



ACCOUNTING

CONTINUING EDUCATION

Navigating the Complexities of Nonprofit GAAP

(NFPG4)

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NAVIGATING THE COMPLEXITIES OF NONPROFIT GAAP
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NOTES

Introduction

Non-profit organizations, while driven by social impact rather than profit, still need robust financial reporting systems. Understanding how accounting principles apply to non-profits is crucial for ensuring transparency and accountability to donors, stakeholders, and the public.

Non-profit organizations adhere to the same Generally Accepted Accounting Principles (GAAP) as commercial entities for the most part. GAAP is a set of accounting standards that dictate how financial transactions are recorded and reported. This consistency allows for comparability between different organizations, even for profit and non-profit ones.

The Financial Accounting Standards Board (FASB) is the independent body responsible for setting GAAP in the United States. However, non-profit organizations have a unique mission and financial structure compared to for-profit businesses. Recognizing these differences, the FASB has issued specific accounting guidance for non-profits in certain areas. Section 958 of the Accounting Codification provides industry-specific guidance tailored to non-profit activities. Understanding these FASB pronouncements is essential for non-profit accountants to ensure their financial statements accurately reflect the organization's financial health and mission fulfillment.

Healthcare entities, both for profit and non-profit, need to pay close attention to industry-specific accounting standards set forth in Section 954 of the Codification. These standards address healthcare-related transactions like revenue recognition for patient services, accounting for medical equipment, and presenting financial information about charity care.

This course delves into specific areas of non-profit accounting that often raise questions in practice. These complexities can arise from:

- Distinguishing Contributions vs. Grants: Understanding the difference between unrestricted contributions used for general operations and restricted grants designated for specific purposes is crucial for proper classification in financial statements.

- **Accounting for Fundraising Costs:** Non-profits spend resources on fundraising activities. Determining how much to report as an expense and how much to capitalize on as an investment in future fundraising efforts requires careful consideration of FASB guidelines.
- **Property and Equipment Valuation:** Non-profit organizations often hold land, buildings, or equipment used to achieve their mission. Valuing these assets appropriately and ensuring depreciation is accurately reflected requires adherence to GAAP.

By grasping these and other complexities, you can ensure your non-profit organization maintains accurate and compliant financial records. This, in turn, fosters trust with stakeholders and allows your organization to effectively demonstrate the impact of its mission.

UNIT 1

Accounting Issues Related to Assets and Revenue

LEARNING OBJECTIVES

At the end of this unit participants will be able to:

- › Select the not-for-profit accounting principles that are appropriate for an organization's assets and revenue.
- › Apply the not-for-profit accounting and disclosure requirements.

CASH AND CASH EQUIVALENTS

Relevant Literature: ASC 958-205, ASC 958-210, ASC 230

Non-profit organizations (NFPs) rely on a clear picture of their readily available funds to make informed financial decisions. This information is presented in the “cash and cash equivalents” line item within their financial statements.

Cash equivalents represent highly liquid investments that can be quickly converted to cash (usually within a day) without significant risk of losing value. This ensures NFPs have access to funds for essential operations and unforeseen expenses. Common examples of cash equivalents include:

- Money Market Funds: These low-risk investments pool funds from many investors and invest them in short-term debt instruments like commercial paper and certificates of deposit.
- Commercial Paper: These are short-term, unsecured promissory notes issued by corporations to raise capital.
- Treasury Bills: These are short-term debt instruments issued by the U.S. government, considered virtually risk-free and highly liquid.

NFPs often receive funds from various sources, such as grants, donations, and membership fees. Unless restricted by specific donor agreements, legal regulations, or internal policies, these funds can be combined into a single bank account for efficient management. This commingling simplifies recordkeeping and allows NFPs to readily access their total available cash for day-to-day operations.

While commingling cash streamlines management, NFPs must maintain transparency about the sources and restrictions attached to their funds. Here are some key considerations:

- **Detailed Records:** NFPs should meticulously track the origin and purpose of each contribution. This allows for proper allocation of funds and ensures compliance with any donor-imposed restrictions.
- **Investment Policies:** Having a clear investment policy outlining the types of cash equivalents NFPs will invest in and the risk tolerance level helps ensure the safety and liquidity of these funds.
- **Internal Controls:** Implementing internal controls, such as dual signatures for large withdrawals, minimizes the risk of misappropriation of funds.

By effectively managing cash and cash equivalents, NFPs can maintain financial stability, ensure efficient use of resources, and demonstrate responsible stewardship to their stakeholders.

Restricted and Designated Cash and Cash Equivalents

NFPs often deal with funds earmarked for specific purposes. Understanding how to account for these “restricted cash and cash equivalents” is crucial for accurate financial reporting.

Accounting Standards Codification (ASC) 958-205 goes beyond the basic definition of cash. It clarifies that cash and contributions designated by donors for acquiring land, buildings, or equipment shouldn’t be lumped with regular cash or contributions receivable. These restricted funds are classified as “assets restricted to investment in land, buildings, and equipment” and positioned closer to property on the balance sheet, reflecting their long-term nature.

NFP boards can also restrict cash for specific purposes, such as future long-term asset purchases or debt repayment. These restricted funds, along with those mandated by lenders for sinking funds, are excluded from current assets.

External parties can also impose limitations on cash usage. Compensating balance requirements and cash held as collateral for loans or loaned securities all fall under this category. Additionally, some government agencies, like the Department of Housing and Urban Development (HUD), mandate setting aside funds for maintenance reserves. These restricted amounts are presented separately from unrestricted operational cash.

FASB deliberately avoids defining “restricted cash,” leading to some variation in practice. Importantly, it’s often the net assets, not the physical cash itself that are restricted. The key distinction lies in separating readily available operational cash from non-current, restricted funds. The physical location of the cash (separate bank account or not) doesn’t dictate its long-term presentation.

Cash temporarily held by a custodian for investment purposes can be included with investments rather than with cash on the balance sheet. NFPs may also manage “cash and cash equivalents” as part of their endowment funds. Uninvested endowment contributions often fall into this category, blurring the line between cash and investments.

By understanding these nuances of restricted cash and cash equivalents, NFPs can ensure their financial statements accurately portray their financial health and responsible use of resources. This transparency fosters trust with donors, stakeholders, and the public.

EXAMPLE PRESENTATION

Caring For Children
Statement of Financial Position
June 30, 20X2

Assets	
Current Assets	
Cash and cash equivalents	\$ 4,874,220
Operating investments	774,223
Accounts receivable, net	2,502,491
Promises to give, net	941,112
Prepaid expenses and other assets	<u>290,813</u>
Total Current Assets	9,382,859
Cash restricted to building project	1,500,000
Property and equipment, net	23,306,381
Right of Use Asset- operating lease	225,300
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	4,081,382
Endowment	
Promises to give, net	2,501,416
Investments	<u>26,732,617</u>
Total assets	<u>\$ 70,614,749</u>

Statement of Cash Flows

The statement of cash flows explains the change during the period in the total of cash, cash equivalents, and amounts described as restricted cash or cash equivalents. Transfers between cash, cash equivalents, and restricted cash or cash equivalents are not intended to be part of the entity's operating, investing, and financing activities so the changes in restricted cash and cash equivalents are not identified separately. The entity will disclose a reconciliation of total cash and cash equivalents and restricted cash and cash equivalents to the amounts presented on the statement of financial position. This may be disclosed in the footnotes or at the bottom the Statement of Cash Flows in narrative or tabular format.

Net Change in Cash and Cash Equivalents and Restricted Cash	5,364,994
Cash and Cash Equivalents and Restricted Cash, Beginning of Year	<u>1,009,226</u>
Cash and Cash Equivalents and Restricted Cash, End of Year	<u>\$ 6,374,220</u>
Cash paid during the year for	
Interest	<u>\$ 296,885</u>
Supplemental Disclosure of Non-cash Investing and Financing Activity	
Donated land	<u>\$ 36,280</u>

Reconciliation to Cash and Cash Equivalents and Restricted Cash on the Statement of Financial Position

Cash and Cash Equivalents	\$ 4,874,220
Cash Restricted to Building Project	<u>1,500,000</u>
Cash and Cash Equivalents on the Statement of Cash Flows	<u>\$ 6,374,220</u>

Other Disclosures

The following disclosures are also required by ASC 958-210:

- If the organization has not maintained necessary amounts of cash and cash equivalents to comply with donor-imposed restrictions, or if significant liquidity problems exist.
- The nature and amounts of restrictions (including donor-imposed restrictions) on cash and cash equivalents or limitations on the organization's ability to withdraw or use cash. This may take the form of compensating balance requirements or cash held for others under agency agreements.
- Requirements to hold cash in separate accounts.

Funds Deposited with a Related Entity

NFPs sometimes participate in centralized cash management arrangements. This can occur when an entity deposits funds with a related entity, such as a national office, a denominational body for churches, or a fundraising organization. Understanding how these arrangements impact financial reporting is crucial for an accurate representation of the NFP's financial health.

The Financial Reporting Entities Council (FinREC) establishes accounting principles for NFP entities in some jurisdictions. Their stance is clear: in a centralized cash management arrangement, deposited funds are not considered "cash and cash equivalents" unless the NFP legally owns the cash. Legal ownership is typically evidenced by the cash being deposited in a demand deposit account under the NFP's specific name.

Centralized cash management often involves "cash pools," where funds from multiple entities are commingled for collective investment or management. In these scenarios, the deposited funds wouldn't be classified as short-term deposits (like cash equivalents) for the NFP. Instead, the NFP would categorize the deposit as a "receivable" from the related entity managing the cash pool. This reflects the fact that the NFP doesn't have immediate access to the funds and must rely on the related entity to repay them.

While centralized cash management can offer benefits like pooled investment opportunities, NFPs must be transparent about these arrangements in their financial statements. Disclosing the existence of cash pools and classifying deposits as receivables ensures an accurate portrayal of the NFP's liquidity and the potential risks associated with relying on another entity for access to funds.

NFPs should carefully consider the implications of centralized cash management before participating. Here are some alternative approaches:

- **Maintaining Separate Accounts:** The NFP can maintain its own demand deposit accounts, ensuring legal ownership and immediate access to funds.
- **Negotiating Access Rights:** If a cash pool is necessary, the NFP can negotiate specific agreements outlining access rights and timelines for withdrawing deposited funds.

By understanding the accounting implications and potential risks, NFPs can make informed decisions regarding centralized cash management arrangements and ensure their financial statements accurately reflect their true financial position.

EXAMPLE DISCLOSURES

Note 2: Summary of Significant Accounting Policies

Cash and Cash Equivalents

Caring for Children defines cash equivalents as highly liquid investments with a maturity of three months or less at the time of purchase. These investments are readily convertible to known amounts of cash and pose an insignificant risk of value fluctuation. Cash and cash equivalents exclude restricted cash, which refers to funds designated by donors for specific long-term purposes.

Restricted Cash

Restricted cash represents the portion of donor contributions that must be used for specific purposes outlined by the donor. These funds are not available for general operations and are excluded from cash and cash equivalents in the statement of cash flows. During 20X0, the agency received a restricted cash contribution of \$1,500,000 earmarked for the facility expansion project. As of December 31, 20X1, this amount remains restricted until the project requirements are met.

If the Agency had board-designated instead of donor-restricted amounts, they might be referred to as “assets limited as to use”. This is a designation that is commonly used in healthcare and other organizations as illustrated below.

Note 2: Summary of Significant Accounting Policies

Assets Limited 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. At December 31, 20X1, \$750,000 was set aside for the Agency’s facility expansion project.

Note 3: Concentration of Credit Risk

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

INVESTMENTS**Investments in Marketable Securities**

Relevant Literature: ASC 958-320 (Debt Securities), ASC 958-321 (Equity Securities), ASC 323, and ASC 958-325 (Investments), ASC 820 (Fair Value)

NFPs 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. They are marked to fair value in the following periods.

Investments not included in ASC 958-320 include derivatives and related entities. Regarding derivatives, if a security has an embedded derivative, 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.

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 are classified according to their net asset class (with or without donor restrictions). 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. For reporting purposes, the organization would report the realized gain less the unrealized gain previously recognized as illustrated below.

EXAMPLE

A NFP purchases an equity security in May 20X3 for \$7,000. The organization's year end is June 30. By June 30, 20X3 the security had a fair value of \$8,000. The security was sold in May 20X4 for \$9,500. The gain on the security would be calculated as follows:

At June 30, 20X3 the organization would increase the security's carrying value to \$8,000. The statement of activities would show an unrealized gain of \$1,000.

At June 30, 20X4 when the security was sold the NFP would report cash of \$9,500, a decrease in the carrying value of the security of \$8,000, and a gain in the statement of activities of \$1,500 (representing the current year appreciation).

Cash	\$9,500
Investments	\$8,000
Gain	\$1,500

Investment Expenses

Investment expenses include investment advice, investment acquisition, due diligence, custodian services, commissions, legal services, and other administrative activities specifically associated with investments. It does not include endowment accounting.

The FinREC recommends that the entity include only the costs of activities it conducts, not those that are conducted on its behalf. For example, if any of the activities identified above were conducted by the investee, e.g., mutual fund or hedge fund management, then they are not considered the reporting entity's investment expense.

EXAMPLE

An independent school had a large endowment and hired a money manager to manage the investments. The school paid the money manager 1.5% of the average assets managed. The money manager charges custodial fees as well as other administrative charges. The money manager invests the schools' money in a mix of investments including hedge funds, publicly-traded securities and private equity securities. Two of the investees (hedge fund and private equity fund) also conduct investment activities. The school was aware of other fees charged by these professionals even though they were embedded in the investment. The school reported only the amounts paid to the money manager but did not report any amounts embedded in the investment balance. This approach overlooks the embedded fees within the investments, potentially understating the total cost of managing the endowment.

Here are some recommendations for the school:

1. **Request Detailed Fee Breakdowns:** The school should request a comprehensive fee breakdown from the money manager, including all custodial, administrative, and performance-based fees charged by the manager itself as well as any embedded fees within the underlying investments.
2. **Evaluate Overall Investment Costs:** By understanding the total cost structure, the school can assess the true expense of managing the endowment and compare it to industry benchmarks.
3. **Consider Fee Structure Transparency:** The school may want to explore investment options with more transparent fee structures, potentially reducing the impact of embedded fees.
4. **Disclosure Considerations:** The school may need to consider additional disclosures in its financial statements regarding the estimated level of embedded fees.

NFPs report investment return net of investment expense. They are no longer required to disclose the amount of investment expenses. Investment expenses include not only the costs of activities conducted by third parties; they also should include activities conducted by employees. These direct internal expenses include personnel costs that develop, execute, and monitor the investment strategy. This also includes employee benefits and occupancy costs. Sometimes boards of directors would prefer to see these expenses on the face of the statements or in the notes. This is permissible.

EXAMPLE DISCLOSURE

Summary of Significant Accounting Policies

Investments

Caring for Children follows specific accounting practices for its investments. When the organization purchases investments, they are recorded at the initial cost. Donated investments are valued differently, being recorded at their fair market price on the day they are received. This fair market price reflects what a willing buyer would pay a willing seller in an arms-length transaction. Once the investments are part of the portfolio, Caring for Children tracks their value using fair value, which is reassessed regularly. This reassessment relies on observable market data whenever possible. If market data isn't readily available, other valuation techniques are employed. The overall performance of the investment portfolio is reflected in the net investment return (loss) reported in the statement of activities. This return considers various factors, including interest earned on bonds, dividends received from stocks, and both realized and unrealized capital gains or losses. Realized gains or losses occur when an investment is sold, with the difference between the

selling price and the original cost or fair value determining the gain or loss. Unrealized gains or losses happen when the fair value of the investment fluctuates during the reporting period, without the investment being sold. Finally, net investment expenses are factored in. These expenses include fees paid to external investment managers and custodians, minus any income recovered directly from the investments, such as reimbursements for custodial fees.

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.

Other Investments

Other investments that an NFP 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.

Colleges, universities and voluntary health and welfare entities may report other investments at fair value or carrying value (cost if purchased and fair value at the date of the contribution if donated). If other investments are carried at the lower of cost or fair value, declines in their value in subsequent periods should be recognized if their aggregate fair value is less than their carrying value. Recoveries can be recognized but they cannot exceed the original cost.

Investments in wasting assets (assets with a limited life span that decline in value over time) are reported in the financial statements net of an allowance for depreciation or depletion if reported at carrying value.

Cash or Investments Held as an Agent

NFPs may hold cash for others as a custodian or an agent. In these cases the cash is treated as an asset and a liability and is given a caption such as “assets held on behalf of others.”

If a NFP is holding an investment as an agent and has little or no discretion in determining how the investment income, unrealized gains and losses, and realized gains and losses resulting from that investment will be used, those investment activities would be reported as agency transactions, therefore, as changes in assets and liabilities, rather than as changes in net assets.

EXAMPLE

A NFP skilled nursing facility held funds for its residents. The residents could draw down on the funds to pay for items and services provided by the facility such as sundries and hair care services. As such these funds would be considered agency transactions and are reported as both an asset and a liability.

EXAMPLE DISCLOSURE

Following is an example disclosure for investments illustrating the fair value hierarchy. Disclosure is required for all recurring and nonrecurring fair value measurements. This disclosure illustrates marketable securities, other investments and those investments that are reported at net asset value per share. They are now reported outside the fair value hierarchy.

Note C – Fair Value Measurements and Disclosures

Caring for Children reports certain assets and liabilities at fair value in the financial statements. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal, or most advantageous, market at the measurement date under current market conditions regardless of whether that price is directly observable or estimated using another valuation technique. Inputs used to determine fair value refer broadly to the assumptions that market participants would use in pricing the asset or liability, including assumptions about risk. Inputs may be observable or unobservable. Observable inputs are inputs that reflect the assumptions market participants would use in pricing the asset or liability based on market data obtained from sources independent of the reporting entity. Unobservable inputs are inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability based on the best information available.

A three-tier hierarchy categorizes the inputs as follows:

Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities that can be accessed at the measurement date.

Level 2 – Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. These include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability, and market-corroborated inputs.

Level 3 – Unobservable inputs for the asset or liability. In these situations, the organization develops inputs using the best information available in the circumstances.

In some cases, the inputs used to measure the fair value of an asset or a liability might be categorized within different levels of the fair value hierarchy. In those cases, the fair value measurement is categorized in its entirety in the same level of the fair value hierarchy as the lowest level input that is significant to the entire measurement. Assessing the significance of a particular input to entire measurement requires judgment, considering factors specific to the asset or liability. The categorization of an asset within the hierarchy is based upon the pricing transparency of the asset and does not necessarily correspond to our assessment of the quality, risk, or liquidity profile of the asset or liability.

A significant portion of the investment assets are classified within Level 1 because they comprise open-end mutual funds with readily determinable fair values based on daily redemption values. The organization invests in CDs traded in the financial markets. Those CDs and U.S. government obligations are valued by the custodians of the securities using pricing models based on credit quality, time to maturity, stated interest rates, and market-rate assumptions, and are classified within Level 2. The fair values of beneficial interests in charitable and perpetual trusts are determined by management using present value techniques and risk-adjusted discount rates designed to reflect the assumptions market participants would use in pricing the underlying assets and are based on the fair

values of trust investments as reported by the trustees. The fair value of the beneficial interest in assets held by the community foundation is based on the fair value of fund investments as reported by the community foundation. These are Level 3 measurements.

The organization uses net asset value (NAV) per share, or its equivalent, such as member units or an ownership interest in partners' capital, as a practical expedient to estimate the fair values of certain hedge funds, private equity funds, funds of funds, and limited partnerships, which do not have readily determinable fair values. Investments that are measured at fair value using NAV per share as a practical expedient are not classified in the fair value hierarchy.

The interest rate swap agreement is valued using a third party's proprietary discounted cash flow model, which considers past, present, and future assumptions regarding interest rates and market conditions to estimate the fair value of the agreement. This is classified within Level 2.

The following table presents assets and liabilities measured at fair value on a recurring basis, except those measured at cost or by using NAV per share as a practical expedient as identified in the following, at December 31, 20X1:

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Investments Measured at NAV
Assets					
Operating investments					
U.S. Government obligations	\$ 276,313	\$ -	\$ 276,313	\$ -	\$ -
Short-term bond mutual fund	497,910	497,910	-	-	-
	<u>\$ 774,223</u>	<u>\$ 497,910</u>	<u>\$ 276,313</u>	<u>\$ -</u>	<u>\$ -</u>
Assets held under split-interest agreements					
Cash and money market funds (at cost)	\$ 178,411	\$ -	\$ -	\$ -	\$ -
U.S. Government obligations	512,904	-	512,904	-	-
Global equity mutual funds	1,285,787	1,285,787	-	-	-
	<u>\$ 1,977,102</u>	<u>\$ 1,285,787</u>	<u>\$ 512,904</u>	<u>\$ -</u>	<u>\$ -</u>
Beneficial interests in					
Charitable trusts held by others	\$ 812,850	\$ -	\$ -	\$ 812,850	\$ -
Perpetual trusts	4,081,382	-	-	4,081,382	-
Assets held by community foundation	1,094,842	-	-	1,094,842	-
	<u>\$ 5,989,074</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 5,989,074</u>	<u>\$ -</u>
Endowment investments					
Cash and money market funds (at cost)	\$ 538,964	\$ -	\$ -	\$ -	\$ -
Certificates of deposit	711,544	-	711,544	-	-
U.S. Government obligations	1,237,881	-	1,237,881	-	-
Global equity mutual funds	6,595,804	6,595,804	-	-	-
Global equity funds	572,375	-	-	-	572,375
Long/short hedge funds	5,961,036	-	-	-	5,961,036
Private equity funds	5,456,648	-	-	-	5,456,648
Real estate funds	6,491,843	-	-	-	6,491,843
	<u>\$ 27,027,131</u>	<u>\$ 6,595,804</u>	<u>\$ 1,949,425</u>	<u>\$ -</u>	<u>\$ 18,481,902</u>
Liabilities					
Interest-rate swap	\$ 240,300	\$ -	\$ 240,300	\$ -	\$ -

The following is a reconciliation of the beginning and ending balance of assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the year ended December 31, 20X1:

	Fair Value Measurements at report Date Using Significant Unobservable Inputs (Level 3)		
	Beneficial Interests		
	Charitable Trusts	Assets Held by Community Foundation	Perpetual Trusts
Balance at December 31, 20X0	\$ 804,179	\$ 1,090,505	\$ 3,998,524
Purchases/contributions of investments	24,334	-	-
Investment return, net	21,209	41,209	188,635
Distributions	(36,872)	(36,872)	(105,777)
Balance at December 31, 20X1	<u>\$ 812,850</u>	<u>\$ 1,094,842</u>	<u>\$ 4,081,382</u>

Investments in certain entities that are measured at fair value using NAV per share as a practical expedient are as follows at December 31, 20X1:

	Number of Investments	Fair value	Unfunded Commitments	Redemption Frequency	Redemption Notice Period
Global equity funds	1	\$ 572,375	\$ -	Quarterly	30 days
Long/short hedge funds	9	5,961,036	-	Daily, Monthly	None, 30 days
Private equity funds	5	5,456,648	500,000	Annually	30 days
Real estate funds	13	6,491,843	225,000	Illiquid	None, 30 days
		<u>\$ 18,481,902</u>	<u>\$ 725,000</u>		

(1) The liquidity of certain investments is limited until the original capital commitment has been met. Additionally, the provisions of two investment contracts require a term exceeding one year for complete divestiture.

Global Equity Funds – These funds invest in private companies, primarily in foreign markets, including emerging economies. These funds target companies that are not publicly traded on stock exchanges. They offer the potential for higher returns but also carry greater risk compared to publicly traded stocks due to less available information and lower liquidity.

Long/Short Hedge Funds – These funds employ flexible investment strategies. They can buy stocks they believe will increase in value (long positions) and sell stocks they believe will decrease (short positions). This allows them to potentially profit in both rising and falling markets. They often invest across different market segments (value, growth, or event-driven) and may use leverage (borrowing money) to amplify potential returns but also magnify potential losses.

Private Equity Funds – These funds focus on investing in companies with high growth potential, buying them out entirely (buyout), or acquiring distressed debt (debt of companies in financial trouble). These investments are illiquid, meaning they cannot be easily sold on a daily basis, though a secondary market exists for them. Investors typically receive returns when the fund sells the underlying companies or debt holdings. The investment terms typically range from 3 to 7 years.

Real Estate Funds – These funds invest in various real estate assets, primarily located in the United States (depending on the specific fund). Similar to private equity, they are illiquid, and investors receive returns through the sale of the underlying properties. The investment terms typically range from 2 to 10 years.

Fair values of assets measured on a nonrecurring basis at December 31, 20X1 are as follows:

Assets	Fair Value Measurements at Report Date Using				Total Losses
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Long-lived asset held and used					
Administration Building	\$ 2,475,000	\$ -	\$ 2,475,000	\$ -	\$ 90,684

During the year ended June 30, 20X1, the administration building, with a carrying amount of \$2,535,000, was written down to its appraised fair value of \$2,475,000, resulting in an impairment loss of \$90,684 which was included in the change in net assets without donor restrictions for the year.

Endowment Funds

Relevant Literature: ASC 958-205

An endowment fund is an established fund of cash, securities, or other assets to provide income for the maintenance of a 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 to provide a permanent source of income.
- A term endowment, which is to provide income for a specified period.

Donors may or may not stipulate the use of any return on their endowment funds. Some donors may stipulate that the return be added to the endowment fund to preserve the purchasing power subject to the donor's stipulations. Others may stipulate that the return be used for specific programs or purposes. Often donors do not make stipulations related to the return and the NFP will spend according to its established spending policy.

NFPs also have what is referred to as board designated or **quasi-endowment** funds. These are amounts set aside by the governing board, generally to provide a stream of funding for an activity or for some other purpose. These funds come from the organization's assets that are without donor restriction.

Uniform Prudent Management of Institutional Funds Act (2006)

The Uniform Prudent Management of Institutional Funds Act (UPMIFA) is a legal framework adopted by most US states (except Pennsylvania and Puerto Rico) to guide how NFPs and charitable organizations manage their endowment funds. These are permanent investments where only a portion of the earnings are typically spent annually on charitable work, ensuring the long-term sustainability of the organization's mission. UPMIFA promotes responsible investment practices, helps establish spending policies, and doesn't apply to temporary assets or those with individual beneficiaries. While some perpetual funds might fall outside its direct scope depending on the state's version, UPMIFA ultimately fosters responsible stewardship of charitable funds, maintains their purchasing power for future generations, and increases transparency in how these valuable resources are managed.

EXAMPLE

Massachusetts adopted UPMIFA in 2011. The adoption of the standard was good for NFPs in the sense that the law permits spending from a donor restricted endowment even when it causes a fund to go under water (decline past the original gift). The adoption helped NFPs that had restricted gifts where the purpose to use them may have been obsolete. With the adoption of UPMIFA NFPs can ask the Attorney General for consent to modify certain restrictions of an institutional fund that has been in existence for twenty (20) years or longer and has a total value of seventy-five thousand dollars (\$75,000) or less as of the end of its last fiscal year to do so without petitioning the court for relief. Following is an excerpt from the version of UPMIFA adopted by Massachusetts.

Section 3 of UPMIFA (Mass)

Section 3. (a) Subject to the intent of a donor expressed in the gift instrument, an institution may appropriate for expenditure or accumulate so much of an endowment fund as the institution determines is prudent for the uses, benefits, purposes, and duration for which the endowment fund is established. Unless stated otherwise in the gift instrument, the assets in an endowment fund shall be donor-restricted assets until appropriated for expenditure by the institution. In deciding to appropriate or accumulate, the institution shall act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, and shall consider, if relevant, the following factors:

- the duration and preservation of the endowment fund.
- the purposes of the institution and the endowment fund.
- general economic conditions.
- the possible effect of inflation or deflation.
- the expected total return from income and the appreciation of investments;
- other resources of the institution; and
- the investment policy of the institution.

(b) To limit the authority to appropriate for expenditure or accumulate under subsection (a), a gift instrument shall specifically state the limitation.

(c) Terms in a gift instrument designating a gift as an endowment, or a direction or authorization in the gift instrument to use only “income”, “interest”, “dividends” or “rents, issues, or profits”, or “to preserve the principal intact” or words of similar import shall:

create an endowment fund of permanent duration unless other language in the gift instrument limits the duration of the fund; and not, standing alone, limit the authority to appropriate for expenditure or accumulate.

Spending Policy

UPMIFA prioritizes donor wishes by keeping investment returns from restricted funds classified as such until the board allocates them for spending. UPMIFA even considers state restrictions, keeping those returns categorized as “donor restricted” until used. Approving funds for spending doesn’t mean immediate use; they can be designated for future programs and only become unrestricted once actually spent. While uncommon, some board-designated funds might have a portion with specific donor restrictions on a certain part of their assets, but UPMIFA’s focus remains on ensuring responsible management and respecting donor intent for permanent endowments.

EXAMPLE

A large disease-related foundation has an endowment subject to the terms of UPMIFA and its spending policy. In years where donations to the organization are higher the board does not feel the need to spend the return that is appropriated for expenditure according to the organization's spending policy. Instead of leaving it in the donor restricted endowment, the board moved the amounts to its quasi-endowment fund for long-term investment.

If there are further restrictions on how the return can be spent, over and above those required by the enacted version of UPMIFA, 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 or 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. Currently only Pennsylvania and Puerto Rico have not adopted UPMIFA. Although Pennsylvania has not adopted UPMIFA it has a similar law with prudence criteria and a spending cap of no less than 2% and no more than 7% of the three-year average value of the assets held by the NFP or trust. On July 23, 2020 Pennsylvania modified its law to allow NFPs to increase the rate at which they spend their endowments for three years to 10%. This was in response to the COVID pandemic which adversely affected all manner of NFP revenue sources.

Since donor stipulations and laws vary, NFPs should 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 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 **may not** be available for expenditure.

When returns on the endowment investments are negative or the spending policy of the organization permits a level of appropriation for expenditure that exceeds the return in the current year, an endowment fund may go "underwater". The amount that exceeds the amount of the original gift is classified as donor restricted.

Presentation and Disclosure

Endowments are reported based on the existence or absence of donor-imposed 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.

The FASB's disclosure requirements are designed to assist the financial statement user to understand all of the following about its **endowment funds** (both donor restricted and board designated). The organization will present information about:

- 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.

In addition, the following additional disclosures are required 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
- Spending policy or policies including its policy, and any actions taken during the period, concerning appropriation from underwater endowment funds
- 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

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

EXAMPLE

Note I: Endowment

Caring for Children's endowment (the Endowment) is a collection of approximately 45 individual funds. Donors established these funds to provide annual support for specific activities or general operations. The Endowment also includes some unrestricted assets designated for endowment status by the Board of Directors.

UPMIFA, the Georgia Uniform Prudent Management of Institutional Funds Act, guides the Endowment's investment strategy. This law emphasizes preserving the purchasing power of donations over time, allowing for responsible spending that considers future needs. Following UPMIFA and the Board's interpretation, the Endowment strives to maintain the original value of each gift, adjusted for market fluctuations, unless the donor explicitly allows otherwise.

For donor-restricted funds with no spending limitations, both the original gift value and any earned income or appreciation are held in perpetuity. This ensures a lasting source of funding for the designated purpose. For funds with specific spending allowances, the Board may allocate those funds based on various factors. These factors include the long-term health of the fund, alignment with the organization's mission and donor intent, economic conditions, potential inflation or deflation impacts, expected investment returns, the organization's overall resources, and its investment policies.

As of December 31, 20X1, Caring for Children 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
	<u>\$ 6,511,186</u>	<u>\$ 20,852,944</u>	<u>\$ 27,364,130</u>

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). Management and the Board have interpreted UPMIFA to permit spending from underwater endowments in accordance with prudent measures required under law. At June 30, 20X3, 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

The Organization has 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. The Organization uses 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 20X3, the spending rate maximum was 4.5%. In establishing this policy, management and the Board 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 December 31, 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 was created to provide guidelines for NFPs to adopt prudent spending of institutional funds. As noted above, each state that has adopted UPMIFA has established certain guidelines of its own such as spending caps. The NFP's board interprets the state law and then creates spending policies. Following are some examples of spending policy formulas.

EXAMPLE

A NFP used a total return formula to separate the endowment's investment return into operating and non-operating amounts. The concept of total return takes the components of investment return – net appreciation (depreciation) and investment income and breaks it down into spendable and nonspendable components. The Board appropriates the spendable portion for expenditure.

The finance committee chair advised that the spendable portion should be designed so that it is less than the actual return on investment considered over a 5-year period would be. This means that in years with higher returns accumulation would result in the endowment and in years with poor or negative returns this excess would be available for spending. The finance committee believes that was also the intent of UPMIFA. He suggested a 7% spending cap even when returns were higher for an extended period. At June 30, 20X3 the following was calculated and \$20,250 was appropriated for expenditure by the board.

Total expected return per year over the life of the assets (debt and equities)	-	Anticipated inflation per year over the life of the assets	=	Spending rate
6.50%		2.50%		4.50%

5 Year Average Investment Balance:	450,000	
	<u>4.50%</u>	
	20,250	Spendable portion
Investment return, YE 6/30/X3:		
Interest	5,000	
Appreciation	<u>22,750</u>	
Total return	<u>27,750</u>	
	7,500	Nonspendable portion

With endowment accounting it is important to remember that the application is fund by fund. Although it is likely that the donors permit spending of the return at the discretion of the NFP, it is possible that some donors may have different instructions about the amount of return that must be retained for purchasing power or must be used for specific purposes.

Investment Pools

NFPs may pool investments to manage the investment portfolios of their endowments (both donor restricted and quasi endowment). When a pool is established, the value of the investments in the pool is divided into units and each pool category (donor restricted or quasi endowment) or participant endowment fund is given an initial number of units. The pool is marked to fair value and a new unit value is 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.

Since 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.

Programmatic Investments

Relevant Literature: ASC 326 and ASC 835

As part of their programs a NFP may make investments in other NFPs or constituents.

- 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 a NFP's debt

Programmatic investments must meet two criteria:

- Further the tax-exempt mission of the NFP
- The production of income or appreciation is not the reason for conducting the activity.

Diversity in Practice

Programmatic loans are challenging because they are made to entities that have more credit risk than most those who receive commercial loans are. Depending on the intent of the NFP in making the programmatic investment they may be loans where the NFP identifies the credit risk and imputes a rate of interest that incorporates the amount the NFP does not expect to collect. This is referred to as the effective interest rate approach. Others are treated as contributions made to others.

Effective Interest Rate Approach

When making programmatic loans, there may be many instances where the loans bear a market rate of interest. In other cases, the loans may be interest free or bear a below market rate of interest. In these cases of below market rate loans, the NFP knows that the borrower

would not be able to afford the loan otherwise and this is part of the organization's loan program. ASC 835 provides guidance on imputing interest on receivables regardless of whether they are interest free or bear interest at a below market rate. Since the loans held by NFPs are not traded on the market the way commercial loans it is difficult to determine the present value. In the case of a programmatic loan the difference between the cash transferred to the borrower and the present value of the contractual payments at the effective interest rate is considered a contribution expense.

EXAMPLE

Scenario 1: A Community Foundation made a 5-year loan to an entity that assists the unemployed in finding work. The loan is a no interest loan with payments of \$5,000 per year and a balloon payment at the end of the 5-year period. The Community Foundation believes the NFP has significant credit risk. The five-year \$100,000 loan is discounted at 15% which is deemed to be a market rate. To do this the Community Foundation considered that the loan was unsecured, the credit worthiness of the NFP, time value of money and market rates. The Community Foundation regards this as a part of its mission so the discount on the loan is recorded as contribution (program) expense.

Loan receivable	\$100,000	
Contribution expense	54,051	
Cash		\$100,000
Discount on loan receivable		54,051

The discount then is amortized into interest income.

Valuation Allowance

The accounting for valuation allowances effective for years beginning after December 15, 2022. The Community Foundation is required to implement the new current expected credit loss standard (CECL) which is a change from the incurred loss model in effect before the effective date. Loans are evaluated for the expected losses. Since the Community Foundation makes this sort of loan as one of its programs it will aggregate this loan with others with similar risk, duration and other characteristics. There is no one specific model to use to evaluate the loan receivable. The easiest model to use is the discounted cash flow model. In this model the Community Foundation would use the carrying value of the loan which at inception is the loan receivable minus the discount (\$45,949).

Note Receivable for Community Foundation 15% interest							
Year	Contractual Cash Flow	Discount at 15%	Present value of loan receivable	Expected cash flow	Discount at 15%	Present value Expected	Difference
20X1	5,000	0.8696	4,348	5,000	0.8696	4,348	
20X2	5,000	0.7561	3,781	5,000	0.7561	3,781	
20X3	5,000	0.6575	3,288	5,000	0.6575	3,288	
20X4	5,000	0.5718	2,859	5,000	0.5718	2,859	
20X5	80,000	0.4972	39,776	15,000	0.4972	7,458	32,318
Total cash flow	100,000		54,051	35,000		21,733	32,318
PV cash flow							

The valuation allowance at inception is \$32,318.

Impairment loss	\$32,318
Allowance for loan losses	\$32,318

Write-offs of loans will be against the valuation allowance.

Sometimes programmatic loans come with a promise of forgiveness. These are conditional promises to give and are based on certain criteria being met. Even if the loan does not include forgiveness, the investor may decide 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 a debit to impairment expense and an adjustment to the allowance for loan losses. If it is simply a decision to forgive the loan for other reasons, it is a programmatic expense.

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. If the donor specifies that a revolving loan fund be created, the net assets are subject to ongoing restriction. This is true even if the loan fund is down due to losses or if it is eventually depleted.

EXAMPLE

Note 7: Programmatic Loans

The Agency provides benefits to the community by making programmatic investments. These unsecured loans are made to businesses in disadvantaged communities. Typically, the interest is between 2 percent and 5 percent below market. The difference between the discounted and market rate of interest is recorded as contribution expense. The organization records the loans in the financial statements using a discount rate that is commensurate with the risk involved, typically between 13 percent and 15 percent. Currently the Agency has made ten programmatic loans. They are treated as one portfolio for the purpose of estimating the allowance for loan losses. At December 31, 20X1 the balance of loans receivable was as follows.

Within one year	\$ 650,000
In one to five years	820,000
Over five years	396,500
	<u>1,866,500</u>
Less discount to net present value at rates ranging from 12.96% to 15.50%	(350,000)
Less allowance for loan losses	(114,000)
	<u>\$ 1,402,500</u>

The Agency has established an allowance for credit losses to adjust the carrying value of the receivable to the estimated amount the Agency believes will ultimately be collected. The Agency estimates this allowance, based on the individual circumstances of the borrowers, historic loss trends for programmatic loans, previously written-off balances and expected recoveries up to balances previously written off, to present the net amount expected to be collected. Loan receivable balances are written off when determined uncollectible and are recognized as a reduction to the allowance for credit losses. Following is a summary of activity for the allowance for credit losses during fiscal year 20X1:

Beginning balance - allowance for credit losses			103,000
Additions charged to costs and expenses			14,000
Write-offs, net of recoveries			(3,000)
Ending balance - allowance for credit losses			<u>114,000</u>

The Agency monitors the credit quality of its financing receivables and loan receivables through the observation of delinquency monthly. The last time the credit quality

indicators were updated was at the fiscal year end. The following table summarizes the amortized cost of loans receivable at December 31, 20X1.

Delinquency	Loans Receivable
Current	1,200,000
30-60 days past due	60,000
61-90 days past due	82,500
91-120 days past due	45,000
120+ days past due	15,000
Total	1,402,500

PROMISES TO GIVE

Contributions of Long-Term Assets- General

Relevant Literature: ASC 958-605

A 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.

Absent donor restrictions, a tangible long-lived asset such as a building or equipment must be classified as support without donor restrictions when it is placed in service. However, contributions of cash or other assets, such as investments, which are to be used to construct or acquire long-lived assets, have purpose restrictions until those restrictions are met. They are recorded as donor-restricted support until such time as the underlying asset is placed in service.

If 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 a period of 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 are received. In this case, the NFP 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.

EXAMPLES

Donor restrictions on contributions can be tricky when it comes to timing and purpose. Here are a few examples to illustrate:

Example 1: An NFP received a pledged donation for a building project. The donor intended the funds to be used "right away" for upfront costs like architect fees. Even though the pledge is spread out over several years, the NFP can consider the

contribution unrestricted support once they use the money for approved building expenses. This is because the donor's intent was for current use, regardless of the remaining pledge balance.

Example 2: An NFP received funding to build a new building. While the donor intended for the money to be used “currently,” the specific purpose was for construction itself. The NFP can't classify this as unrestricted support until the building is actually operational. So, the timing restriction might be met, but the purpose restriction takes precedence here.

Example 3: An NFP received a donation earmarked for upcoming debt service on their building. The donor clearly intended for the funds to be used for current debt payments. Even if the NFP receives the donation late, they can still release the restriction as long as the original due date for the debt payment has passed. The key here is the intended use date, not necessarily when the NFP receives the money.

Although not a frequent occurrence, donors may put restrictions on the NFP's other assets or their own gifts.

EXAMPLE

A donor to a NFP organization group home contributed \$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 as 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.

Contributions of Cash to be Paid Over a Period of Time

To achieve their goals, NFPs run fundraising campaigns that fall into two main categories: annual funds and capital campaigns. Annual funds are yearly events that raise unrestricted funds for ongoing operational costs. Donors are expected to fulfill their pledges quickly, within the same fiscal year. These unrestricted contributions become part of the NFP's net assets without donor restrictions. However, if a donor specifies that their contribution can only be used later, it becomes temporarily restricted until the designated time. In contrast, capital campaigns aim to raise large sums for major projects or acquisitions. Pledges for capital campaigns are often structured with payments spread out over several years. Similar to annual funds, how these contributions are classified in the NFP's net assets depends on the donor's intended use. Unrestricted pledges are reported without restrictions, while those with future-use limitations are recorded as temporarily restricted net assets. Beyond net asset classification, NFPs must also consider accounting for receivables generated by pledges from both types of campaigns, ensuring these are accurately reflected in their financial statements.

Measurement of Contributions

Contribution revenue is 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.

Initial Measurement

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. 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.

This method 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 calculated, and a discount recorded. If present value techniques are used to measure the fair value of unconditional promises to give, a 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

When making a valuation, the NFP does not have to use exhaustive efforts to obtain credit information about a donor. The FinREC believes that the factors are relevant.

- 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

It is also important to consider whether the NFP has a practice of not enforcing its right to receive promises to pay.

Discounting Methods

ASC 820-10-55 outlines two primary approaches for calculating present value: the discount rate adjustment (DRA) and the expected present value (EPV) methods. Both aim to estimate the fair value of an asset or liability by considering the time value of money and inherent risks.

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 considers a range of possible cash flow scenarios, each assigned a probability of occurrence. There are two variations within the EPV method:

- **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.

Conceptually, these methods should end up producing comparable results.

EXAMPLE

In 20X5, an independent school celebrated a successful capital campaign, raising \$3 million. However, the controller, mindful of potential economic downturns, recognized the need for a realistic collection strategy. Historical data showed recessions occurring roughly every 8–10 years, potentially impacting donor contributions in the coming years. To estimate the most likely amount ultimately collected, she not only considered the current economic climate but also delved into the results of the previous capital campaign held five years prior in 20X0. This historical analysis, combined with an awareness of potential economic fluctuations, would guide the controller in establishing accurate and reliable projections for the current campaign's receivables.

The campaign results from the 20X0 campaign were:

Experience from 2005 Capital Campaign					
Type of Donor	Average Donation	Amount Pledged Total for Campaign	Percentage of Total Pledged	Amount Collected	Percentage Collected
Individual (parents - high net worth, large givers)	130,781	2,615,620	78.50%	2,432,527	93%
Individual (parents - smaller givers)	511	583,100	17.50%	524,790	90%
Teachers and employees of the school	1,111	83,300	2.50%	73,304	88%
Corporations	12,495	49,980	1.50%	50,000	100%
	144,897	3,332,000	100%	3,080,621	92%

The controller sought information from three similar schools that had capital campaigns. She did this because she wanted to first use probability weighted-cash flows. The information provided by the other schools was derived from periods when a recession was present, and she used this to forecast the **most likely cash flow**. Since certain donors default at different percentages, she considered the most likely cash flow to be derived from the campaign by donor type. She obtained the following information from other similar schools.

Type of Donor	% Collected of Amounts Promised To Date	% Collected of Amounts Promised To Date	% Collected of Amounts Promised To Date
	School 1	School 2	School 3
Individual (parents - high net worth, large givers)	90%	95%	94%
Individual (parents - smaller givers)	85%	87%	91%
Teachers and employees of the school	82%	89%	92%
Corporations	100%	100%	100%

The controller developed the most likely amount to be received from each group of donors using a probability weighted approach.

(Expected pledges of \$3,000,000 - rounded)	
Probability weighted cash flows	Individual High Net Worth
Seventy-five percent chance of getting 92%	1,624,950
Ten percent chance of getting 95%	223,725
Fifteen percent chance of getting 90%	317,925
Projected collections	2,166,600
Percentage Collectible (weighted average)	92%
Probability weighted cash flows	Individual - Smaller
Fifty percent chance of getting 90%	236,250
Twenty percent chance of getting 87%	91,350
Twenty percent chance of getting 91%	95,550
Ten percent chance of getting 85%	44,625
	467,775
	89%
Probability weighted cash flows	Teachers & Employees
Fifty percent chance of getting 93%	34,875
Twenty percent chance of getting 92%	13,800
Fifteen percent chance of getting 89%	10,013
Fifteen percent chance of getting 82%	9,225
	67,913
	91%
Probability weighted cash flows	Corporations
Ninety percent chance of getting 100%	40,500
Ten percent chance of getting 95%	4,275
	44,775
	100%
Total expected pledges to be collected	2,747,063
Percentage of total pledges dollars	92%

Discount rate: Since the DRA method was ultimately used controller identified an unsecured borrowing rate for an individual of 5.5%. This was used for the most credit-worthy of the donors. Two percent was added to the unsecured rate for the credit-worthy for a resulting rate of 7.5%, reflecting the risk in the teacher/employee category and the smaller donor category. A corporate rate of 3.5% was used. The controller wanted to be conservative in the amount she recorded to limit adjustments later on.

Actual 20X5 campaign results

	Pledged	Amount per year	Estimated % Collectible	Estimated \$ Collectible	Discount Rate	Discounted Cash Flow
Individual (parents - high net worth, large givers)	2,196,000	439,200	93%	408,456	5.50%	1,744,223
Individual (parents - smaller givers)	610,000	122,000	90%	109,800	7.50%	444,238
Teachers and employees of the school	457,500	91,500	88%	80,520	7.50%	325,775
Corporations	250,000	50,000	100%	50,020	3.50%	225,843
	3,513,500	702,700	93%	648,796		2,740,079
Amount of the discount on pledges receivable	503,901					
[(648,796 X 5) - 2,470,079]						

The controller made the following journal entry to record pledges receivable and the contribution revenue which was donor restricted for purpose and timing.

Promises to give	3,243,890
Discount of promises to give	503,901
Contribution revenue-donor restricted	2,740,079

Each year as the cash is due the release from restriction occurs provided the purpose restriction is met. The discount is amortized into contribution revenue – without donor restriction. When cash is received the receivable is reduced.

Subsequent Measurement

During the time that contributions receivable are outstanding, events may take place that affect their valuation and measurement. For example, a donor may determine that they do not have the ability to pay their promise to give. In most cases, 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 uncollectible promises to give	\$4,000

Some NFPs have sued donors for nonpayment but this is rare. NFPs generally do not use outside parties to pursue collection on delinquent donors.

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. Note that the current expected credit loss standard is not applicable to receivables from promises to give.

Request for Return of Donation

Donor remorse and concerns about an organization's practices are the leading reasons gifts are requested back. A donor might simply change their mind or, more concerningly, believe the NFP is misusing funds, straying from its mission, or implementing initiatives they disagree with. In some cases, donors feel their designated use of funds is being ignored.

While no federal law mandates NFPs to return donations, individual states have indirect regulations assuming a gift becomes the donee's property upon acceptance. To mitigate negative publicity, NFPs often strive to find solutions.

If a return is granted, the reporting would mirror the “loss on promises to give” scenario. Material contributions might warrant a separate line item, while others might be categorized as outside operating expenses for entities with an operating indicator.

Revising the Discount Rate

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*. Then 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.

Decline in the Value of a Gift

Many NFPs receive gifts of appreciated securities. When a donor promises to give an NFP securities where delivery is not immediate, there is a possibility that the value of the securities will either increase or decrease requiring adjustment in the underlying asset. This adjustment would occur in the period in which the change occurs, in the net asset class in which the contribution is recorded. When the value eventually received by the NFP is different from that expected the NFP should evaluate whether it was due to failure of the donor to deliver or a change in the value of the asset.

EXAMPLE

Scenario 1: During the year ended December 31, 20X2, a donor pledged 1,000 shares of Home Depot stock which the NFP recorded at \$329 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 in early 20X3.

The donor delivered the promised number of shares but at the date of transfer the fair value of the security was \$320. Therefore, the NFP had a reduction of revenue.

Journal Entries:

Promise to give	329,000	
Contribution revenue –donor restricted		329,000
To record the promise to give		
Contribution rev –donor restricted	9,000	
Investment	320,000	
Promise to give		329,000

To record the change in the value of the security at delivery.

Scenario 2: During the year ended December 31, 20X2, a donor pledged \$329,000 of Home Depot stock which the NFP recorded at that value at the date of donation as donor restricted revenue. The stock was to be delivered in early 20X3. At the delivery date the donor did not have sufficient shares with a value of \$320,000 since the price had declined since the promise was made by \$9 a share. Accordingly, the NFP had a loss of that amount.

Journal Entries:

Upon receipt of pledge:

Promise to give	329,000	
Contribution rev –donor restricted		329,000
To record the initial promise to give		
Investment	320,000	
Loss– donor restricted	9,000	
Promise to give		329,000

DISCLOSURE Example**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		<u>122,000</u>
		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		<u>(145,539)</u>
	\$	<u>941,112</u>

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

Promises to give, net	\$	941,112
Endowment promises to give, net		<u>2,501,416</u>
	\$	<u>3,442,528</u>

Gifts in Kind

Many NFPs overlook a valuable source of support: gifts-in-kind, which are non-cash contributions like services or assets. These assets can range from land and equipment to cryptocurrency, but not investment securities, which are considered financial assets. Unfortunately, many NFPs fail to record these contributions due to a lack of awareness among accountants or the absence of a clear financial trigger. This can lead to an inaccurate picture of the organization's resources.

Furthermore, some auditors might not inquire about in-kind contributions if they perceive them to have minimal financial impact. However, it's crucial to remember that these contributions are recorded at their fair value on the date of donation. Depending on their intended use, they can impact various accounts. For example, donated office equipment might be recorded as fixed assets, while donated food for a shelter might be classified as an expense. Long-term contributions, such as leased space or utilities, are recognized as expenses over time. Overall, proper recording of in-kind contributions ensures NFPs have a clear understanding of their financial health and the true value of their donor support.

EXAMPLE

In 20X1, a large national NFP foundation faced a challenge with its regional affiliates. Several regional branches, sharing the parent organization's name, were underperforming. To address this, the executive team made a strategic decision to streamline operations. This involved acquiring the struggling affiliates and centralizing administrative services through the parent's existing shared service department. This restructuring plan, however, came with a hidden cost.

The streamlining process demanded a significant amount of legal work, and a board member, acting in good faith but exceeding their typical responsibilities, stepped in to handle these legalities. This generous contribution of legal expertise went unrecorded in the NFP's financial statements for 20X0. As a result, the legal expenses appeared artificially low, potentially misrepresenting the organization's financial picture.

A critical turning point came later in 20X1, when the NFP switched audit firms. During the standard client acceptance procedures, the new auditor meticulously reviewed the financial statements. This included scrutinizing legal expenses, which appeared unusually low given the nature of the restructuring. Upon further inquiry, the auditor discovered the board member's pro bono legal work, a substantial contribution that had been overlooked.

The new auditor, bound by professional ethics, informed both management and the board of a crucial decision. To maintain accurate and transparent financial records, a restatement of the 20X0 financial statements would be necessary if they were to accept the NFP as a client. The unrecorded legal fees, representing the board member's contribution, were deemed material, meaning they could significantly impact the financial picture and potentially mislead stakeholders.

This situation also highlighted the importance of clear communication between board members and management. The board member's generous service, while well-intentioned, should have been properly documented and accounted for as a non-cash contribution. This incident serves as a valuable reminder for NFPs to be mindful of all forms of support, including those provided by board members, and to ensure accurate and transparent financial reporting.

Valuation

ASU 2020-07 was recently effective for NFPs. Although it is a presentation and disclosure standard and does not affect the accounting for in-kind donations, it places focus on the importance of completeness in recording these gifts and the importance that NFPs properly consider their fair value. This is one of the more challenging aspects of gifts in kind. ASC 820 states that fair value is the estimated price at which an asset can be sold, or a liability settled in an orderly transaction to a third party under current market conditions.

ASC 958-605 provides guidance that is tailored for nonfinancial assets donated to NFPs either to be used in the provision of the services, sold, or used in fundraising.

Measuring the fair value of donated nonfinancial assets is challenging because:

- The gifts do not have an active market.
- Some gifts, like preservation easements, are not generally bought or sold.
- Some gifts are items a NFP would not otherwise purchase.
- Many gifts are not used at their highest and best use by NFPs.

Most gifts have future economic benefit or service potential. The future economic benefit or service potential of a tangible item usually can be obtained by exchanging it for cash or by using it to produce goods or services.

Fair Value

NFPs often receive donated assets that require fair value measurement. The fair value hierarchy, established by accounting standards, prioritizes the types of inputs used to ensure the most reliable valuation possible.

The ideal scenario (Level 1) involves a readily available quoted price in an active market for an identical asset. This price reflects real-world transactions and provides the most dependable evidence of fair value. However, for many donated assets, active markets may not exist.

In such cases, NFPs move down the hierarchy to Level 2 inputs. These might include publicly available information on transactions for similar assets in inactive markets like auction websites. While not identical, this data can still offer valuable insights for valuation.

The situation becomes more complex when dealing with principal-to-principal markets (Level 2 as well). These markets, often private, offer limited publicly available transaction information. Here, the NFP might rely on industry data or valuations performed for similar assets.

When even Level 2 inputs are scarce, the hierarchy moves to Level 3: unobservable inputs. Here, the NFP essentially becomes a market participant itself, making assumptions about how a hypothetical market transaction for the asset might occur. This requires careful consideration of several factors:

- The specific characteristics of the non-financial asset itself.
- The most relevant market for the asset, considering its intended use.
- The types of market participants likely to be involved in a transaction.

The NFP doesn't need to go on an exhaustive search for information, but it should make a reasonable effort to gather data on typical market participant assumptions. This process ensures the organization's assumptions are grounded in real-world market behavior.

Understanding and navigating the fair value hierarchy is crucial for NFPs to accurately value donated non-financial assets. By prioritizing reliable market data and making informed assumptions when necessary, NFPs can maintain transparent and trustworthy financial reporting.

The FinREC believes that the market in which an NFP would normally sell or distribute the asset may not be the principal, or even the most advantageous, market for the donated nonfinancial item. Some of this comes down to motive. A NFP may be more interested in fulfilling mission than maximizing the amount they would get from selling the assets. Therefore, the entity would **not** look to the amount the beneficiaries receiving gifts in kind from NFPs would pay since those amounts are not a good indicator of a principal market. **The market in which the goods would normally be sold is the market that should be considered.**

EXAMPLE

As part of its mission, an NFP sells donated food and other products to low-income families at a significant discount. During 20X1 the NFP received donated goods with a fair value of \$10,000, which is what a market participant would pay to a low-cost retailer like the Dollar Store. The NFP paid a shipping and handling fee of \$1,000. The NFP intends to sell the goods at an 80% discount in the entity's programs. The accounting manager recorded the contribution revenue at \$9,000 (the fair value net of the cash disbursement of \$1,000) with a corresponding entry to inventory.

Sometimes issues arise when the NFP may have other reasons for not pursuing highest and best use. In addition to the programmatic issues discussed above, tax law or donor-imposed restrictions limit the use of the nonfinancial asset to a use other than its highest and best use. For example, a donor may provide gifts in kind to a NFP and require that they be restricted to specific geographic locations or sold at auction immediately with the proceeds restricted to a particular program. ASC 820 notes that the highest and best use of a nonfinancial asset considers the use of the asset that is physically possible, legally permissible, and financially feasible.

In contrast, restrictions that are specific to the donee should be reflected in the classification of net assets, not in the measurement of fair value. The FinREC believes that in implementing that guidance, limitations imposed by the IRS prohibiting NFPs from selling the gifts in kind, as well as donor restrictions limiting the geographic locations area in which the gifts in kind may be distributed, are restrictions specific to the entity. Since those sorts of restrictions are not a characteristic of the asset, they **would not transfer** to market participants, and therefore would not be considered in pricing the asset.

ASC 958-605 states that in determining fair value of gifts in kind, entities should consider the quality and quantity of the gifts, as well as any applicable discounts that would have been received by the entity, including discounts based on that quantity if the assets had been acquired in exchange transactions. Whenever a gift in kind differs from the item observed in the marketplace transaction, the NFP should consider whether an adjustment is needed to determine fair value.

EXAMPLE

A NFP receives donations of medical supplies from pharmaceutical companies and sends them to developing countries as part of its mission. The standards for expiration are not the same in these countries as they are in the US so many of the products donated are very close or at their expiration date. This makes them less desirable than other products that are sold in the US and a discount should be applied. The CFO valued the products at a discount since the gift differed from others in the marketplace due to the expiration date.

Valuations Provided by Donors

If the NFP receives an appraisal or other evidence of valuation, this does not mean that the entity should use the valuation as provided without challenging it, without bias, to determine whether it is appropriate. In addition, there are published sources that exist that provide values of various assets that may be received vehicles. The FinREC believes that the entity should consider whether those published sources are appropriate inputs for measuring fair value. The value that a donor recognizes for tax purposes or that a published source indicates is not necessarily fair value and may differ significantly from fair value.

Donated Gifts Sold at Fundraisers

NFPs may also receive items, such as tickets, gift certificates, works of art, and merchandise, which are to be used for fundraising purposes such as auctions where they are “sold” to persons participating in fundraising events. When the eventual sale happens those gifts in kind can be directly attributed to the original gift from the donor. In effect, they are part of the same transaction.

The NFP will report the original contribution as revenue measured at fair value at the date of donation. The difference between the amount received for those items from participants at fundraisers and the fair value of the gifts in kind when originally contributed to the entity should be recognized as adjustments to the original contributions when the items are transferred to the ultimate recipients.

EXAMPLE

A fish and wildlife group received week stay at a luxury resort with a fair value of \$4,500 from a donor. This trip was auctioned to the highest bidder. There was a lag between the time of the original donation and the fundraising event so that original donation took place in 20X1 and the fundraiser in 20X2. The initial donation was reported as a \$4,500 contribution with donor restriction and the gift reported as an asset. At the fundraiser the trip sold for \$6,000. The additional \$1,500 was reported in 20X2. No cost for the ticket was reported on the statement of activities.

Note that in the example above, if the trip had sold for \$2,000 then a reduction of revenue would have been recorded.

Valuing Contributions of Media and Advertising

Technical Q&A 6140.24, *Contributions of Certain Nonfinancial Assets, Such as fundraising Material, Informational Material, or Advertising, Including Media Time or Space for Public Service Announcements or Other Purposes*, states that when nonfinancial assets are used for a NFP’s benefit or provided to them free of charge to help the entity with fundraising or communication about its mission, the entity should consider whether it has received a contribution. If it has received a contribution, the nonfinancial asset received should be measured at fair value, and the related expense, at the time the expense is recognized, should be reported by function, based on the nature of the contributed item.

The FinREC believes that in the case of fundraising material, informational material, advertising, and media time or space, the NFP has received an asset and should record a contribution if the NFP has an active involvement in determining and managing the message and the use of the materials. The future economic benefit received may be either cash inflows, such as contributions arising from fundraising activities or revenues arising from exchange transactions, or service potential in conducting program or management and general activities.

FinREC believes that the NFP’s involvement in determining and managing the content does need to be absolute in order to conclude that a contribution has been received.

EXAMPLE

A NFP arts organization received advertising time from a local TV station. As part of the donation the TV station helped the NFP in creating the advertising spot. In addition, the NFP was not given a choice as to when the advertising would be played. The controller determined that these two factors would not be an issue in reporting this as a donation since the not for profit was determining the content.

The second decision point was whether the gift met the criteria for donation- that is would the NFP have purchased it were it not given by donation.

Contributed Services

Contributions services are recorded at fair value at the date of donation. However, there are special rules for recording them. First, the services must either create or enhance a nonfinancial asset. Alternatively, they must require specialized skills provided by entities or persons possessing those skills, and the organization would need otherwise to purchase those services if not donated. Services that do not meet these criteria are not recorded although it is desirable to disclose that volunteered their time and performed services that did not meet the requirements for recognition in the financial statements.

EXAMPLE

A NFP preschool wanted to add an extension to its building to create additional storage. Volunteers who were not professionals but were experienced in projects such as this undertook the project and enhanced the value of the space.

Disclosure Requirements

ASU 2020-07 was issued to improve the disclosure of in-kind donations. The statement refers to them as nonfinancial assets although they are not required to be titled as such in the financial statements. Disclosure requirements include a separation of the revenue on the statement activities from donation of financial assets. It also requires additional qualitative information on the organization's policies related to use and disposition, valuation techniques and any restrictions on the disposition or proceeds from selling or otherwise disposing of the assets.

EXAMPLE Disclosures

Caring for Children
Statement of Activities
Year ended December 31, 20X1

Changes in net assets without donor restrictions	
Revenues and gains:	
Contributions of cash and other financial assets	\$ 6,790
In-Kind Contributions	1,850
Fees	5,200
Investment return (net)	6,650
Gain on sale of equipment	200
Other	150
Total revenues and gains without donor restrictions	\$ 20,840

EXAMPLE ACCOUNTING POLICY

Donated Services and In-Kind Contributions

Caring for Children reports in-kind contributions within their 20X1 statement of activities by recognizing contributions as a separate line item and showcasing the value of donated assets like buildings, vehicles, food, and medical supplies. These contributions are typically unrestricted unless specified by the donor.

For donated vehicles, Caring for Children prioritizes quick turnaround, selling them promptly through auctions or salvage, and using the actual cash proceeds for valuation. The contributed building, intended for general operations, was valued based on comparable sales in the Baltimore real estate market. Food, clothing, and medical supplies were valued based on estimated wholesale selling prices in the US. Notably, pharmaceuticals with donor-imposed restrictions for Baltimore were used in designated programs for underserved communities, and their valuation relied on the Federal Upper Limit reflecting US average wholesale prices. Additionally, professional services from attorneys were recognized at the market rate for similar legal work.

While volunteers significantly contribute their time, their efforts are not reflected because they do not meet recognition criteria prescribed by generally accepted accounting principles. This breakdown of in-kind contributions highlights Caring for Children's commitment to transparency and their reliance on a variety of assets to support their mission.

Note K – Donated Professional Services and Materials

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

Building	\$	1,155
Food		45
Medical supplies		172
Pharmaceuticals		213
Clothing		25
Vehicles		73
Services		167
	<u>\$</u>	<u>1,850</u>

UNIT 2

Accounting Issues Related to Liabilities and Expenses

LEARNING OBJECTIVES

At the end of this unit participants will be able to:

- › Select the NFP accounting principles that are appropriate for an organization's liabilities and expenses.
- › Apply the NFP accounting requirements.

LIABILITIES AND EXPENSES

Most of the obligations of NFPs are similar to those of for-profit entities. Those will not be discussed here. Liabilities that are unique to NFPs are the obligations under split interest agreements, agency transactions, promises to give that the NFP makes to another entity, and guarantees. Split interest agreements and promises to give are discussed below.

Split Interest Agreements

Relevant Literature: ASC 958-30

Non-profit organizations (NFPs) can leverage innovative strategies to attract donors seeking alternative giving options. Split-interest agreements, also known as deferred giving arrangements, offer donors a way to support an NFP while also benefiting other parties. These agreements can involve trusts, with some held by independent third parties for greater control over the assets.

In a split-interest agreement, the donor contributes assets to either a trust or directly to the NFP. However, unlike traditional donations, the NFP isn't the sole beneficiary. The agreement outlines a specific timeframe for distributing the benefits, often tied to the donor's lifespan or a set number of years. These agreements are typically irrevocable, ensuring the donor's initial intent is carried out.

This approach provides a win-win scenario:

- **Donors:** Receive tax benefits and the satisfaction of supporting both the NFP and other designated beneficiaries.
- **NFPs:** Secure future funding while potentially attracting donors who might not otherwise consider traditional giving.

Understanding the different types of split-interest agreements (charitable remainder trusts, charitable lead trusts, etc.) is crucial for NFPs to effectively present these options to potential donors and maximize their fundraising potential.

Types of Split Interest Agreements

There are two main types of agreements, lead interests and remainder interests. Where there is a lead interest, the NFP receives the periodic payments and then at the end of the agreement, the donor or donor's designee receives the remainder. Where there is a remainder interest, the donor (or some party designated by the donor) receives periodic payments during the term of the agreement. When the agreement terminates, which is most often but not always through the death of the donor, the remainder goes to the not-for-profit. Split-interest agreements, therefore, have two transaction elements – a contribution element and an exchange element. Not all split interest agreements will result in the recording of a liability. Only charitable gift annuities and instances where the NFP is the trustee will result in liabilities being recorded. In other cases the NFP will have a beneficial interest in a trust.

Lead Interests

In a lead interest, generally the donor will establish and fund a trust with specific payments to be made to a designated NFP over a specified period. The payments could be fixed (annuity trust) or could be a unitrust where the payments are based on a fixed percentage of the trust's fair value. Fair value would be determined each year. At the death of the donor or termination of the trust, the remainder is paid to the donor or donor's designee.

Remainder Interests

There are three general types of remainder agreements: Charitable remainder trusts, charitable gift annuities, and pooled income funds.

Charitable Remainder Trusts

A charitable remainder unitrust (CRUT) is a powerful estate planning tool that benefits both donors and non-profit organizations (NFPs). Established by the IRS in 1969, a CRUT allows a donor to establish a trust that provides income to designated beneficiaries for a set period or over their lifetimes. Here's how it works:

- **Donors:** Contribute assets to the CRUT and receive an immediate tax deduction for a portion of the contribution's value. They can also potentially avoid estate taxes on the remaining trust assets upon their passing.
- **Beneficiaries:** Receive fixed-percentage payments (unitrust amount) from the trust's assets, typically ranging from 5% to 50% of the fair market value annually, as determined by the trustee.
- **NFP:** After the designated payout period concludes, the remaining trust assets (charitable remainder) are distributed to the chosen NFP.

Key Considerations:

- The IRS mandates a minimum fixed annuity percentage of 5% and a maximum of 50% to ensure a substantial charitable benefit.
- The initial contribution's fair market value is established by the trustee and becomes the basis for future unitrust calculations.
- Some CRUTs limit the annual payout to the lesser of the stated unitrust percentage or the actual income generated by the trust's assets.
- The NFP's benefit is assured, as beneficiary obligations are solely funded by the trust's assets.

CRUTs offer a compelling option for donors seeking tax advantages and the ability to support loved ones while ultimately leaving a lasting legacy for a chosen NFP. By understanding the structure and benefits of CRUTs, NFPs can effectively present this valuable giving option to potential donors, expanding their fundraising opportunities.

Charitable Gift Annuities

Charitable gift annuities (CGAs) offer a simpler alternative to CRUTs for donors seeking both income and charitable benefits. Unlike CRUTs, CGAs eliminate the need for a separate trust. Here's the key difference:

- **CGAs:** Assets are directly transferred to the NFP and become part of their general funds. In exchange, the NFP assumes a legal obligation to pay the donor (or designated beneficiaries) a fixed annuity for a set period or lifetime.

Benefits for Donors and NFPs:

- **Donors:** Receive a guaranteed stream of income and an immediate tax deduction for a portion of the donated asset's value.
- **NFPs:** Secure a future source of funding while providing an attractive giving option for donors seeking income security.

Compared to CRUTs, CGAs offer a more straightforward structure. However, both options share some key advantages:

- Tax benefits for donors.
- Guaranteed income for beneficiaries.
- Future charitable contributions for NFPs.

Understanding the nuances of both CGAs and CRUTs allows NFPs to effectively present a wider range of giving opportunities to potential donors, ultimately strengthening their fundraising efforts.

Pooled Income Funds

Pooled income funds offer a unique way for non-profit organizations (NFPs) to attract donors seeking both long-term charitable impact and income benefits. Here's how it works:

- **The Structure:** The NFP acts as a trustee for a pooled income fund, a trust that combines contributions from multiple donors. These combined assets are then invested collectively.
- **Donor Participation:** Donors contribute assets to the fund and receive units based on the proportional fair value of their contribution compared to the fund's total value at the time of entry.

- **Income Distribution:** Throughout their lifetime, donors (or designated beneficiaries) receive a portion of the fund's actual income, calculated based on the number of units they hold. This income distribution is clearly defined within the pooled income fund agreement.
- **Charitable Impact:** Upon the donor's passing, the value of their assigned units becomes a permanent contribution to the NFP, furthering their mission.

Pooled income funds offer advantages for both donors and NFPs:

Donors:

- Benefit from a professionally managed investment portfolio.
- Receive a steady stream of income.
- Qualify for an immediate tax deduction for a portion of their contribution.

NFPs:

- Attract a wider pool of donors seeking income alongside charitable giving.
- Receive a significant charitable contribution upon the donor's passing.
- Benefit from economies of scale through collective investment management.

By offering pooled income funds, NFPs can expand their fundraising options and attract donors who might not otherwise consider traditional giving methods.

Accounting for Split Interest Agreements

Initial Measurement

ASC 958-30 dictates the initial measurement of assets, liabilities, and contributions associated with split-interest agreements where the non-profit organization (NFP) holds a remainder interest. This measurement is crucial for accurate financial reporting. The choice of method depends on the specific structure of the agreement.

NFP Holds Remainder Interest:

Income approach: The income approach, also known as the discounted cash flow method, was traditionally used. This method estimates the present value of the future cash flows the NFP expects to receive as the remainder beneficiary.

NFP Holds Lead Interest:

Simplified Method: When the NFP holds a lead interest and manages the assets directly (either through a trust or as general assets), fair value can be directly estimated. This method calculates the present value of the future distributions the NFP will receive as a lead beneficiary.

Independent Trustee Holds Assets:

Ongoing Valuation: If an independent trustee manages the assets and the NFP has a beneficial interest, the agreement's fair value must be initially measured and subsequently re-measured at fair value using appropriate valuation techniques. This ensures the NFP's financial statements reflect the current value of its expected future distributions.

Understanding these fair value measurement techniques allows NFPs to accurately record and report their split-interest agreements, leading to greater transparency and improved financial health.

Subsequent Re-measurement

Revenue is recognized as donor restricted support when the trust is formed. During the term of the agreement, the liability is adjusted by amortizing the discount associated with the liability to the donor and if necessary, by revaluations of future payments to beneficiaries based on changes in life expectancy and other actuarial changes. The discount rate is not changed.

If the NFP elects fair value under ASC 958-30-35, then the liability would be adjusted to fair value. The changes in the value of the split-interest agreement are recorded under this caption in the statement of activities. This may include a release from a timing and purpose restriction according to the terms of the agreement. Note that most NFPs do not find it necessary to elect fair value.

Summary of Accounting for Split Interest Agreements

Agreement	Initial Recording of Fair Value of the Contribution	Subsequent Re-measurement
Remainder interests – held by the NFP in trust with the NFP as trustee or as general assets and liabilities of the NFP	Estimated based on the fair value of the assets transferred by the donor less the present value of the payments to be made to the other beneficiaries. See discussion below relative to income and market approaches for split-interest agreements with variable and fixed payment streams.	The discount is amortized, and changes are made if there are changes in any of the assumptions such as the life expectancy of the donor.
Lead Trusts – if held in trust by the NFP	Fair value of the contribution can be estimated directly based on the present value of the future distributions to be received by the NFP as a beneficiary. The future payments to be made to other beneficiaries are made by the NFP only after the NFP receives its benefits.	The discount is amortized, and changes are made if there are changes in any of the assumptions such as the life expectancy of the donor.
Trusts where there is an outside trustee	Initial recording is as noted above but is made by the trustee. The NFP will have a beneficial interest that is reported to it by the trustee. This may be 100% of the trust or may be less.	The trust is marked to fair value with an adjustment for appreciation/ depreciation so that the trust is stated at fair value. The adjustment is made to temporarily restricted net assets.

The following example illustrates the income method that would be used to calculate the liability to the donor when a NFP is the trustee.

EXAMPLE

A NFP museum encourages donors to give through split interest agreements. In 20X1 it entered into a charitable remainder trust where the NFP was the trustee. Under the terms of the agreement, the NFP agreed to pay the donor 5% of the value of the trust for the remainder of her life. At the time of the agreement the donor was 58 years old.

Assets contributed to the trust	\$500,000
Age of donor – female	58
Life expectancy according to Society of Actuary tables	84
Payout over time	5% of the net assets of the trust until the donor's death – another 26 years (measured at the beginning of the year).
Expected return on assets	Assume 3.95% average return over time. This assumes that the trust's portfolio has more diversity than just treasuries which pay out at a very low rate. However, it is a prudent return given that this is a trust, which in turn, pays out benefits to a donor. The spreadsheet below could be altered to model various expectations of return and various donors' life expectancies.

Estimate of Fair Value of Obligation to the Beneficiary and Museum's Contribution					
Year	Projected Trust Balance Beginning of the Year	Projected Trust Income (3.95%)	Projected Trust Payout (5%) Paid at End of the Year	Present Value Factor	Present Value of Payout
Year 1	500,000	19,750	(25,000)	0.96015	(24,004)
Year 2	494,750	19,543	(24,738)	0.9246	(22,872)
Year 3	489,555	19,337	(24,478)	0.889	(21,761)
Year 4	484,415	19,134	(24,221)	0.8548	(20,704)
Year 5	479,328	18,933	(23,966)	0.8219	(19,698)
Year 6	474,295	18,735	(23,715)	0.7903	(18,742)
Year 7	469,315	18,538	(23,466)	0.7599	(17,832)
Year 8	464,388	18,343	(23,219)	0.7307	(16,966)
Year 9	459,512	18,151	(22,976)	0.7026	(16,143)
Year 10	454,687	17,960	(22,734)	0.6756	(15,359)
Year 11	449,912	17,772	(22,496)	0.6496	(14,613)
Year 12	445,188	17,585	(22,259)	0.6246	(13,903)
Year 13	440,514	17,400	(22,026)	0.6006	(13,229)
Year 14	435,888	17,218	(21,794)	0.5775	(12,586)
Year 15	431,312	17,037	(21,566)	0.5553	(11,975)
Year 16	426,783	16,858	(21,339)	0.5339	(11,393)
Year 17	422,302	16,681	(21,115)	0.5134	(10,840)
Year 18	417,867	16,506	(20,893)	0.4936	(10,313)
Year 19	413,480	16,332	(20,674)	0.4746	(9,812)
Year 20	409,138	16,161	(20,457)	0.4564	(9,337)
Year 21	404,842	15,991	(20,242)	0.4388	(8,882)
Year 22	400,592	15,823	(20,030)	0.422	(8,452)
Year 23	396,385	15,657	(19,819)	0.4057	(8,041)
Year 24	392,223	15,493	(19,611)	0.3901	(7,650)
Year 25	388,105	15,330	(19,405)	0.3751	(7,279)
Year 26	384,030	15,169	(19,201)	0.3607	(6,926)
		Fair Value of the Donor's Interest			359,313
		Fair Value of the Museum's Interest			140,687

The museum would make the following journal entry:

Cash (to the trust for investment)	500,000	
Liability to the donor		359,313
Contribution to the museum – donor restricted		140,687

To record the contribution at fair value at the date of donation and the liability to the donor.

Entries over the term of the trust would be:

Ongoing Journal entries until the death of the donor

(1) DR Liability under unitrust agreement	XX		payout
CR Assets held in remainder Trust		XX	
(2) DR Assets in remainder Trust	XX		Investment income
CR Liability under unitrust agreement		XX	
(3) DR Liability under trust agreement			
CR Change in value of Split-interest agreement- donor restricted			Amortize discount
At the termination of the trust and closing the trust			
DR Liability under unitrust agreement	XX		
CR Change in Value of split interest agreements- donor restricted		XX	Reverse remaining liability
DR Endowment assets	XX		
CR Assets held in remainder trust		XX	Remove assets from trust and create endowment

As is evident from the model above, the amounts to be paid from the trust are less than the amount in the trust. Since the model is built around a percentage of the trust, the trust will never be drained. This is an improvement over past models where a fixed annuity payment was the norm and trusts could find themselves paying the donor substantially more than anticipated. Some donors live longer than normal life expectancy even using the preferred tables.

At the donor's death the remainder in the trust comes back to the museum. Unless the museum elected fair value as a reporting mechanism, the liability would not be adjusted unless there were changes in the underlying assumptions such as the donor's life expectancy. If there are amounts of liability on the books, they are reversed as is any remaining contribution to unrestricted.

Derecognition of Liability

Some NFPs may prefer not to have a liability on the books. When a NFP organization has control over the assets in a split-interest agreement, it also has a liability to the donor or donor's heirs which represents 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 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.

Promises Made

Relevant Literature: ASC 605

Promises to give that the NFP receives were discussed earlier in Section 1. Certain NFPs make promises to give to other NFPs, often referred to as grants, and those commitments may be reported as liabilities under certain circumstances. The decision process for contributions/grants made is the same as for contributions/grants received. If the contribution/grant is deemed to be conditional, it will be disclosed in the notes to the financial statements. If it is deemed to be unconditional then it will be recorded. With unconditional contributions/grants, the grantor will record a promise to give when committed and relieve that liability when funding is disbursed to the recipient.

Determining if the contribution is conditional or unconditional.

The NFP grantor will determine whether the contribution is conditional or unconditional. ASU 2018-08 (ASC 605) defines a donor-imposed condition as one where:

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

In deciding whether a transaction is conditional or unconditional the accountant looks to the grant document. The grantor should write the grant document so that it is clear and easy to understand the appropriate accounting treatment. This is not always the case. An accountant should be able to determine, based on reading the agreement or another document referenced in the agreement, that a recipient is only entitled to the transferred assets or a future transfer of assets if it has overcome stipulated barriers.

The agreement does not need to include the specific phrase right of return or release from obligation. However, it should be sufficiently clear to be able to support a reasonable conclusion about when a recipient would be entitled to the transfer of assets.

When there is no apparent indication that a recipient is only entitled to the transferred assets or a future transfer of assets if it has overcome a barrier, the agreement is considered to be an unconditional contribution. In those cases the grantor would record a liability to the recipient to the extent funding has not been paid.

The guidance emphasizes that neither the likelihood that a barrier will be met nor the resource provider's intent to enforce the right of return should 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. This means that the substantive work under the agreement is complete although there may be administrative requirements, such as the filing of a report or an audit, which have not been completed.

Evaluating Performance Barriers

The FASB identifies three criteria for entities to use when evaluating barriers. The entity should ask these questions:

1. Does the stipulation require performance by the entity or that some event, beyond the recipient's control, occurs?
2. Does the stipulation limit the discretion of the entity on how the activity is conducted in order for it to be funded?
3. 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% as opposed to **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 very specific requirements such as a list of specific are allowed or not allowed or specific activities that can be performed. The key here is related to whether the entity is entitled to the resources if they do not comply with the funder's requirements. For example, grants that are subject to compliance with the Uniform Guidance have very specific requirements. These requirements relate to the purpose of the grant.

Right of Return/ Right of Release

The right of return/right of release 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. This wording is included in the Uniform Guidance. The right of return must be linked to a specific barrier except for the administrative requirement discussed earlier.

EXAMPLES

Understanding the distinction between conditional and unconditional grants is crucial for both grantors and NFPs to ensure proper accounting practices. Here's a breakdown of two scenarios to illustrate the key differences:

Scenario 1: Conditional Grant

An NFP receives a grant to train disabled veterans. The \$400,000 grant is released quarterly, with \$100,000 contingent upon serving at least 2,000 veterans per quarter. This measurable performance barrier makes the grant conditional. Additionally, any unused funds must be returned, further solidifying its conditional nature.

Accounting Treatment: The grantor only records a liability upon the NFP meeting the quarterly benchmarks. The NFP mirrors this approach, recording revenue only for the earned portion of the grant each quarter.

Scenario 2: Unconditional Grant

An NFP receives a grant to support its mission-aligned services. The grant amount (e.g., \$50,000) comes with a pre-defined budget for expenses but lacks specific service targets. While a right-of-return clause might exist, it's not tied to performance metrics. The absence of measurable performance barriers makes this an unconditional grant.

Accounting Treatment: The grantor immediately records a liability for the entire grant amount. The NFP also recognizes the full grant amount as revenue upon approval.

These contrasting scenarios emphasize the importance of scrutinizing grant agreements for performance conditions and return clauses. This clarity ensures both parties maintain accurate financial records for the awarded funds.

DIRECT DONOR EXPENSES FROM SPECIAL EVENTS

Relevant Literature: ASC 958-220

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.

Generally the donation of goods and services to be sold at special events happens in the same time period as the event. If so, the NFP will generally wait until the event occurs to record the transactions associated with in-kind donations. If not, the NFP should record inventory for those goods and services donated for the event. When the event occurs the contribution revenue may need to be adjusted to reflect the actual proceeds from the event.

The FinREC believes that if the event is intended to take place after the date of the financial statements, the contribution portion for donations of sponsorships is conditioned on the event taking place. It would ordinarily be recorded as a refundable advance. Ticket sales are exchange transactions so any advance funding would be considered deferred revenue.

Technical Questions & Answers 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.

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 restricted component to them. The examples in the ASC all assume that the proceeds from the event are without donor restrictions.

Statement of Activities

The FASB illustrates 3 different disclosure methods for special events. Two of those methods illustrate the cost of direct donor benefits in a contra revenue account on the statement of activities.

Illustration 1

Contributions and Net Revenue from Special Event:		
Contributions		\$250,000
Special event revenue	\$25,000	
Less: Costs 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

Illustration 1 presents the direct donor benefits as a contra revenue account.

Illustration 2

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

Illustration 2 presents the direct donor benefits as an expense

Illustration 3

Contributions 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

Illustration 3 is a presentation that is least likely to be used in practice. It shows the sales related to the direct donor benefits and the other special event revenue is included in contributions.

FUNCTIONAL EXPENSES

Relevant Literature: ASC 958-720

NFPs are required to present functional expenses either in the form of a statement or in the footnotes. Alternatively, they may be presented on the face of the statement of activities. This may be too cumbersome because although some organizations present expenses by nature or by function on the statement of activities, it is challenging to present both without a matrix format. Functional expenses may not be presented as supplementary information. All expenses are required to be presented in one place except for investment expenses which are netted against investment return. Gains and losses should also be excluded from the analysis.

One challenge related to the functional expense presentation is the capture of all expenses in the presentation and functional attribution of expenses related to special events or other nonprogram related exchange transactions in a separate supporting service column. The other is in the allocation itself.

The NFP will identify components of the various functions, program, management and general and fundraising. The number of programs disclosed in the presentation is at the discretion of the NFP. The information should be meaningful so having too many programs may be overkill and too few insufficient. A good rule to follow is to mirror the services

described in first paragraph of the footnotes about the organization, its mission and how it accomplishes that mission.

Donors and other funding sources, the governing board, and regulatory agencies are usually more interested in the costs of providing the organization's program services and the relationship or ratio of program expenses to supporting (particularly fund-raising) expenses than they are with the particular types of expenses incurred.

Functional Categories

Functional expense categories are typically program, management and general and fundraising. Other possible categories could be membership, (if that is a significant activity of the NFP and not just a fundraising tactic), cost of sales (unless the activity producing the costs is a program activity), and cost of direct donor benefits.

Practically every organization, unless it is in the winddown phase, will have management and general expenses. Not every organization will have fundraising expenses. Certain NFPs such as religious organizations, organizations that are mainly fee for service, or organizations that primarily receive federal and state grants or may not solicit funds. Other organizations may use volunteers that do not meet the criteria for expense recognition as fundraisers. A good practice would be to disclose that the entity is not involved in fundraising and the reason why. Otherwise, a user of financial statements such as GuideStar or Charity Navigator could misconstrue the lack of fundraising expense as an attempt to improperly categorize fundraising expenses as program expenses.

Allocating Costs

ASC 958-720 provides guidance on classification and allocation of expenses among the various activities (management and general, fund-raising, or membership development), including making allocations. The NFP should apply a reasonable method for allocating expenses among functions.

Proper functional expense allocation may also help the organization know how to release donor restricted net assets from restriction and analyze the effects of unrelated business income generating activities. In addition, third-party reimbursement agreements may provide for the reimbursement of indirect (as well as direct) costs and may specify an allocation basis for determining reimbursable indirect costs.

Program activities are those related to the conduct of the NFP's programs. Some, such as the personnel costs of people working solely on a program activity, are directly attributable to a particular program and some, such as operating costs (telephone, utilities, etc.) may be allocated.

Management and general activities are supporting activities that are not directly identifiable with one or more program, fund-raising, or membership-development activities.

They include:

- oversight
- business management
- general record keeping and payroll.
- budgeting
- financing

- soliciting funds other than contributions and membership dues such as promotion costs for the sale of goods or services to customers)
- advertising costs
- responding to government, foundation, and other requests for proposals including billing and collecting fees and grant and contract financial reporting
- providing information to the public related to the NFP's activities
- producing and disseminating the annual report
- employee benefits management and oversight (human resources)

Management and general also includes costs of the governing board, the CEO/executive director, and the support staff. It is possible that some of the time of the people in administrative functions is spent in program activities. In this case the allocation to program would be appropriate.

Fundraising activities include:

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

Technical Q&A 6140.11 states that fund-raising activities include soliciting contributions of services from individuals, regardless of whether those services meet the recognition criteria for contributions. The soliciting contributed services to be used in program functions or management and general functions should be accounted for as fund-raising expenses, even if the contributed services do not meet the recognition criteria.

Allocation Bases

Certain costs may apply to more than one program such as the salary of a person who works on two or more different programs or overhead costs such as rent or telephone. It is possible that fund-raising costs will include elements that pertain to program services and should be allocated. The rules governing joint costs are very specific and not discussed in this program.

Suggested allocation bases.

Expense element	Allocation Base
Salaries and benefits	Time studies or other time reporting mechanisms
Automobile and travel costs	Allocated on basis of expense or time reports of the employees involved.
Telephone expense	Use by extensions, generally following the charge assigned to the salary of the employee using the telephone, after making direct charges for the international calls or other service attributable to specific functions.
Stationery, supplies, and postage costs	Study of use

Expense element	Allocation Base
Occupancy costs	Square-footage basis
Depreciation and rental of equipment	Asset usage or a square-footage basis.
Information technology department costs	Estimates of time and costs of specific technology used

Many NFPs do not collect sufficient detail on IT costs, stationery, postage and supply costs and telephone to use the bases suggested above. Where there is insufficient detail the NFP could consider using salaries and benefits or direct costs as an allocation base.

Disclosure

Challenges noted in disclosure.

Often an NFP will classify the direct donor benefits as fundraising costs in the functional expense presentation. Since the direct donor benefits represent exchange transactions this would not be appropriate. A supporting service should be included in the presentation in a separate column. It could be titled cost of sales or even direct donor benefits.

Another issue that may occur is that direct donor benefits may consist of more than one component. The functional expense presentation must illustrate the breakdown of those expenses in the lines for natural classification. They may be included in personnel cost, facility rental, food, supplies or some other category.

Following is an example of a functional expense presentation with the two challenges illustrated.

EXAMPLE

An accountant was preparing a statement of functional expenses for the auditor. When she got to the cost of direct donor benefits she asked the advancement department to break down the information into the natural categories, supplies, facility rental and food.

	Program Services			Management and General	Fundraising and Development	Cost of	
	Advisory	Training	Total			Direct Donor Benefits	Total
Grants and other assistance	\$ 294,261	\$ -	\$ 294,261	\$ -	\$ -	\$ -	\$ 294,261
Salaries and wages	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	9,667	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
Meals and entertainment	-	-	-	-	-	6,500	6,500
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
Gift shop cost of goods sold	48,621	-	48,621	-	-	-	48,621
Facility rental	-	-	-	-	-	5,000	5,000
Supplies	-	-	-	-	-	1,001	1,001
Depreciation and amortization	1,042,663	74,425	1,117,088	20,134	13,960	-	1,151,182
Bad debt expense	-	-	-	16,892	-	-	16,892
Rent expense	31,569	5,977	37,546	-	7,474	-	45,020
Total expenses by function	11,487,391	2,864,692	14,352,083	754,593	442,867	12,501	15,562,044

In addition to the functional expense presentation (already shown) the NFP must also disclose qualitative information about functional expenses including allocation bases and methods. A sample disclosure follows.

NOTE 8- FUNCTIONAL EXPENSES

The costs of program and supporting services activities have been summarized on a functional basis in the statement of activities. The statement of functional expenses presents the natural classification detail of expenses by function. Accordingly, certain costs have been allocated among the programs and supporting services benefited. 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 on the basis of estimates of time and effort.

UNIT 3

Accounting Issues Related to Consolidations

LEARNING OBJECTIVES

At the end of this unit participants will be able to:

- › Select the NFP accounting principles that are appropriate in consolidation
- › Apply the NFP accounting and disclosure requirements.

Relevant Literature: ASC 810, ASC 958-810

Consolidation literature can be found in ASC 810. The FASB's presumption is that users of the financial statements are interested in a complete picture of the operations and financial position of the entity that has either a direct or indirect controlling financial interest in other entities. Therefore, under GAAP parent company financial statements do not meet that requirement and should not be issued. In the NFP space there may be times when a grantor only wants to see the results of operations and financial position of the grantee. In those or similar situations issuing a report on parent only financial statements is permissible as long as consolidated financial statements are issued as well.

When evaluating the consolidation of other entities, NFPs exclusively use a voting-interest model, and therefore disregard the guidance in the variable interest entity subsections of ASC 810. The manner in which the voting interest model is applied differs depending on whether the relationship involves another NFP or a for-profit entity. There are three main focus points for consolidation.

- Relationships of NFPs with NFPs
- Relationships of NFPs with for profits
- Consolidation of a special purpose leasing entity

CONSOLIDATION WITH OTHER NOT-FOR-PROFIT ORGANIZATIONS

While most states restrict NFPs from issuing traditional stock, there are alternative ownership structures that enable NFPs to exert influence over other entities. Let's explore these options and their accounting implications.

Alternatives to Stock Ownership:

- **Membership Certificates:** Unlike for-profit corporations, NFPs typically use membership certificates. These certificates grant voting rights for electing board members and influencing major organizational changes, similar to stockholders in a for-profit setting. However, NFP membership certificates don't convey any financial ownership or profit-sharing rights.
- **Joint Ventures:** NFPs can engage in joint ventures with other organizations to pursue shared goals. These ventures involve a contractual agreement where both parties contribute resources and share control over the venture's operations.
- **Partnerships:** NFPs can also form partnerships with other NFPs or for-profit entities. The specific partnership structure (general, limited liability, etc.) determines the level of control and financial responsibility each partner assumes.

Accounting for NFP Ownership:

The way NFP ownership is structured impacts how it's reflected in financial statements. Here are some key control scenarios:

- **Controlling Financial Interest:** This occurs when the NFP holds a majority voting interest (directly or indirectly) or is the sole corporate member of another NFP. The NFP would likely consolidate the other entity's financial statements with its own.
- **Control Through Board Influence:** The NFP exerts control through a majority vote on the board, even without direct ownership. In such cases, the NFP might prepare separate financial statements but disclose its significant influence over the other entity.
- **Economic or Control Interest (but not both):** The NFP may have economic benefits from the other entity (e.g., receiving a portion of profits) or control its operations through means other than ownership. Here, the accounting treatment depends on the specific nature of the arrangement.

Understanding these ownership structures and their accounting implications is crucial for NFPs considering collaboration with other entities. Careful planning ensures transparency and responsible financial reporting.

Consolidation Decision Tree

Consolidation Required

For consolidation to be **required** there must be a controlling financial interest through direct or indirect ownership of a majority voting interest. There may be times when control does not rest with the majority owner or sole corporate member. This could happen in bankruptcy or if legal or contractual limitations are severe. In these situations consolidation would be prohibited.

EXAMPLE

A health plan had 14 regional affiliates. The health plan was the sole corporate member in each of them. As such, the health plan had a majority voting interest in each of the affiliates and consolidation was required.

Sometimes the organization's bylaws may call for a supermajority vote. This may be in cases of dissolution of the NFP or amending the articles of incorporation. In those instances the FASB states that the NFP should look carefully as to whether this diminishes substantive control before concluding that consolidation is not required.

An interest by an NFP in another NFP may be less than a complete interest. For example, an NFP may appoint 70 percent of the board of the other NFP. Since there is no ownership interest other than the interest of the reporting entity, the basis of consolidation would not reflect a noncontrolling interest for the portion of the board that the reporting entity does not control. Health care entities, addressed in ASC 954-810 have different requirements which are not addressed here.

Consolidation Permitted but Not Required

There are other ways that consolidation could be appropriate. To determine when consolidation is permitted but not required it is helpful to have an understanding of certain definitions.

Control: 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

A NFP charity has a 12-member board, and a simple majority is required to approve board actions. The charity has an affiliated foundation that has 8 board members, officers and employees on the board. If the Charity does not have the ability to require that those members serve on the affiliate's board, then the Charity does not have a majority voting interest in the affiliate. Unless the relationship meets the economic interest criteria, consolidation would not be appropriate and related party disclosures would be made.

Note that the evaluation of whether a majority voting interest exists is made in relation to the NFP's fully constituted board, including any vacant board positions. For example, in the case above, if vacancies on the board of the affiliate cause the charity to temporarily possess a majority voting interest in the affiliate, that circumstance, in and of itself, would not automatically trigger consolidation by the charity.

Economic 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. The following situations demonstrate economic interest:

- One organization is responsible for the liabilities of the other
- One organization guarantees debt of another.
- One organization assigns certain significant functions to another.
- One organization solicits 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 donor or 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.

EXAMPLE

Building on the scenario above, assume that the Foundation raises money for the charity. It solicits funds in the name of the charity. This is the Foundation's sole purpose. The Charity has an economic interest in the Foundation. If control was also present, consolidation would be permitted but not required. If control was not present, consolidation would not be appropriate.

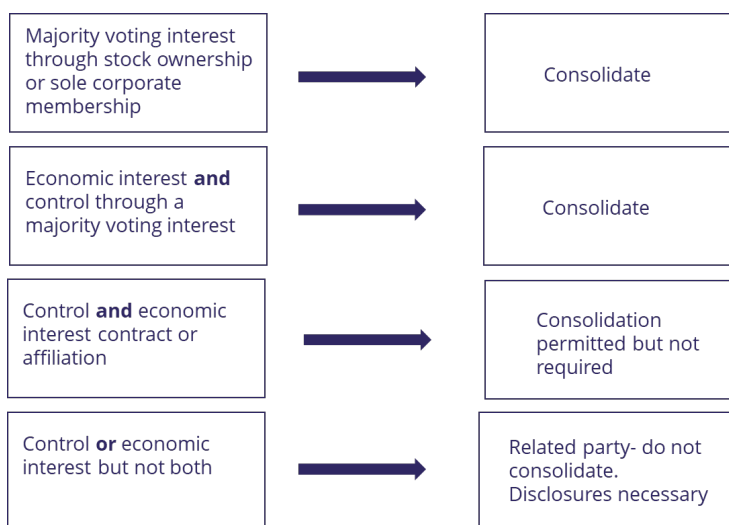
EXAMPLE

Faced with a desire to expand services, a large NFP agency providing housing and furniture assistance to low-income residents identified a smaller NFP in a neighboring town offering similar services. However, the smaller NFP lacked access to favorable loan rates. Recognizing a strategic opportunity, both NFPs entered into an affiliation agreement.

This agreement, while not establishing a formal voting majority, granted the larger agency a degree of control. The agreement stipulated specific policies and procedures the smaller NFP had to follow, ensuring uniformity in service delivery and pricing. Additionally, the larger agency took a significant step by guaranteeing the smaller NFP's debt, demonstrating a clear economic interest in their success.

These factors—control through standardized operations and economic interest through debt guarantee—allow for, but don't necessarily require, consolidation of the NFPs' financial statements. The unique nature of this agreement, with its influence exceeding a typical affiliation but falling short of a full merger, justifies exploring consolidation as it reflects the true depth of the financial ties established between the two organizations. This approach ensures transparency and accurate financial reporting for both NFPs.

Following is a decision tree for consolidation of NFPs with NFPs

**Additional Accounting Requirements**

When one NFP consolidates another, the definitions of with and without donor 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 donor 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. But if the mission of the subsidiary is broader than the parent it may be the opposite.

EXAMPLE

NFPs sometimes work alongside related foundations. When these entities prepare consolidated financial statements, the reporting of donor-restricted contributions can differ from how each individual organization presents them. Let's explore two scenarios:

Scenario 1: Trade Group and Scholarship Foundation

Imagine a trade group advocating for attorneys and a separate foundation it controls that raises funds for minority law student scholarships. They prepare consolidated statements. Donors contribute specifically to scholarships, a cause unrelated to the trade group's direct mission. In the consolidated view, these donations indirectly support the legal field by nurturing future attorneys, so they're reported as unrestricted. However, the foundation itself would report them as without donor restrictions because they directly fulfill its core scholarship mission.

Scenario 2: Adoption Agency and Fundraising Foundation

An adoption agency offers adoption services and family support. It controls a foundation that raises money for various children's causes. They prepare consolidated statements. Donors contribute to the foundation specifically for adoption services. Within the consolidated statements, these donations are reported as unrestricted because the adoption agency is the primary beneficiary. However, the foundation, looking at its own financials, would categorize these contributions as donor-restricted for adoption as they target a specific program area.

These examples highlight that consolidation focuses on the combined NPO's mission and who ultimately benefits. Donor intent is still considered, but in consolidated reporting, the broader picture of how contributions support the overall cause takes precedence.

Exception to Guidance

As noted in the discussion above, if a NFP has control or economic interest but not both the consolidation is not appropriate. There is an exception for NFPs that presented consolidated financial statements when there was one but not both elements present before December 1994 in conformity with Statement of Position 78-10. They may continue the practice.

Joint Ventures

NFPs may use a variety of approaches to combine or coordinate their services, operations, and resources. For example, two or more NFPs might form of a new legal entity through which they will collaboratively provide a new service or program or carry out an essential function. Often, such arrangements are referred to as joint ventures. These joint ventures may or may not require consolidation.

In evaluating the accounting and financial reporting for joint ventures the NFP will consider substance over form. In situations where the venture provides its participants with ownership interests, or the functional equivalent of ownership interests, it would not meet the GAAP definition of an NFP for accounting purposes even though its purpose is to carry out a nonprofit activity. Therefore, in evaluating whether consolidation of the venture is required, a participant would consider the guidance discussed for equity interests in for-profit business entities.

Combined Financial Statements

If a reporting entity concludes that consolidated financial statements are not required, it may be meaningful to combine the financial statements of two or more affiliated companies into a single set of comprehensive financial statements. The financial statements of the affiliated group are referred to as “combined” financial statements and should be labeled as such.

ASC 810 provides guidance about instances where combined financial statements may be useful and more meaningful than separate financial statements. For example, combined financial statements would be useful if one entity owns a controlling financial interest in several entities that are related in their operations. Combined financial statements might also be used to present the financial position and results of operations of entities under common management.

EXAMPLE

A disease related charity had several affiliates around the country. They were under common management. Common management was provided by a national office. It provided centralized billing, marketing and other services to the affiliates. The affiliates had essentially the same operations. Combined financial statements were prepared because management of the national office and the affiliates believed this would provide more meaningful information to the financial statement users.

When combined financial statements are prepared for a group of related entities, such as a group of commonly-controlled entities, intra-entity transactions and profits or losses are eliminated, and noncontrolling interests, different fiscal periods, or income taxes, if any, are treated in the same manner as in consolidated financial statements.

Consolidation with For-Profit Entities

ASC 958-810 provides guidance for determining whether a for-profit entity should be consolidated with a NFP. The major decision point is whether 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 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. NFPs 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.

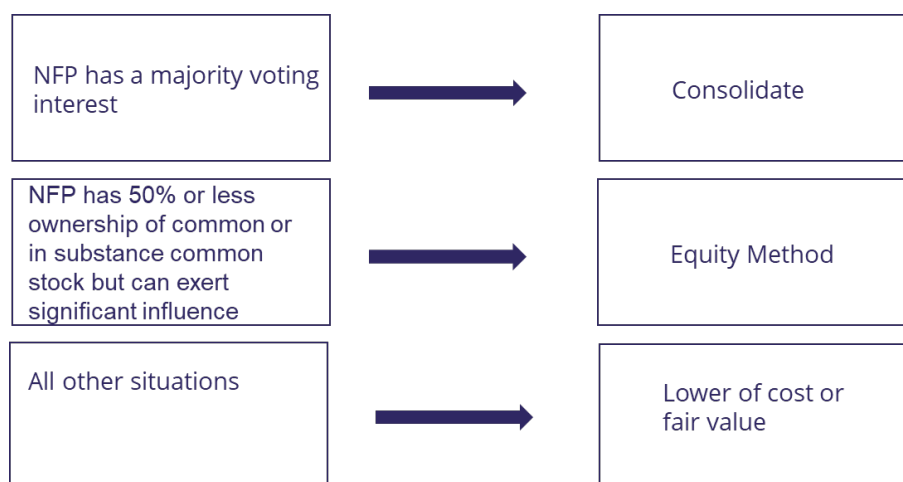
It is possible that minority rights could keep the NFP from having a controlling interest with this level of ownership. In these cases, the entity should not be consolidated. If the entity has a research and development arrangement where all of the funds for those activities are provided

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 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 cost¹ or fair value. The entity may also elect to report at fair value.



Consolidated vs. Consolidating

When for profit entities are consolidated with NFPs management should evaluate the situation to determine whether consolidated or consolidating statements are more useful to users of the financial statements. With consolidating statements the user has a snapshot into the level of detail that would be present when stand-alone subsidiary financial statements are issued. The FinREC believes that the NFP should consider:

- Size of the subsidiary in relation to the NFP. The larger the subsidiary is to the whole, the more likely it is that discrete information should be presented.
- The activities of the for profit and their significance to the NFP's mission. If the activities are integral discrete information is less important. If the activities are marginal then discrete information is more important.
- Need for creditors to have separate information

¹ The entity would report at cost if purchased or fair value at the date of donation if donated.

The Fin REC believes that the same level of detail should be shown on the statement of financial position and the statement of activities/operations in the consolidating format. The cash flow statement should be shown consolidated but have the appropriate level of operating detail for both entities.

EXAMPLES

Scenario 1: A NFP trade association provides training to its members. It created a wholly owned subsidiary training company to extend its ability to provide training to more members and nonmembers at a time. To do this the for-profit entity incurred debt to build a new training facility. The debt is secured by the building. The NFP believes that training is integral to its mission. Therefore, consolidated information was provided.

Scenario 2: A NFP college created a wholly owned subsidiary to provide day care to the children of the faculty and staff. The day care center was very small in relation to the college. Therefore, consolidated information was provided.

Scenario 3: A NFP social service agency received a contribution of 100% of the shares of an employment agency. The employment agency was material to the NFP. Because it was peripheral to the mission the NFP decided that consolidating information would be more useful for users of the financial statements.

Noncontrolling Interests

When the NFP is required to consolidate because the ownership is less than 100%, but more than would be appropriate for equity method financial statements, there will be a noncontrolling financial interest.

Noncontrolling financial interests are reported in the appropriate net asset class as a separate component of net assets in the statement of financial position. The noncontrolling interest must be adequately described so the user can distinguish it from the other components of net assets. For example, the title “noncontrolling interest in subsidiary” would be appropriate.

EXAMPLE

An NFP durable medical equipment company had an 80 percent investment in a specialized imaging company. The net asset section of the NFP parent with noncontrolling interest in imaging center follows.

Net Assets		
Without donor restriction		
Total unrestricted net assets of DME company		438,600
Noncontrolling interest in Imaging Company		49,400
Total net assets without donor restriction		488,000
Net assets with donor restriction		38,500
Total net assets		\$ 496,000
Total liabilities and net assets		<u>\$1,371,000</u>

Revenues and expenses, gains and losses, excess of revenues over expenses and changes in unrestricted net assets are reported in the statement of operations and include amounts attributable to the parent and the noncontrolling interest.

The footnotes would describe the changes in the noncontrolling interest in net assets attributable to the parent. Alternatively, the NFP could choose to put the information on the face of the financial statements. This schedule would include:

- Performance indicator, if the NFP is a healthcare organization
- Amounts of discontinued operations
- Changes in ownership interests including investments and distributions
- Aggregate amount of other changes

EXAMPLE

Note G Changes Consolidated Assets without Donor Restriction Attributable to Happy Valley and Transfers to and from the Noncontrolling Interest

					Controlling Interest	Noncontrolling Interest	Total
Balance July 1, 20X0					400,000		400,000
Excess of revenues over expenses					17,600	5,400	23,000
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					38,600	49,400	88,000
Balance June 30, 20X1					438,600	49,400	488,000

Special Purpose Leasing Entity (SPE)

Some NFPs form other entities to carry out activities, such as leasing, through for-profit entities that exist primarily to benefit the NFP. They are often used in an effort to achieve off balance sheet treatment of assets and liabilities.

When evaluating SPE leasing entities for consolidation, NFPs apply different requirements than business entities. Where for profit entities use the variable interest entity guidance, NFPs apply the guidance in ASC 958-810-25. This guidance was in place earlier than the variable interest entity guidance. Under that guidance, an NFP lessee must consolidate an SPE lessor if **all three** of the following conditions exist:

- Substantially all of the SPE's activities involve assets that are to be leased to a single lessee
- The expected substantive residual risks, substantially all the residual rewards of the leased assets, and the obligation imposed by the underlying debt of the SPE directly or indirectly reside with the lessee
- The SPE's owner of record has not made an initial substantive residual equity capital investment that is at risk during the entire lease term. This criterion is deemed to be met if the majority owner of the lessor is not an independent third party, regardless of the level of capital investment.

If the SPE's owner made a substantive residual equity capital investment that will be at risk during the entire lease term, the NFP does not have to consolidate the SPE. To qualify as **substantive**, an investment must represent an equity interest in legal form, must be subordinate to all debt interests, and must represent the residual equity interest during the entire term of the lease. In addition, the AICPA believes that the minimum acceptable investment to qualify as substantive would be equal to 3% of the assets owned by the SPE.

A greater level of investment may be necessary depending on the facts and circumstances, including the credit risk associated with the lessee and market risk factors associated with the leased property. For example, the cost of borrowed funds for the transaction might be indicative of the risk associated with the transaction and whether an equity investment greater than 3% is needed.

In some build-to-suit lease transactions, the lease or related construction agreement provides that the SPE will construct, or cause to be constructed, the property that is to be leased. When SPEs are established for both the construction and subsequent lease of the asset, consolidation by the lessee should begin at the beginning of the construction arrangement, rather than at the beginning of the lease term, if the conditions requiring consolidation are met.

Consolidation by NFPs of SPEs used in activities other than leasing is not explicitly addressed in the codification. However, during the FASB's deliberations on the SPE leasing guidance for NFPs, they noted that nothing precludes an NFP from applying the SPE leasing guidance by analogy to other SPE situations.

Limited Partnerships and Similar Entities

Limited partnership or LLC that is the functional equivalent of a limited partnership is comprised of one or more general partners and one or more limited partners. In these arrangements, it is rare that voting power and economic interests would be aligned because the authority to make decisions for the entity is generally vested in the general partner. The general partner may have a very small ownership interest as compared to the limited partners.

It is usually the general partner who has the authority to transact on the partnership's behalf, direct the partnership's operations, and commit the partnership by entering into contracts. The limited partners, primary role is usually to invest capital. They generally are not able to direct the activities of the partnership.

Since evaluations of control or significant influence cannot be based only on the level of ownership by the investor, the way they are with other for-profit entities or LLCs that function like corporations the FASB provides another model to assess control. ASC 958-810 provides guidance to evaluate limited partnership interests to determine if they should be consolidated or whether the equity method should be applied.

General Partner in Limited Partnerships

The general partner in a limited partnership is presumed to control that limited partnership regardless of the extent of the general partner's ownership interest in the limited partnership.

The presumption of control by the general partner is overcome if limited partners hold either substantive kick-out rights or substantive participating rights. If the presumption is overcome, the general partner's interest in the limited partnership is accounted for using the equity method.

FASB ASC 958-810 states that if one limited partner directly or indirectly owns more than 50 percent of a limited partnership's **kick-out rights** through voting interests, then that limited partner would be deemed to have a controlling financial interest in the limited partnership and would consolidate the limited partnership. This is because that partner generally would have the ability to unilaterally remove the general partner or cause the partnership to be dissolved.

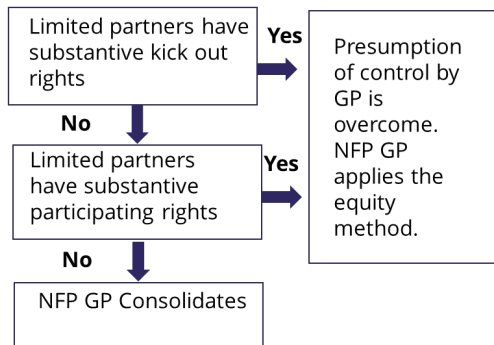
However, if noncontrolling limited partners have substantive **participating rights**, then the limited partner with a majority of kick-out rights through voting interests does not have a

controlling financial interest, should not consolidate the partnership. The general partner would use the equity method to account for the partnership interest unless the fair value option was elected. The limited partners would use the equity method as well unless fair value was elected.

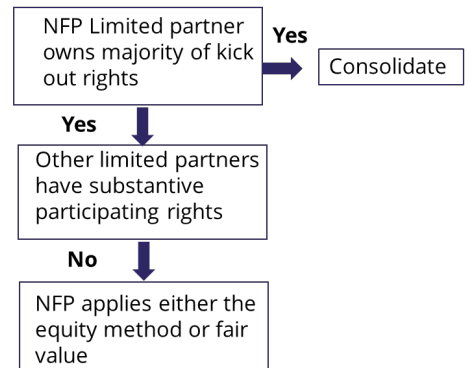
EXAMPLE

A Limited Partnership has three partners which are all NFPs. The partnership agreement provides the general partner with the authority to direct the partnership's operations and enter into binding contracts on behalf of the partnership. The limited partners have no authority beyond certain limited rights granted in the operating agreement that are neither kick-out nor participating rights. Since there is a presumption that the general partner has control and should consolidate the partnership, only the existence of substantive kick out or participatory rights would cause a different evaluation. The limited partners would not consolidate.

NFP holds general partner interest



NFP holds limited partner interest



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