



Navigating the Complexities of Nonprofit GAAP

(NFP4)

KAPLAN

Unit 1

Issues Related to Assets
and Revenues

KAPLAN



Accounting Issues Related to Assets and Revenue

- **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 assets and revenues.
 - Apply the NFP accounting requirements.

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Cash and Cash Equivalents and Restricted Cash

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

- Restrictions may be donor-imposed related to use.
- Cash and contributions receivable restricted by donors to investment in land, buildings, and equipment are not included with the line items cash, cash equivalents, or contributions receivable.
 - Report as assets restricted to investment in land, buildings, and equipment and are sequenced closer to property.
- Boards may set aside or designated cash to be used for acquisition of long-term assets or to liquidate debt. They should be excluded from current assets. This also applies when a lender requires cash to be set aside in a sinking fund.
- There may also be other limitations imposed by outside parties such as compensating balance requirements, cash held as collateral on debt obligations or for loaned securities.
- Government agencies such as HUD impose requirements related to funds set aside for reserves for maintenance and other purposes. These amounts are presented separately from cash to be used for operating purposes.

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Cash and Cash Equivalents and Restricted Cash (con't)

- FASB does not to define the term "restricted cash" so there will be differences in practice for disclosure.
- More often, it is net assets, not cash, that will be restricted.
- The important distinction is the separation of cash that is able to be used for operating purposes and cash that is noncurrent.
- The presentation of cash that is long term is not determined by whether the cash is required to be maintained in a separate bank account.
- When cash is held temporarily by a custodian for investment purpose, it may be included as part of investments in a statement of financial position rather than as cash.
- Cash and cash equivalents may be included as part of the organization's endowment funds. Cash and cash equivalents held temporarily by a custodian for investment purposes may be presented with investments.

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Cash and Cash Equivalents and Restricted Cash (con't)

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	290,813
Total Current Assets	<u>9,382,859</u>
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	26,732,617
Total assets	<u>\$ 70,614,749</u>

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Cash and Cash Equivalents and Restricted Cash (con't)

- 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.

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Cash and Cash Equivalents and Restricted Cash (con't)

Net Change in Cash and Cash Equivalents and Restricted Cash	5,364,994
Cash and Cash Equivalents and Restricted Cash, Beginning of Year	1,009,226
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	1,500,000
Cash and Cash Equivalents on the Statement of Cash Flows	<u>\$ 6,374,220</u>

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Cash and Cash Equivalents and Restricted Cash (con't)

Additional Disclosures

- 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.

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Funds Deposited with Related Entity

- Certain entities deposit funds with a related entity, such as a national office, a church with a denominational body, or an interrelated fundraising organization.
- The FinREC believes that where there is a centralized cash management arrangement, those cash amounts would **not** be considered cash and cash equivalents unless the entity has legal title to the cash on deposit.
- This is generally evidenced by the cash or cash equivalent being deposited in a demand deposit with the specific entity's name.
- Amounts in a cash pool are generally not short-term deposits, and the entity would classify the deposit in the cash pool as a receivable from the related entity.

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Example Disclosure

Summary of Significant Accounting Policies

Cash and Cash Equivalents and Restricted Cash and Cash Equivalents

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

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

During 20X0, the Agency received a donation of cash which was restricted to the facility expansion project. At December 31, 20X1, \$1,500,000 had not been released from restriction.

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Example Disclosure (con't)

Note 2 Assets Limited as to Use

Assets limited as to use comprise 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 by us to be creditworthy. At times, amounts on deposit may exceed insured limits or include uninsured investments in money market mutual funds. To date, we have not experienced losses in any of these accounts.

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Investments

- **Relevant Literature:** ASC 958-320 (Debt Securities), ASC 958-321 (Equity Securities), ASC 323 and ASC 958-325 (Investments), ASC 820 (Fair Value)
- ASC 958-320 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.
- Unrealized and realized gains and losses are classified according to their net asset class.
- Realized 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.

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Investments – Gains and Losses

- 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 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.

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Investments – Gains and Losses (con't)

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

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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, for example, mutual fund or hedge fund management, then they are not considered the reporting entity's investment expense.

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Investment Expenses (con't)

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.

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Investment Expenses (con't)

- NFPs report investment return net of investment expense.
- They are no longer required to disclose the amount of investment expenses.
- Direct internal investment expenses include costs of activities conducted by third parties and activities conducted by employees.
 - personnel that develop, execute, and monitor the investment strategy including employee benefit and occupancy costs.

Example

Investments

Caring for Children records investment purchases at cost, or if donated, at fair value on the date of donation. Thereafter, investments are reported at their fair values in the statement of financial position. Net investment return/(loss) is reported in the statement of activities and consists of interest and dividend income, realized and unrealized capital gains and losses, and less external and direct internal investment expenses.

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Other Investments

- NFPs may own 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 and 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).
 - 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 – not to exceed 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.

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Cash or Investments Held as an Agent

- Cash held as a custodian or agent.
- When NFP has little or no discretion in determining how the investment income, unrealized/realized gains and losses, will be used, report as agency transactions (asset and liability) 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.

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Sample Investment Disclosure

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.

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Sample Investment Disclosure (con't)

A three-tier hierarchy categorizes the inputs as follows:

Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities that we can access 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, taking into account 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.

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Sample Investment Disclosure (con't)

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 considered to be Level 3 measurements.

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Sample Investment Disclosure (con't)

We use 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.

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Sample Investment Disclosure (con't)

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	\$ 276.3B	\$ -	\$ 276.3B	\$ -	\$ -
Short-term bond mutual fund	497.9B	497.9B	-	-	-
	<u>\$ 774.223</u>	<u>\$ 497.9B</u>	<u>\$ 276.3B</u>	<u>\$ -</u>	<u>\$ -</u>
Assets held under split-interest agreements					
Cash and money market funds (at cost)	\$ 78.411	\$ -	\$ -	\$ -	\$ -
U.S. Government obligations	52.904	-	52.904	-	-
Global equity mutual funds	1285.787	1285.787	-	-	-
	<u>\$ 1977.02</u>	<u>\$ 1285.787</u>	<u>\$ 52.904</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	1094.842	-	-	1094.842	-
	<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	1237.881	-	1237.881	-	-
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>\$ 27,027.61</u>	<u>\$ 6,595,804</u>	<u>\$ 1949,425</u>	<u>\$ -</u>	<u>\$ 16,481,902</u>
Liabilities					
Interest-rate swap	\$ 240,300	\$ -	\$ 240,300	\$ -	\$ -

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Sample Investment Disclosure (con't)

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>

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Sample Investment Disclosure (con't)

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 1 year for complete divestiture.

Global Equity Funds – Funds focused on private equity investments primarily in foreign markets, including emerging markets.

Long/Short Hedge Funds – Funds that can invest long and short, primarily in common stocks. Fund managers may invest in value, growth, or event-driven equity opportunities and typically are not restricted by market capitalization, industry sector, or geography. Leverage may be utilized, which can magnify changes in the values of the underlying securities.

Private Equity Funds – Funds focused on growth in equity, buyout opportunities, or distressed debt. These investments are not readily redeemable; however, a secondary market does exist. Distributions normally are received through the liquidation of the underlying assets in the fund. The terms of these investments range from 3 to 7 years.

Real Estate Funds – Funds focused on real estate assets primarily located in the United States. These investments are not redeemable. Instead, distributions are received through the liquidation of the underlying assets in the fund. The terms of these investments range from 2 to 10 years.

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Sample Investment Disclosure (con't)

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

	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)	
Assets					
Long-lived asset held and used					
Administration Building	<u>\$ 2,475,000</u>	<u>\$ -</u>	<u>\$ 2,475,000</u>	<u>\$ -</u>	<u>\$ 90,684</u>

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.

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Endowment Funds

- **Relevant Literature:** ASC 958-205
- Established fund of cash, securities, or other assets to provide income for the maintenance of an NFP.
- 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.
 - Added to the endowment fund to preserve the purchasing power subject to the donor's spending stipulations.
 - Used for specific programs or purposes.
 - No stipulations – NFP will spend according to its established spending policy.

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Endowment Funds (con't)

- Quasi-endowment funds – 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.
- UPMIFA – 2006
- Institutional funds are those that are held by an institution exclusively for charitable purposes.
- Term does not include program related assets or assets held by a trustee that is not charitable institution or a fund where a beneficiary that is not an institution has an interest.
- A perpetual fund, although an endowment, would not be considered an endowment subject to UPMIFA. It should be noted that UPMIFA is a model law. Each state in the United States has now adopted a version of UPMIFA.

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Endowment Funds (con't)

- Massachusetts adopted its version of UPMIFA in 2011.
- Law permits spending from a donor restricted endowment even when it causes a fund to go under water (decline past the original gift).
- Law helped NFPs that had restricted gifts where the purpose to use them may have been obsolete.
- With the adoption of UPMIFA NFPs are able to 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.

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Endowment Funds (con't)

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 making a determination 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:

- (i) the duration and preservation of the endowment fund;
- (ii) the purposes of the institution and the endowment fund;
- (iii) general economic conditions;
- (iv) the possible effect of inflation or deflation;
- (v) the expected total return from income and the appreciation of investments;
- (vi) other resources of the institution; and
- (vii) 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:

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

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Endowment Funds (con't)

- **Spending Policy**
- UPMIFA was created to guide the spending policies of institutions for endowment funds.
- UPMIFA extends a donor's restriction to use of the funds, including the investment return until the funds are appropriated for expenditure by the board.
- If the donor or state law imposes a restriction on the investment return, it is reported in the donor restricted net asset class until appropriated.
- Just because funds are appropriated for expenditure does not mean they must be spent right away. They will be reported in the endowment as "without donor restriction" until spent.
 - Although this doesn't happen often, sometimes a board-designated or quasi-endowment fund will include a portion of net assets with donor restrictions.

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Endowment Funds – 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.

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Endowment Funds – Example (con't)

- 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 (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.
- At this time 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 3-year average value of the assets held by the NFP or trust.

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Endowment Funds – Example (con't)

- On July 23, 2020, Pennsylvania modified its law to allow NFPs to increase the rate at which they spend their endowments for 3 years to 10% (response to COVID).
- 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.
- 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 considered to be available for expenditure.

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Endowment Funds – Example (con't)

- 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.
 - There are rare circumstances where a board-designated endowment fund also can include a portion of net assets with donor restrictions.

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Endowment Funds – Example (con't)

Presentation and Disclosure Requirements

- Net asset classification
- Net asset composition by type (board-designated endowment funds or donor-restricted endowment funds)
- Changes in net asset composition
- Spending policies
- Related investment policies
- Description of the governing board's interpretation of the law or laws that govern the entity's net asset classification of donor-restricted endowment funds, including its interpretation of the ability to spend from **underwater endowment funds**.

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Endowment Funds – Example (con't)

Presentation and Disclosure Requirements

- Description of the entity's policy or policies for the appropriation of endowment assets for expenditure
- Spending policies including its policy, and any actions taken during the period, concerning appropriation from underwater endowment funds
- Description of the NFP's endowment investment p.policies, including all of the following:
 - Return objectives and risk parameters
 - How return objectives relate to the entity's spending policy or policies
 - The strategies employed for achieving return objectives

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Endowment Funds – Example (con't)

Presentation and Disclosure Requirements

- 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

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Endowment Funds – Example (con't)

Presentation & Disclosure Requirements

- The entity must disclose each of the following, in the aggregate, for all underwater endowment funds:
 - The fair value of the underwater endowment funds
 - The original endowment gift amount or level required to be maintained by donor stipulations or by law that extends donor restrictions
 - The amount of the deficiencies of the underwater endowment funds

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Endowment Disclosure – Example

Note I: Endowment

Caring for Children's endowment (the Endowment) consists of approximately 45 individual funds established by donors to provide annual funding for specific activities and general operations. The Endowment also includes certain net assets without donor restrictions that have been designated for endowment by the Board of Directors.

The Board of Directors has interpreted the Georgia Uniform Prudent Management of Institutional Funds Act (UPMIFA) as requiring the preservation of the fair value of the original gift as of the date of the donor-restricted endowment funds, unless there are explicit donor stipulations to the contrary. At December 31, 20X1, there were no such donor stipulations. As a result of this interpretation, the Organization retains in perpetuity (a) the original value of initial and subsequent gift amounts (including promises to give net of discount and allowance for doubtful accounts donated to the Endowment and (b) any accumulations to the endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is added. Donor-restricted amounts not retained in perpetuity are subject to appropriation for expenditure by us in a manner consistent with the standard of prudence prescribed by UPMIFA.

The following factors are considered in making a determination to appropriate or accumulate donor-restricted endowment funds:

- ☐ The duration and preservation of the fund
- ☐ The purposes of the organization and the donor-restricted endowment fund
- ☐ General economic conditions
- ☐ The possible effect of inflation and deflation
- ☐ The expected total return from income and the appreciation of investments
- ☐ Other resources of the organization
- ☐ The investment policies of the organization

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Endowment Disclosure – Example (con't)

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>

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Endowment Disclosure – Example (con't)

From time to time, certain donor-restricted endowment funds may have fair values less than the amount required to be maintained by donors or by law (underwater endowments). We have interpreted UPMIFA to permit spending from underwater endowments in accordance with prudent measures required under law. At June 30, 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

We have adopted investment and spending policies for the endowment that attempt to provide a predictable stream of funding for operations while seeking to maintain the purchasing power of the endowment assets. Over time, long-term rates of return should be equal to an amount sufficient to maintain the purchasing power of the Endowment assets, to provide the necessary capital to fund the spending policy, and to cover the costs of managing the endowment investments. The target minimum rate of return is the Consumer Price Index plus 5% on an annual basis. Actual returns in any given year may vary from this amount. To satisfy this long-term rate-of-return objective, the investment portfolio is structured on a total-return approach through which investment returns are achieved through both capital appreciation (realized and unrealized) and current yield (interest and dividends). A significant portion of the funds are invested to seek growth of principal over time.

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Endowment Disclosure – Example (con't)

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

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Endowment – Spending Policy

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 of time. At June 30, 20X3, the following was calculated and \$20,250 was appropriated for expenditure by the board.

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Endowment – Spending Policy (con't)

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	22,750	
Total return	<u>27,750</u>	
	<u>7,500</u>	Nonspendable portion

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Endowment Accounting

- 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.

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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 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.

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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.

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Programmatic Investments (con't)

- **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.
- Referred to as the effective interest rate approach.
- Others are treated as contributions made to others.

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Programmatic Investments (con't)

- **Effective Interest Rate Approach**

- Loans may bear a market rate of interest or below market interest or interest free.
- With 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 are, 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.

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Programmatic Investment 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 5-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.

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Programmatic Investment Example (con't)

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).

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Programmatic Investments Example (con't)

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.

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Programmatic Investments

- 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.

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Programmatic Investment Disclosure

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% and 5% 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% and 15%. Currently, the Agency has made 10 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>

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Programmatic Investment Disclosure (con't)

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>

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Programmatic Investment Disclosure (con't)

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

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Promises to Give

- **Relevant Literature: ASC 958-605**
- Contributions of long-lived assets such as buildings or equipment or cash to purchase these items without instructions from the donor.
- Absent donor restrictions, a tangible long-lived asset must be classified as support without donor restrictions when it is placed in service.
- Contributions of cash or other assets, such as investments, that are to be used to construct or acquire long-lived assets, have purpose restrictions until those restrictions are met.
- Recorded as donor-restricted support until such time as the underlying asset is placed in service.
- Contributions received over multiple years may have both timing and purpose restrictions.
- Discounting may be appropriate.

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Promises to Give (con't)

- 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.
- 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 (for example, when the building was placed in service).
- The receivable does not have to be collected to be classified in net assets without donor restrictions.
- Technical Q&A 6140.03 – timing restrictions associated with contribution receivables lapse when the payment is due, not when it is received.

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Promises to Give – Examples

Example 1: A donor gave an NFP cash in connection with a building project. The donor's intent as described in the transmittal was to use the money in the current period to pay for any expenses incurred in preparation for building such as architect fees. The donor pledged to pay the \$300,000 over a 3-year period. When the NFP spends the money on the building, then it is considered unrestricted support even though the cash will be due in future periods.

Example 2: An NFP received funding to build a building. The timing restriction was met because the donor meant for it to be used currently but the purpose restriction was not met until the building was placed in service.

Example 3: A NFP received funding to pay debt service on its building when due. The donor meant for the support to be used currently to pay the payments. In June, the donor was late sending the payment to the NFP. The NFP released the promise to give from restriction even though the payment had not yet been made.

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Promises to Give – Examples (con't)

- Donor may require the NFP to restrict its own net assets as a condition for making a gift.
- This is rare.

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

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Contributions and Contributions Receivable

- Contributions represent unconditional, nonreciprocal gifts of assets (or settlement of its liabilities) from one entity to another.
- Financial (securities or cash) or nonfinancial assets.
- Contributions may have donor-imposed restrictions.
- Contributions may be promises to give – long term or short term.
- Measurement – fair value date of donation.

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Contributions and Contributions Receivable (con't)

- Promises to give within the next year are deemed to be at fair value.
- Promises to give greater than a year must be recorded at fair value (ASC 820).
- Fair value of a long-term contribution – based on the present value of expected future cash flows.
- NFP considers the creditworthiness of the parties, its past collection experience and policies about enforcing promises to give.
- NFP also considers the economic climate that may affect future cash flows.

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Contributions and Contributions Receivable (con't)

- ASC 820-10-55 discusses two types of present value techniques:
 1. **DRA – Discount Rate Adjustment** – most likely or projected cash flows derived from observed rates of return for comparable assets or liabilities that are traded in the market, the amount that market participants would demand for bearing the uncertainty inherent in the cash flows.
 2. **EPV – Expected Present Value – 2 methods**
 - **EPV 1 – 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.
 - **EPV 2** – a probability weighted cash flow or expected value. An **adjusted risk-free rate** is used. The risk-free rate is adjusted for general market risk by adding a risk premium. This adjusted rate is the expected rate of return.

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Contributions and Contributions Receivable (con't)

In 20X5, an independent school held a capital campaign and raised \$3,000,000. The amounts were to be paid by the donors ratably over 5 years. The controller realized that she had to be realistic in her expectations. She was aware that recessions happened every 8–10 years and this could impact the collectability of the receivables, maybe not this year but in the coming years. She also evaluated the results of the previous capital campaign which was held 5 years ago in 20X0 to determine the most likely amount that would be collected.

Previous campaign results- 20X0

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%

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Case Study 13 – Fair Value of Contributions Receivable

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**. Because donors default at different percentages, she considered the most likely cash flow to be derived from the campaign by donor type

Information obtained from other schools reflecting percentage collected in less favorable times.

Type of Donor	% Collected of Amounts Promised To Date School 1	% Collected of Amounts Promised To Date School 2	% Collected of Amounts Promised To Date 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%

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Case Study 13 – Fair Value of Contributions Receivable (con't)

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%

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Case Study 13 – Fair Value of Contributions Receivable (con't)

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]						

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Case Study 13 – Fair Value of Contributions Receivable (con't)

Journal Entry

Pledges receivable	3,243,890	
Discount on pledges receivable		503,901
Contribution revenue with donor restriction		2,740,079

To record pledges receivable and contribution revenue restricted for purpose and timing.

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.

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Contributions and Contributions Receivable

- Events may take place that affect valuation and measurement.
 - 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.

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Contributions and Contributions Receivable (con't)

- 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.
- Current expected credit loss standard is not applicable to receivables from promises to give.

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Contributions and Contributions Receivable (con't)

Request for Return of Donation

- Donor may simply have changed their mind.
- Donor may believe that the organization is misusing or wasting donated funds or that it's no longer fulfilling its charitable mission. This might involve philosophical differences or a recent trend that the donor dislikes.
- In some cases, donors argue that their wishes for the funds are being ignored.
- Presently, there is no federal law that requires nonprofits to return donations.
- Individual states have enacted various laws that relate to this issue, but they are not directly on point and assume that a gift is no longer the property of a donor once the donee accepts it.
- NFPs generally try to avoid negative publicity.
- Should the NFP decide to return a contribution, the reporting could take the same form as the loss on promises
- If material, the entity may wish to put the amount on a separate line. Some entities with an operating indicator will show it outside operations.

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Contributions and Contributions Receivable (con't)

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.
- 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.

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Contributions and Contributions Receivable (con't)

Decline in the Value of a Gift

- Many NFPs appreciated 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.

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Contributions and Contributions Receivable (con't)

Decline in Value of Gift – 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.		

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Contributions and Contributions Receivable (con't)

Decline in Value of Gift – Example

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

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Contributions and Contributions Receivable (con't)

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		122,000
		1,209,645
Less discount to net present value at rates ranging from 2.96% to 3.50%		(122,994)
Less allowance for uncollectable promises to give		(145,539)
	\$	941,112

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

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

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Contributed Nonfinancial Assets

- These contributions may be nonfinancial assets or services.
- Examples of nonfinancial assets are land, buildings, equipment, and cryptocurrency. Investment securities are financial assets.
- Many NFPs fail to value nonfinancial assets. May be because the accountants are unaware that they should be recorded. Some entities fail to record them because there is no financial trigger and the contributions are ignored.
- Some auditors fail to ask management about the existence of in-kind contributions because they believe that the recording of them has no financial impact.
- Contributions are recorded at fair value at the date of donation.
- When the revenue is recorded, corresponding entries are made to the expense, prepaid expenses, promise to give or fixed assets.
- Unless the donation is long term, such as the contribution of leased space, utilities or other assets that will be recognized as expense over a period of time, there is no impact on net assets.

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Contributed Nonfinancial Assets (con't)

A large NFP foundation had several regional affiliates around the country that bore the name of the parent. Executive management decided to acquire the affiliates that were not performing well, streamline operations, including eliminating most of the regional executives, and service the region's administrative needs through the parent's shared service department. This plan required a significant amount of legal work which was performed by a board member.

In 20X1, the entity changed audit firms and during the client acceptance procedures the successor auditor reviewed the financial statements. The auditor noted that there was very little legal expense and inquired about it. She learned about the board member's role in executing the acquisitions, which was above and beyond the responsibilities of a board member. She informed management and the board that if the firm accepted the entity as a client there would be a restatement required since the amount was material. This should be discussed with the predecessor auditor. Management acknowledged that they had never known that the services should be recorded as nonfinancial contributions.

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Contributed Nonfinancial Assets (con't)

- **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.

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Contributed Nonfinancial Assets (con't)

- The highest level (level 1 input) of the fair value hierarchy is a quoted price (unadjusted) in an active market for an identical asset or liability that the reporting entity can access at the measurement date.
- A quoted price provides the most reliable evidence of fair value.
- Donated asset may not have an active market, defined as a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis, then the NFP should look for level 2 inputs.
- May be publicly available information about transactions for the identical items or similar items on inactive markets, such as auction websites, to provide management with acceptable level 2 inputs.

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Contributed Nonfinancial Assets (con't)

- Sometimes the only transactions for the contributed item occur in principal-to-principal markets for which little information is made publicly available.
- When there is little, if any, market activity for the asset or liability at the measurement date and relevant observable inputs are not available, unobservable inputs are used to measure fair value.
- The FinREC notes that is when the NFP should determine fair value by making its own assumptions about the assumptions that a market participant would use in pricing the asset in a hypothetical transaction occurring at the measurement date (a level 3 input).
- NFP would consider factors specific to the nonfinancial asset, the principal market for the asset or liability (or at least the most advantageous market), and market participants that would enter into a transaction.

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Contributed Nonfinancial Assets (con't)

- Organization does not need to make exhaustive efforts to obtain information about market participant assumptions but should consider information about market participants that is reasonably available.
- 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 its 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.**

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Contributed Nonfinancial Assets – 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, a cash disbursement of \$1,000 with a corresponding entry to inventory.

86



Contributed Nonfinancial Assets

- *Valuations Provided by Donors*
- Even if NFP receives an appraisal or other evidence of valuation, it should challenging the appraisal, 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.

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Contributed Nonfinancial Assets (con't)

- **Valuations Provided by Donors**
- Even if NFP receives an appraisal or other evidence of valuation, it should challenging the appraisal, 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.

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Contributed Nonfinancial Assets (con't)

- **Gifts Sold at Fundraisers**

- NFPs may also receive items, such as tickets, gift certificates, works of art, and merchandise, that are to be used for fundraising purposes.
- 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.

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Contributed Nonfinancial Assets (con't)

Gifts Sold at Fundraisers – 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.

If the trip had sold for \$2,000 then a reduction of revenue would have been recorded.

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Contributed Nonfinancial Assets (con't)

Valuing Contributions of Media and Advertising

- Technical Q&A 6140.24 – 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 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.

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Contributed Nonfinancial Assets (con't)

Valuing Contributions of Media and Advertising – 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.

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Contributed Services

- Contributions services are recorded at fair value at the date of donation.
- Services must either create or enhance a nonfinancial asset or be performed by people with specialized 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.

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Donations of Nonfinancial Assets – Disclosure

- ASU 2020-07 was issued to improve the disclosure of in-kind donations.
- 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.

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

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Donations of Nonfinancial Assets – Disclosure (con't)

Donated Services and In-Kind Contributions

Caring for Children recognizes in-kind contributions within revenue on a separate line items in the statement of activities. For the year ended December 31, 20X1 in-kind contributions included a building, vehicles, food, medical supplies, pharmaceuticals, clothing, and services. Unless otherwise noted, these donations did not have donor-imposed restrictions.

Our policy is to sell all contributed vehicles immediately upon receipt at auction or for salvage unless the vehicle is restricted for use in a specific program by the donor. No vehicles received during the period were restricted for use. All vehicles were sold and valued according to the actual cash proceeds on their disposition.

The contributed building will be used for general and administrative activities. In valuing the contributed building, the Agency estimated the fair value on the basis of recent comparable sales prices in the Baltimore real estate market.

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Donations of Nonfinancial Assets – Disclosure (con't)

Contributed food was utilized in the following programs: domestic community development, and services to community shelters. Contributed clothing was used in the Agency's homeless shelter. Contributed medical supplies were utilized in the Agency's medical clinics. In food, clothing, and medical supplies, the Agency estimated the fair value on the basis of estimates of wholesale values that would be received for selling similar products in the United States.

Contributed pharmaceuticals were restricted by donors to use in the metropolitan Baltimore area and were utilized in programs for underserved adults and children. In valuing contributed pharmaceuticals, the Agency used the Federal Upper Limit based on the weighted average of the most recently reported monthly Average Manufacturer Prices (AMP) that approximate wholesale prices in the United States (that is, the principal market).

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Donations of Nonfinancial Assets – Disclosure (con't)

Contributed services recognized comprise professional services from attorneys advising the Agency on various administrative legal matters. Contributed services are valued and are reported at the estimated fair value in the financial statements based on current rates for similar legal services.

Volunteers contribute significant amounts of time to our program services, administration, and fundraising and development activities. However, the financial statements do not reflect the value of these contributed services because they do not meet recognition criteria prescribed by generally accepted accounting principles.

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Donations of Nonfinancial Assets – Disclosure (con't)

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>1,850</u>

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Unit 2

Issues Related to Liabilities and Expenses



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 liabilities in a NFP are comparable to for-profit entities.
- Liabilities that are unique to NFPs are:
 - Obligations under split interest agreements
 - Agency transactions
 - Promises to give that the NFP makes to another entity
 - Guarantees
 - Discussion of split interest agreements and promises made

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Split-Interest Agreements

Split-Interest Agreements

Relevant Literature: ASC 958-30

- Some NFPs actively seek donations in which the NFP
 - Entity receives donation but there are also other parties involved
 - May be trustee or not, and with trusts, NFP may be the trustee or trustee may be a third party
 - Time period could be a specific period or death of donor
- Generally, the arrangement is irrevocable
- Two main types – lead interest and remainder interest

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Split-Interest Agreements (con't)

- **Lead Interests** – generally, the donor will establish and fund a trust with specific payments to be made to a designated not-for-profit over a specified period.
- 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.

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Split-Interest Agreements (con't)

- Three types of remainder interests – charitable remainder trust, charitable gift annuity and pooled income funds.
- **Charitable remainder trust** – the donor establishes and funds a trust with specified payments to be made to a designated beneficiary over the term of the trust.
 - In some cases, these periodic payments are for a specific dollar amount, called an annuity trust. Another form of charitable remainder trust is the unitrust or CRUT.
 - Some charitable remainder unitrusts limit the annual payout to the lesser of the stated percentage or the actual income earned. Obligations to the beneficiaries are limited to the trust's assets.

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Split-Interest Agreements (con't)

- **Charitable gift annuity** – held in general asset and liability of NFP. Under charitable gift annuities, the not-for-profit agrees to pay a fixed amount for a specified period of time to the donor, or individuals, or entities designated by the donor. No trust.

105



Split-Interest Agreements (con't)

- **Pooled Income Fund** - trust where the not-for-profit is a trustee.
- Trust pools the contributions of many donors and invests those gifts as a group.
- Donors are assigned a specific number of units in the pooled income fund based on the proportion of the fair value of their contributions to the total fair value of the pooled income fund on the date of the donor's entry to the pooled fund.
- Until a donor's death, the donor (or the donor's designee) is paid the actual income earned on the donor's assigned units, defined by the agreement.
- When the donor dies, the value of the assigned units belongs to the not-for-profit.

106



Split-Interest Agreements (con't)

Initial Measurement

- ASC 958-30 requires that the assets, liabilities, and contribution inherent in the split-interest agreement where the NFP has a remainder interest are initially measured at fair value. The income approach was typically used.
- For lead interests in agreements where the assets are held by the NFP (either in trust with the NFP as trustee or as general assets of the NFP), the fair value of the contribution can be directly estimated based on the present value of the future distributions to be received by the NFP as a beneficiary.
- For split-interest agreements where independent trustees hold the transferred assets and the NFP has a beneficial interest, the agreement is initially and subsequently re-measured at fair value.

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Split-Interest Agreements (con't)

Subsequent Remeasurement

- 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.

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Accounting Summary

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.

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Accounting Summary (con't)

Agreement	Initial Recording of Fair Value of the Contribution	Subsequent Re-measurement
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.

110



Split-Interest Agreements, 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.

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Split-Interest Agreements, Example (con't)

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)
All years not shown due to space constraints					
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

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Split-Interest Agreements, Example (con't)

Journal entry to record the trust			
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 FV at the date of donation and the liability to the donor			

- For the remainder of the donor's life the trust will:
 - make the required payout
 - increase the value of the trust by the income
 - amortize the discount and adjust the liability to reflect changes in actuarial assumptions

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Split-Interest Agreements, Example (con't)

- Ongoing Journal entries until the death of the donor
 - | | | | |
|---------------------------------------|----|----|---------------|
| DR liability under unitrust agreement | XX | | |
| CR assets held in remainder trust | | XX | payout |
 - | | | | |
|---------------------------------------|----|----|--------------------------|
| DR assets in remainder trust | XX | | Investment income |
| CR liability under unitrust agreement | | XX | |
 - | | | | |
|---|--|--|--------------------------|
| 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 |

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Split-Interest Agreements

- 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.

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Split-Interest Agreements (con't)

- Derecognition of liability
 - Some NFP prefer not to have a liability on their books and would like to purchase an annuity to cover the payments to the donor
 - NFP may do this, 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.

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Promises Made

Relevant Literature: ASC 605

- 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. No recognition takes place.
- 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.

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Promises Made (con't)

- 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.
- 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.

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Promises Made (con't)

- The agreement does not need to include the specific phrase right of return or release from obligation.
- 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 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, that have not been completed.

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Promises Made (con't)

Evaluating Performance Barriers

- 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%.

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Promises Made (con't)

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.

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Promises Made (con't)

Example 1: A grantor provided a grant to NFP Agency to provide career training to disabled veterans. The grant stipulated that the not-for-profit must serve 7,500 veterans during the year. The grant also stipulated other targets that must be achieved every quarter. The grant was for \$400,000 to be released ratably over the year if the Agency served at least 2,000 per quarter. The grant also specified that unused funds would be returned. The grantor determined that this grant is conditional because there is a measurable performance barrier and there is a right of return. Therefore, no liability was recorded until the barriers were met.

Example 2: A grantor provided funding to a NFP to provide services that were consistent with the NFPs mission. There were no specific metrics in the grant that could be deemed performance barriers. The grant document included a budget with line items for salaries and other costs applicable to the grant. There was a provision for the right of return/right of release. Since there were no specific performance barriers or limited discretion in spending this grant was deemed to be unconditional an a liability was recorded for the amount promised to the NFP.

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Direct Donor Benefits – 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.
- 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.

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Direct Donor Benefits – Special Events (con't)

- 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.

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Direct Donor Benefits – Special Events (con't)

Presentation 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

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Direct Donor Benefits – Special Events (con't)

Presentation 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

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Direct Donor Benefits – Special Events (con't)

Presentation 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

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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.
 - 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.
 - The other challenge is in the allocation itself.

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Functional Expenses (con't)

- 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 the 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 expenses.

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Functional Expenses (con't)

- 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.
- Users such as GuideStar or Charity Navigator could misconstrue the lack of fundraising expense as an attempt to improperly categorize fundraising expenses as program expenses.

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Functional Expenses (con't)

- ASC 958-720 provides guidance on classification and allocation of expenses among the various activities (management and general, fundraising, 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.

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Functional Expenses (con't)

- **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, fundraising, or membership-development activities.
 - Oversight
 - Business management
 - General record keeping and payroll.
 - Budgeting
 - Financing
 - Producing and disseminating the annual report
 - Advertising costs
 - Soliciting funds other than contributions and membership dues
 - Responding to government, foundation, and RFP
 - Providing information to the public related to the NFP's activities
 - Employee benefits management and oversight (human resources)

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Functional Expenses (con't)

- **Fundraising**

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

Q&A 6140.11 states that fundraising 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 fundraising expenses, even if the contributed services do not meet the recognition criteria.

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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 fundraising costs will include elements that pertain to program services and should be allocated. Joint cost rules are very specific.

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
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

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Functional Expense Example

	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	9,867	22,794	-	176,386
Information technology	37,858	706,535	744,393	12,399	14,653	-	771,445
Occupancy	346,801	29,799	376,600	14,918	53,427	-	444,745
Travel	70,957	18,263	89,240	93,292	-	-	182,532
Conferences, conventions and meetings	32,516	76,265	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

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Functional Expense Disclosure Example

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.

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Unit 3

Accounting Issues Related to
Consolidations



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.



Consolidations by NFPs

- **Relevant Literature: ASC 810, ASC 958-810**
- 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, separate parent company financial statements do not meet that requirement and should not be issued unless consolidated statements are also issued.
- 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.
- 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.
- Three main focus points for consolidation.
 - Relationships of NFPs with NFPs
 - Relationships of NFPs with for-profits
 - Consolidation of a special purpose leasing entity

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Consolidation – NFP with NFP

- Controlling financial interest through direct or indirect ownership of a majority voting interest. Alternatively, the ownership form could be a sole corporate membership in another NFP.
- Control through a majority voting interest in the board of the NFP by a means other than ownership or sole corporate membership.
- Economic interest in the other NFP along with control through means other than ownership or sole corporate membership.
- Either an economic interest in the other NFP or control but not both.

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Consolidation – NFP with NFP (con't)

- **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.

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Consolidation – NFP with NFP (con't)

- 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 situations, 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% 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.

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Consolidation – NFP with NFP (con't)

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.
- Evaluation of whether a majority voting interest exists is made in relation to the NFP's fully constituted board, including any vacant board positions.
- 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.

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Consolidation – Example, Control

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 eight 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.

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Consolidation – Consolidation – NFP with NFP

- **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 or required to be transferred to the reporting organization or to be used at its direction.

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Consolidation – Examples, Economic Interest

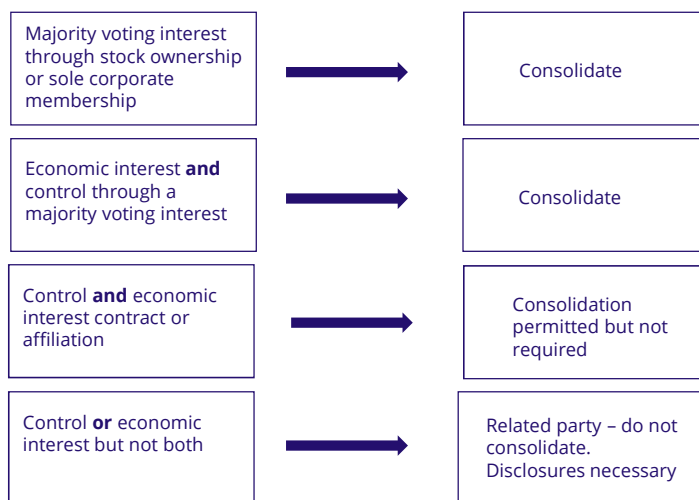
Example 1: Assume that the Foundation raises money for a charity. It solicits funds in the name of the charity. This is the Foundation's sole purpose. The Charity has an economic interest in the Foundation. If control was also present, consolidation would be permitted but not required. If control was not present, consolidation would not be appropriate.

Example 2: An NFP Agency works with lower income people to find housing for them and where needed, furniture. It grew to the point where management and the board believed another branch would be useful. There was another smaller NFP in the neighboring town that performed essentially the same functions. The boards of each organization agreed that it would be efficient to join forces. The smaller organization did not have the ability to borrow at a favorable rate, so the two signed an affiliation agreement and the Agency guaranteed the debt of the smaller organization. The affiliation agreement called for one of the members of the Agency's governing board to sit on the board of the smaller entity. This did not constitute a voting majority. However, the affiliation agreement specified certain policies and procedures that the smaller entity was required to follow for the sake of uniformity in service and pricing. Since there was control through the agreement and economic interest through the guarantee of debt, consolidation was permitted but not required.

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Consolidating an NFP with an NFP



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Consolidation

- When one NFP consolidates another, the definitions of with and without donor restrictions should be applied from the perspective of the reporting entity.
- The results could be different from the way that the standalone subsidiary reports.
- **Subsidiary:** 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.
- **Consolidated:** If the purpose of the subsidiary 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.

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Consolidation – Examples

- **Illustration 1:** An NFP trade group has a related foundation where there is control and economic interest. The reporting entity prepares consolidated financial statements. The mission of the trade group is to provide advocacy and educational services to attorneys. The mission of the foundation is to raise funds to provide scholarships for minority law students. Donors make contributions to the foundation without restriction because they understand the purpose is to provide scholarships. Since this is not the purpose of the trade association, the contributions are reported as donor restricted at the reporting entity but are without donor restriction when stand alone foundation financial statements are prepared.
- **Illustration 2:** An NFP adoption agency focuses on adoption but also performs various other related services for families. It is the sole corporate member of a fundraising foundation. The mission of the foundation is to raise money for children's causes. This includes adoption, foster care, services for special needs services and parental training. Contributions received by the foundation for adoption services are considered donor restricted to the foundation since they are to be used for the benefit of the adoption agency. But because of the mission of the adoption agency, they would be considered to be without donor restriction in the consolidated financial statements.

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Consolidation

- **Exception to Guidance**
- Exception for NFPs that presented consolidated financial statements when there was economic interest or control but not both present before December 1994 in conformity with Statement of Position 78-10. They may continue the prior practice.
- **Joint Ventures**
- NFPs may use a variety of approaches to combine or coordinate their services, operations, and resources such as form a new legal entity through which they will collaboratively provide a new service or program or carry out an essential function.
- NFP will consider substance over form to determine whether to consolidate.
- 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 despite the fact that 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 for equity interests in for-profit business entities.

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Combined Financial Statements

- **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.
- Example – combined financial statements would be useful if one entity owns a controlling financial interest in several entities that are related in their operations or under common management.

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Combined Financial Statements – 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.

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Consolidating Not-for-Profit and For-Profit

- Major decision point is whether or not the NFP organization has a controlling financial interest in the for-profit organization through direct or indirect ownership of a majority voting interest.
- This is generally ownership of over 50% of the shares.
- ASC 810 also says that the power to control could exist with a smaller percentage ownership.
- 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.

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Consolidating Not-for-Profit and For-Profit (con't)

- 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 additional 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 it should be consolidated.

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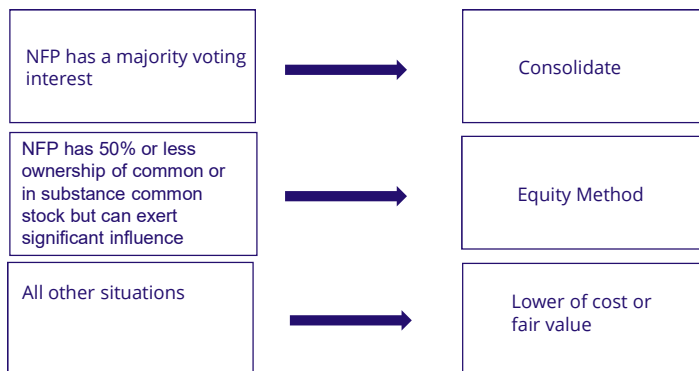
Consolidating Not-for-Profit and For-Profit (con't)

- 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.
- ASC 810 indicates that there may be instances where there is significant influence but less than 20% ownership could still be sufficient to apply the equity method.
- When the ownership is not sufficient for the equity method of accounting and the securities are marketable, the entity would report the fair value of its interest.
- If the securities do not have a readily determinable fair value, then the entity would report at the lower of cost or fair value. The entity may also elect to report at fair value.
- The entity would report at cost if purchased or fair value at the date of donation if donated.

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Consolidating an Non-For-Profit with a For-Profit (con't)



If control does not rest with the majority owner (i.e., bankruptcy or legal reorganization), then do not consolidate.

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Consolidated versus 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.
- With consolidating statements, the user has a snapshots into the level of detail that would be present when stand alone 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
 - 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.

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Consolidated versus Consolidating – 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.

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Noncontrolling Interests

- When the NFP is required to consolidate and the ownership is less than 100% but more than would be appropriate for equity method financial statements there is 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.

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Noncontrolling Interests (con't)

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		\$1,371,000

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Noncontrolling Interests – Example

An NFP durable medical equipment company had an 80% 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		\$1,371,000

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Noncontrolling Interests

- Operating results include amounts attributable to the parent and the noncontrolling interest.
- The footnotes would describe the changes in the noncontrolling interest n 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

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Noncontrolling Interests – 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

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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 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.
- 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.

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Special Purpose Leasing Entity (SPE) (con't)

- 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.
- 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.

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Special Purpose Leasing Entity (SPE) (con't)

- 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.

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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% 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.
- 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 and 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.

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Limited Partnership – Example

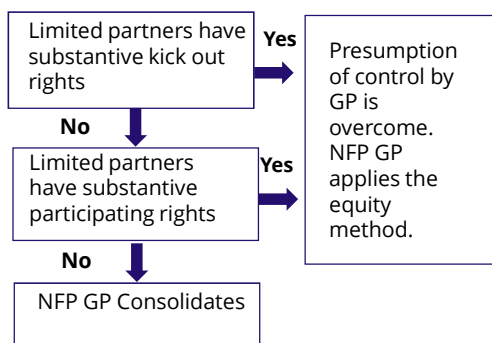
A Limited Partnership has three partners which are all NFPs. The partnership agreement provides the general partner with the authority to direct the partnership's operations and enter into binding contracts on behalf of the partnership. The limited partners have no authority beyond certain limited rights 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.

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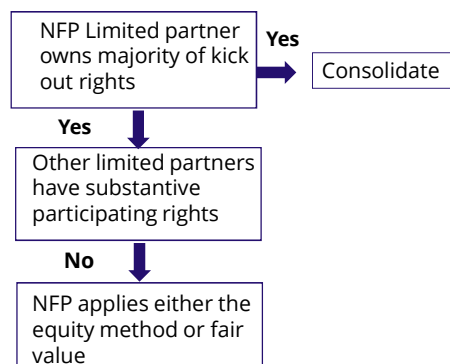


NFP Holds Partnership Interest

NFP holds general partner interest



NFP holds limited partner interest



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Reminders

- **Post event evaluation:** Please complete the course evaluation that will be pushed out to you as a pop up link on your screen. We welcome your feedback!

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