the standalone subsidiary reports. For example, if donor stipulations pertaining to the use of the contributed assets are not specific and only have broad limits resulting from the mission of the NFP, they may be considered to be without restrictions in the subsidiary's financial statements. But in the consolidated statements, if the purpose is narrower than that of the reporting entity, the net assets may be considered donor restricted.

EXAMPLE

A not-for-profit CPA Society has a foundation that is consolidated as a subsidiary. The mission of the foundation is to provide scholarships for CPAs. Donors make contributions to the foundation without restriction because they understand the purpose is to provide scholarships. Since this is not the purpose of the CPA association, the contributions are reported as donor restricted.

Conversely, the mission of the subsidiary is broader and the parent is narrower that the following might result.

EXAMPLE

An NFP adoption agency has subsidiary foundation. The mission of the foundation is to raise money for children's causes. This includes adoption, foster care, services for special needs services and parental training. Contributions received by the foundation for adoption services would be considered donor restricted to the foundation. But because of the mission of the adoption agency, they would be considered unrestricted in the consolidated financial statements.

If two or more NFP entities are combined in one set of financial statements, there is no controlling interest even if the parent has less than a complete interest.

For example, if an NFP entity appoints 80% of the board of the other NFP, the basis for consolidation does not reflect a noncontrolling interest the way it would for a for-profit. There is no other "ownership" interest.

The NFP with a for-profit subsidiary should consider the most meaningful way to disclose the assets, liabilities and operations of the subsidiary.

EXAMPLE A

An NFP trade association buys a wholly-owned training company. It was purchased specifically so the NFP could provide training for the members of the NFP trade association. The training company built a new building and issued debt but the debt is guaranteed by its assets.

The training company is integral to the NFP membership entity so it may be more meaningful to treat it as if it were part of the overall activities. Any important disclosures for the training company should be presented such as the disclosure of the debt and collateral.

EXAMPLE B

An NFP college creates a for-profit day care center. The center provides services for the college's students with children. This is only incidental to the mission of the college. The college would report the operations of the day care center in one line for revenues and one line for expenses. The statement of financial position and cash flows do not show any separate disclosure for ancillary operations.

EXAMPLE C

An NFP community center received a contribution of 100% of the voting stock of a computer resale company. The donor stated that the net income from this company could be used for the NFP in any way they chose. The NFP is not involved in the management of the for-profit company.

Depending on the size of the for-profit entity, the community center could choose to present consolidating information or provide note disclosures of the assets, liabilities, equity, and cash flows of the for-profit entity.

MERGERS AND ACQUISITIONS

The National Center for Charitable Statistics states that there are more than 1.5 million tax exempt entities in the United States. Many of them are created for a specific purpose and that is no longer as compelling as it once was. Others are duplicative in an area where the need may just not be as great. NFPs are finding that they obtain economies of scale, work together to reduce redundancies, and develop operational efficiencies by merging, forming alliances, or collaborating.

A strategic alliance is a collaboration that is designed to leverage the strengths of both entities to achieve a common goal. Sometimes people refer to alliances as partnerships, but it is important to remember that a partnership is a term that implies legal obligations. An alliance is truly a mutually beneficial relationship. Some of the reasons for a strategic alliance is to share administrative costs. The overhead of a smaller NFP may be extremely costly when it would fare better spending its resources on programs and sharing the administrative burden with another organization. Alliances can be a good way to expand the reach or the nature of the mission-driven programs. Following are some best practices from the Montana Nonprofit Association:[24]

- Create a written agreement that lays out the responsibilities of each party to the alliance.
- Have a legal review performed whether it be a memorandum of understanding or some other document. There is generally risk involved in NFP activities whether it is related to loss of property or responsibility for insurance for other reasons.
- Be especially careful if the alliance is with a for-profit entity considering the possibility of private benefit and investigate the reputation of any entity. When there are alliances, outside parties may assume that the other party's issues are the issues of the NFP. For example, if a disease-related charity has an alliance with a pharmaceutical company, the stigma attached to

[24] https://www.councilofnonprofits.org/tools-resources/mergers-collaborations-and-strategic-alliances.

the pharmaceutical company may rub off on the charity. Or if the other party has a poor reputation, this could taint the NFP as well.

Mergers

Mergers are often the best way to combine forces. If an entity seeks a merger partner, they should proceed cautiously. Mergers are expensive and can take focus away from the mission. In addition, constituents of the NFP may not be pleased with the results. Not that these factors should prevent merger activity, but they should be discussed with the board and legal counsel.

From an accounting standpoint, the distinction between a merger and an acquisition is important because the method for accounting differs between them. For mergers, the NFP organization will use the carryover method that has been used for most business combinations for NFPs up until this time. In order for a transaction to be a merger, the two must create a new NFP organization by ceding control to the new organization. However, this does not mean that a new legal entity needs to be created. An acquisition clearly has an acquiring organization that gains control over the other.

Sometimes people refer to an acquisition as a merger when one is actually ceding control. Therefore, this is an important discussion to have with the board members who could lose the control that they prize.

That being said, mergers are very popular in today's uncertain landscape and can be effective. The following tips are from the 2016 Metropolitan Chicago Nonprofit Merger Research Report.[25]

- Trust is the most important factor that holds together all other issues during negotiations.
- The most successful mergers are mission-driven.
- All parties must be clear about their organization's overall goals and use the merger as a strategy to achieve them.
- NFPs should make sure to acquire as much information as possible about their potential partner.
- The CEO is often critical in prompting discussions about a strategy, especially when the CEO position is in transition.
- Boards and board chairs must be advocates for mergers to succeed.
- Staff involvement, particularly management, is critical to the success of a merger and post-merger integration.
- Leaders must pay attention to cultural alignment, premerger, and the merger integration process.
- Most successful mergers rely on outside experts, such as attorneys, accountants, or merger facilitators.

[25] Metropolitan Chicago Nonprofit Merger Research Report. https://chicagonpmergerstudy.org/.

- Participants must do their homework regarding all aspects of the process and become familiar with merger strategy.

Mergers, collaborations, and partnerships are not a sign of failure but a way to creatively address financial issues as well as a strategy to achieve the entity's mission.

The distinction between a merger and an acquisition is important because the method for accounting differs between them. For mergers, the NFP organization will use the carryover method that has been used for most business combinations for NFPs up until this time. In order for a transaction to be a merger, the two must create a new NFP organization by ceding control to the new organization. However, this does not mean that a new legal entity needs to be created. An acquisition clearly has an acquiring organization that gains control over the other.

Acquisitions

There are four major elements in recording an acquisition:

1. Identify the acquirer
2. Determine the acquisition date
3. Recognize and measure the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree
4. If the assets acquired measured at fair value are less than the liabilities assumed plus any consideration paid, recognize and measure goodwill or, if the acquiree is supported primarily by contributions and return on investments, a charge in the statement of operations. If the assets acquired measured at fair value are greater than the liabilities assumed plus any consideration paid, recognize a contribution

Identify the Acquirer

When one NFP acquires another, the one that retains control is considered the acquirer. For health care entities, the same definitions and principles are used that is identified in ASC 954-810, dealing with consolidations. Control is defined as the direct or indirect ability to determine the direction of management and policies through ownership, contract, or otherwise.

Determine the Acquisition Date

The acquisition date is the date on which one obtains control of the other. This is generally when the acquirer legally transfers any consideration or assumes liabilities and is considered the closing date. If one becomes the sole corporate member of the other, then the acquisition date would be the date when that event occurred.

Recognize and Measure the Identifiable Assets Acquired, Liabilities Assumed, and Noncontrolling Interest

At the acquisition date, the acquirer recognizes identifiable assets acquired, liabilities assumed and any noncontrolling interest in the acquiree. These must be measured at fair value. There are certain exceptions. Donor relationships are not generally recognized as identifiable intangible

assets separate from goodwill except as discussed below. If an organization does not capitalize collections, then only those purchased will be recognized. Conditional promises to give are not recognized unless the conditions are substantially met.

Contingencies

If the fair value of an asset or a liability that arises from a contingency can be estimated during the measurement period, then it is recognized at the measurement date. The measurement period is the period after the acquisition date during which the acquirer may adjust the provisional amounts recognized for the acquisition. If the amount cannot be measured at the acquisition date, the acquirer will only recognize the contingency if information is available before the measurement period that it is probable that an asset existed or liability was incurred at the acquisition date. It is necessary for one or more future events confirming the existence of the asset or liability to occur. The amount must also be able to be reasonably estimated. The seller may contractually indemnify the acquiring NFP organization for the outcome of a contingency. In this case, the acquirer has obtained an indemnification asset. It is measured on the same basis as the underlying asset or liability.

NOTE: ASU 2016-01 provides that adjustments to provisional amounts determined during the measurement period would be recognized in the period they were determined, with no retrospective adjustment. Any related effects on earnings would be calculated as though the adjusted amounts were known at the acquisition date. In other words, items such as depreciation, amortization, accrued interest, etc., which are affected by the measurement period adjustments, would need a "catch up" or "slow down" adjustment.

EXAMPLE

An NFP hospital acquired an organization that had significant obligations under warranty agreements. These were able to be estimated so the liability was recognized at the date of acquisition.

Income Taxes

The acquirer will recognize and measure deferred tax assets or liabilities arising from the assets acquired and liabilities assumed in an acquisition in accordance with the guidance related to income taxes found in ASC 740.

Employee Benefits

Liabilities that are assumed related to the acquiree's employee benefit arrangements are recognized.

Costs Associated with Exiting an Activity

If there are any costs associated with the acquisition where the acquirer expects to but is not obligated to exit the activity of the acquiree or terminate employees or relocate employees, then the acquirer does not include those costs as part of implementation of this guidance. Instead, the costs would be recognized in post combination financial statements.

Recognizing Identifiable Assets Including Intangible Assets

When recognizing the identifiable assets acquired, some may be intangible assets. To be identifiable, they must be capable of being separated or divided from the acquiree and sold, transferred, licensed, rented or exchanged. An example would be a donor, customer or subscriber list. These lists are frequently licensed and so would meet the criteria unless there were confidentiality agreements that prohibited the organization from exchanging the information.

EXAMPLE

An NFP acquired another NFP that had a donor list that was comprehensive and extensive including the regular contract it had with its donors. However, it would have been very difficult and expensive to estimate the fair value of the donor list. Therefore, the acquirer decided not to pursue it.

The acquirer may need to recognize certain assets and liabilities that the acquiree had not recognized in its financial statements. If the acquiree developed certain items such as an intangible asset, a patent or customer relationship, it would have charged the items to expense. These items would be recorded as intangibles in the business combination.

EXAMPLE

An NFP developed a patent in connection with a machine it used in its research activities. The cost was expensed as the patent was developed. However, the patent is able to be separated and sold. Therefore, it is a separate identifiable asset and would be separated from goodwill on the books of the acquirer.

Operating leases are not recognized unless the terms are favorable or unfavorable compared with the market terms of other leases.

EXAMPLE

An NFP organization acquired an organization that had a favorable operating lease arrangement. The lease was significantly below market because the location, which was once unfavorable, became desirable. This lease would be considered a separated identifiable intangible and separated from goodwill.

Noncontrolling Interests

The acquirer is required to measure a noncontrolling interest in the acquiree at fair value at the acquisition date. This may be possible if there is an active market for the shares not held by the acquirer. However, there are times when shares may not be actively traded and so other valuation techniques may need to be used.

To qualify for the acquisition method, the assets acquired and liabilities assumed must be included in the acquisition transaction rather than the result of separate transactions. This may happen because the two parties had a pre-existing relationship or other agreement. It is important to identify what is included and what is not part of the acquisition.

EXAMPLE

A large charity was recording its acquisition of a smaller one with a similar mission. The two entities had an existing relationship where the large charity performed recordkeeping and other administrative functions for the smaller one. When the two entities entered into the acquisition, there were several transactions that took place outside the acquisition arrangement:

- The smaller organization owed the larger one for administrative services performed before the acquisition
- The smaller organization also needed to reimburse the larger one for amounts that were paid to third parties on its behalf

Accordingly, these items were settled outside the acquisition transaction.

There will generally be costs that the acquirer will incur such as legal, valuation, accounting and other professional fees. The acquirer accounts for these as expenses when the costs are incurred except if there are costs to issue debt securities to fund the acquisition. These would be recorded in accordance with other standards.

At the acquisition date, the acquirer classifies the assets acquired and liabilities assumed. Some items that need to be considered are the classification of securities as trading or other than trading, assessment of whether an embedded derivative should be separated from the host contract or marked to fair value in a split interest agreement, and the designation of a derivative instrument as a hedging instrument. With regard to classification of contracts such as leases or insurance contracts, these should be classified according to the terms of the contract.

EXAMPLE

A university had several leases and they were recorded as capital leases. The day care center that they just acquired had a lease. The university looked to the terms of the lease of the day care center and determined that it was an operating lease.

Other Issues

- The assets acquired and liabilities assumed and any noncontrolling interest in the acquirer is measured at fair value.
- Donor relationships are not considered identifiable intangible assets.
- If there are collections and the acquirer has a policy of not capitalizing them, then it would not capitalize the acquired collections either. It would recognize the cost of purchased collections as a decrease in the appropriate net asset class in the statement of activities and a cash outflow from investing activities. It would not recognize the fair value of contributed collection items.
- In the acquisition, if the acquirer obtains a promise to give that is conditional, it would record it only if the conditions were substantially met at the acquisition date. If cash or other assets

had already been transferred to the acquiree, then, unless the conditions were substantially met, they would be accounted for as a refundable advance.

RECOGNIZE AND MEASURE GOODWILL OR AN IMMEDIATE CHARGE TO THE STATEMENT OF ACTIVITIES OR A CONTRIBUTION

When an NFP organization acquires another organization that is expected to be supported predominantly by contributions and investment return, if the consideration paid plus liabilities assumed exceed the assets acquired, then the difference should be recognized as a separate charge in the Statement of Activities, not recognized as goodwill. The caption might state "**excess of liabilities assumed over assets acquired in acquisition of … (name of organization acquired)**". For a health care organization, this would be presented inside the performance indicator.

If the acquiree is not expected to be supported primarily by contributions and investment return, then the difference between the consideration paid plus liabilities assumed and the assets acquired would be considered goodwill.

When the fair value of the assets acquired are larger than the liabilities assumed and any consideration paid, then this is deemed to be a contribution received by the acquirer. The Statement of Activities would include a caption such as "**excess of fair value of net assets acquired over consideration paid in acquisition of …. (name of organization acquired)" Or "contribution received in donation of … (name of organization acquired)**."

If contingent consideration is involved, then the acquirer recognizes the acquisition date fair value of that contingent consideration as part of the consideration transferred. It is subsequently re-measured and considered a measurement period adjustment. During the measurement period, the acquirer recognizes adjustments to the provisional amounts as if the accounting had been completed at the acquisition date. Comparative information for prior periods is revised to make any changes necessary. This does not run through net assets. There will be a footnote that discusses the fact that there has been a change.

EXAMPLE

An NFP research organization acquired another organization and at the date of the financial statements (12/31/11) an appraisal for certain fixed assets had not been completed. In the financial statements for the year after the acquisition (12/31/12), the organization adjusted the carrying amount of the property, plant and equipment so that it is at fair value, less depreciation for the 2012 year and adjusted goodwill. Depreciation expense was increased. The 2012 financial statements were adjusted. The footnote stated the following:

In 2012, comparative information was adjusted retrospectively to increase the fair value of the property, plant and equipment at the acquisition date to $25,000, offset by a decrease to goodwill and an increase in depreciation expense of $1,000.

When goodwill is recognized, in subsequent years, the NFP would follow the guidance in ASC 350 on goodwill and FASB's new simplified guidance on accounting for goodwill in ASU 2019-06.

Disclosures

Statement of Cash Flows: The entire amount of any net cash flow (cash paid as consideration, if any, less acquired cash of the acquiree) would be reported as an investing activity. Any noncash contributions received and any other noncash amounts received or transferred would be reported in related disclosures as noncash activities.

Footnote disclosures (acquisition made during the current reporting period or after the reporting date but before the financial statements are issued or are available to be issued).

Following are some of the disclosures required in an acquisition:

- Name and a description of the acquiree.
- Acquisition date.
- If applicable, the percentage of ownership interests, such as voting equity instruments, acquired.
- The primary reasons for the acquisition and a description of how the acquirer obtained control of the acquiree.
- Qualitative description of the factors, such as expected synergies from combining operations of the acquiree and the acquirer, intangible assets that do not qualify for separate recognition, or other factors that make up the goodwill recognized or the separate charge recognized in the statement of activities.
- Acquisition-date fair value of the total consideration transferred (or if no consideration was transferred, that fact) and the acquisition-date fair value of each major class of consideration, such as:
  - Cash
  - Other tangible or intangible assets, including a business or subsidiary of the acquirer.
  - Liabilities incurred, for example, a liability for contingent consideration.
- For contingent consideration arrangements and indemnification assets:
  - The amount recognized as of the acquisition date.
  - A description of the arrangement and the basis for determining the amount of the payment.
  - Estimate of the range of outcomes (undiscounted) or, if a range cannot be estimated, that fact and the reasons why a range cannot be estimated.
  - If the maximum amount of the payment is unlimited, disclose that fact

- For assets and liabilities arising from contingencies recognized at the acquisition date:
  - Amounts recognized at the acquisition date and the measurement basis applied (i.e., fair value or at an amount recognized in accordance with contingency guidance). Similar contingencies can be aggregated.
  - Nature of the contingencies.
  - When assets and liabilities arising from contingencies that have not been recognized at the acquisition date, the disclosures required by the FASB guidance on contingencies.
- The amount of collection items acquired that are recognized in the statement of activities as a decrease in the acquirer's net assets.
- The undiscounted amount of conditional promises to give acquired or assumed and a description and the amount of each group of promises with similar characteristics, such as amounts of promises conditioned on establishing new programs (like completing a new building, or raising matching gifts by a specified date).
- For transactions that are recognized separately from the acquisition of assets and assumptions of liabilities in the acquisition as described above:
  - A description of each transaction.
  - How the acquirer accounted for each transaction.
  - Amounts recognized for each transaction and the line item in the financial statements in which each amount is recognized.
  - If the transaction is the effective settlement of a preexisting relationship, the method used to determine the settlement amount.
  - Disclosure of separately recognized transactions shall include the amount of acquisition-related costs, the amount recognized as an expense, and the line item or items in the statement of activities in which that expense is recognized. The amount of any issuance costs not recognized as an expense and how they were recognized also shall be disclosed.
  - If the acquisition results in an inherent contribution received, a description of the reasons that the transaction resulted in a contribution received.
  - If the acquirer presents comparative financial statements, the supplemental pro forma information for the comparable prior reporting period as though the acquisition date for all acquisitions that occurred during the current year had been the beginning of the comparable prior annual reporting period.
    - If disclosure of any of the information required by this subparagraph is impracticable, disclosure of that fact and explanation of why the disclosure is impracticable.
- For individually immaterial acquisitions occurring during the reporting period that are material collectively, the information should be aggregated.

- If the date of an acquisition is after the reporting date but before the financial statements are issued or available for issue, the acquirer shall disclose the information outlined above unless the initial accounting is incomplete. If the initial accounting for an acquisition is incomplete for particular assets, liabilities, noncontrolling interests, or items of consideration and the amounts recognized in the financial statements for the acquisition have been determined only provisionally:
  - Reasons that the initial accounting is incomplete.
  - Assets, liabilities, equity interests, or items of consideration for which the initial accounting is incomplete.
  - Nature and amount of any measurement period adjustments recognized during the reporting period.

EXAMPLE

On May 10, 2011, the Organization, Durham Social Services (DSS) acquired substantially all of the assets of Social Services South (SSS), an NFP social service organization located in New Hampshire. This acquisition will provide us with the ability to improve the quality and efficiency of our programs and services, increase the level of funding to support our programs, better develop the skills of existing employees and enhance our succession plan through economies of scale, a larger presence in our service area and additional high caliber employees.

The purchase price and initial recording of the transaction was based on preliminary valuation assessments and is subject to change. The purchase price was $1,600,000, all of which was paid at the closing date.

The purchase price allocation and resulting impact on corresponding statements of financial position at June 30, 2011 follows:

Accounts receivable	$105,751
Pledges receivable	450,000
Property and equipment	725,000
Goodwill	354,049
Liabilities assumed	(34,800)
Cash paid for net assets acquired	$1,600,000

The Organization acquired $487,500 in promises to give. We estimate that of that amount, $450,000 will be collectable.

Prior to the acquisition, the Organization had business arrangements with SSS and at the acquisition date there was a receivable in the amount of $20,000 outstanding. This receivable was repaid with the proceeds of the purchase price.

The operating results of SSS have been included in the financial statements from the date of acquisition. The following table presents supplemental unaudited pro forma information, presented as if the results of all of 2010 had been included in operations during the year ended June 30, 2010.

Supplemental Pro Forma Information

	DSS	**SSS**	**Combined**
Revenue	$20,882,955	$2,001,810	$22,884,765
Changes in net assets without donor restrictions	$ 231,694	($169,570)	$62,124
Changes in net assets with donor restrictions	($15,000)	($2,500)	($17,500)

Mergers

An NFP organization will account for a merger by applying the **carryover method**. The criteria for a merger are that **both entities cede control to a new organization**. A new organization does not need to be a new legal organization. In a merger, no one party controls the other in the combined entity. Governance and control powers and financial capacity are important factors.

EXAMPLE

Two NFP community service organizations decided to combine. In determining whether this was a merger instead of an acquisition, the parties looked to the financial capacity. Neither one was in financial distress so that characteristic did not play a part in one party controlling the other. The other characteristic that was evaluated was the management and the governing board. It was agreed that each of the parties would nominate the same number of board members and that the senior leadership would be evenly split between the two parties.

The merger is accomplished by combining all the assets and liabilities of the entities into a newly formed organization that assumes them. Fair value is not adjusted. The date of the merger is the date of the new organization's opening balances. The merged entities' Statements of Activities and Cash Flows for the first period reflect the combined amounts of the merged entities' net assets as of the merger date in its opening amounts. The financial statements should include activity from the merger date through the end of the period.

The opening amounts for the merged organization should be adjusted to conform the individual accounting policies of the merging entities at the merger date. A newly merged NFP organization should include specified pro forma premerger information as supplementary information.

Disclosures

- Name and a description of each merging organization
- Merger date
- Primary reasons for the merger
- For each merging organization:
  - The amounts recognized as of the merger date for each major class of assets and liabilities and each class of net assets.
- Nature and amounts, if applicable, of any significant assets (for example, conditional promises receivable or collections) or liabilities (for example, conditional promises payable) that GAAP does not require to be recognized.
- Nature and amount of any significant adjustments made to conform the individual accounting policies of the merging entities or to eliminate intercompany balances.
- If the new organization is a public organization, generally by virtue of conduit debt, this supplemental pro forma information is also required:
  - If the merger occurs at other than the beginning of an annual reporting period and the organization's initial financial statements cover less than an annual reporting period, the information below will be for the current reporting period as though the merger date had been the beginning of the annual reporting period:
    - Revenue
    - The performance indicator
    - Changes in net assets without donor restrictions, changes in net assets with donor restrictions
    - Comparable prior period supplemental pro forma information, if the organization presents comparative information for the year following the merger year as if the merger had been at the beginning of the prior annual reporting period.

EXAMPLE

Southeastern Association for Dementia (Region) is an NFP voluntary health agency by charter to the National Association for Dementia, seeking to improve lives through leadership in the prevention, control and cure of dementia. Major funding sources are from direct public contributions, grants and bequests. The Region provides education, community service programs and research funding.

The Region was formed on July 1, 2010 when the Dementia Association Chapters of Georgia, Mississippi and Alabama merged. The three entities shared a common mission. Through their merger, the entities seek to achieve economies of scale and other synergies through integrating their services. Following is a summary of the assets and liabilities that were transferred to the Region under the terms of the merger agreement.

	Georgia	Alabama	Mississippi	Combined
Assets				
Cash and cash equivalents	$145,861	$24,857	$75,871	$246,589
Investments	475,815	52,528	268,513	796,856
Grants receivable	61,704	12,500	64,337	138,541
Contributions receivable	2,500	9,750	2,251	14,501
Deposits	12,000	1,275	1,500	14,775
Property and equipment (net)	53,848	32,575	25,781	112,204
Total assets	$751,728	$133,485	$438,253	$1,323,466
Liabilities				
Account payable and accrued expenses	$48,174	$24,970	$5,675	$78,819
Deferred revenue	65,453	51,220	4,564	121,237
Total liabilities	$113,627	$76,190	$10,239	$200,056
Net Assets				
Net assets without donor restrictions	$586,679	$54,552	$403,250	$1,044,481
Net assets with donor restrictions	51,422	2,743	24,764	79,929
Total net assets	638,101	57,295	428,014	1,123,410
Total liabilities and net assets	$751,728	$133,485	$438,253	$1,323,466

Noncontrolling Interests

ASU 2010-07 also made effective the guidance related to noncontrolling ownership interests. It amends ASC 958-810.

Noncontrolling interests in the net assets of consolidated subsidiaries are reported as a separate component of the appropriate class of net assets in the consolidated statement of financial position in the NFP organization. It should be clearly identified to distinguish it from the components of net assets of the parent. As illustrated in the example below, “reporting organization,” has a noncontrolling interest in “affiliate” that is without donor restrictions.

Catskill Hospital System
At June 30, 20X1

Assets	
Current assets	
Cash	$566,000
Accounts receivable	125,000
Prepaid expenses	15,000
Investment securities	125,000
Total current assets	831,000
Plant and equipment	220,000
Total assets	1,051,000
Liabilities and Net Assets	
Liabilities	
Current liabilities	
Accounts payable	125,500
Current portion of long term debt	75,000
Total current liabilities	200,500
Long term debt	354,500
Total liabilities	555,000
Net assets without donor restriction:	
Reporting Entity	
Undesignated	333,000
Amounts designated for capital spending	100,000
Total net assets without donor restriction Reporting Entity	433,000
Noncontrolling interest in Barbee Hospital	**48,000**
Total net assets without donor restriction	481,000
Net assets with donor restriction	15,000
Total net assets	496,000
Total liabilities and net assets	$1,051,000

This may not always be the case. If there are donor-imposed restrictions on a partially owned subsidiary's net assets, they would be reported in that net asset class.

Disclosure

An NFP parent that has one or more consolidated subsidiaries with a noncontrolling interest is required to provide a schedule of changes in consolidated net assets attributable to the parent and the noncontrolling interest either in the footnotes or on the face of the financial statements. This schedule would reconcile beginning and ending balances of the controlling and noncontrolling interests for each class of net assets that is applicable to the reporting period.

This schedule would include a performance indicator, in the case of a health care organization, discontinued operations (if any), extraordinary items (if any), changes in ownership interest and an aggregate amount of all other changes.

Catskill Hospital System

Footnote H

Changes in Consolidated Net Assets Without Donor Restriction Attributable to GPHS and Transfers to and from the Noncontrolling Interest

Year Ended June 30, 20X1

	Controlling Interest	Noncontrolling Interest	Total
Balance July 1, 20X0	$400,000		$400,000
Excess of revenues over expenses from continuing operations	17,600	$5,400	$23,000
Discontinued operation (net of tax)	(5,600)	(1,400)	($7,000)
Net unrealized gains and losses on other than trading securities	12,000	3,000	$15,000
Affiliate adjustments (net)	9,000	41,000	$50,000
Change in net assets	33,000	48,000	81,000
Balance June 30, 20X1	**$433,000**	**$48,000**	**$481,000**

Technical Q&A 6140.26 – Not-for-Profit Entity With For-Profit Subsidiary and Adoption of FASB ASU No. 2014-02 on Goodwill

NFPs may have for-profit, privately-owned subsidiaries that they are required to consolidate under GAAP. As a private company, it could elect the option to amortize goodwill. However, the option is not permitted to be used by NFP entities. The literature discussing this option refers to the reporting entity which would be the NFP. Should the for-profit entity prepare standalone financial statements, it could elect to use the option to prepare those statements.

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