

Working Draft of AICPA Audit and Accounting Guide
Not-for-Profit Entities

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DRAFT

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Chapter 1

Introduction

Scope

Entities

1.01 This Audit and Accounting Guide covers entities that meet the definition of a *not-for-profit entity* (NFP) included in the Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary. That definition is

an entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity:

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

Entities that clearly fall outside this definition include the following:

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

As noted in the preceding definition, NFPs have characteristics (a), (b), and (c) in varying degrees. An entity could meet the definition of an NFP without possessing characteristic (a), (b), or (c). For example, some NFPs, such as those that receive all their revenue from exchange transactions, receive no contributions.

1.02 This guide applies to the following nongovernmental NFPs:

- Cemetery organizations
- Civic and community organizations
- Colleges and universities
- Elementary and secondary schools

- Federated fund-raising organizations
- Fraternal organizations
- Labor unions
- Libraries
- Museums
- Other cultural organizations
- Performing arts organizations
- Political parties
- Political action committees
- Private and community foundations
- Professional associations
- Public broadcasting stations
- Religious organizations
- Research and scientific organizations
- Social and country clubs
- Trade associations
- Voluntary health and welfare entities
- Zoological and botanical societies

Additionally, the guidance in this guide applies to all entities that meet the definition of an NFP in paragraph 1.01, regardless of whether they are included in this list.

1.03 Paragraph 1.02 states that this guide applies to certain nongovernmental NFPs. *Nongovernmental entities* are all entities other than governmental organizations. Public corporations^{fn 1} and bodies corporate and politic are governmental organizations. Other

^{fn 1} Black's Law Dictionary defines a *public corporation* as:

organizations are governmental organizations if they have one or more of the following characteristics:

- a. Popular election of officers or appointment (or approval) of a controlling majority of the members of the organization's governing body by officials of one or more state or local governments
- b. The potential for unilateral dissolution by a government with the net assets reverting to a government
- c. The power to enact and enforce a tax levy

Furthermore, organizations are presumed to be governmental if they have the ability to issue directly (rather than through a state or municipal authority) debt that pays interest exempt from federal taxation. However, organizations possessing only that ability (to issue tax-exempt debt) and none of the other governmental characteristics may rebut the presumption that they are governmental if their determination is supported by compelling, relevant evidence. Governmental entities report under standards issued by the Governmental Accounting Standards Board or the Federal Accounting Standards Advisory Board. Those standards are not discussed in this guide.

1.04 Providers of health care services that are described in FASB ASC 954-10-15 are not covered by this guide and should refer to the AICPA Audit and Accounting Guide *Health Care Entities*. That guide applies to entities whose principal operations consist of providing or agreeing to provide health care services and that derive all or almost all of their revenues from the sale of goods or services; it also applies to entities whose primary activities are the planning, organization, and oversight of such entities, such as parent or holding companies of health care entities. The health care guide does not apply to voluntary health and welfare entities (see paragraph 1.05), but it does apply to not-for-profit health care entities that have no ownership interest and are essentially self-sustaining from fees charged for goods and services (as described in paragraph 8 of FASB Concept No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*).

1.05 If a provider of health care services meets the definition of a *voluntary health and welfare entity* in the FASB ASC glossary, it should follow this guide. That definition is as follows:

An artificial person (for example, [a] municipality or a governmental corporation) created for the administration of public affairs. Unlike a private corporation it has no protection against legislative acts altering or even repealing its charter. Instrumentalities created by [the] state, formed and owned by it in [the] public interest, supported in whole or part by public funds, and governed by managers deriving their authority from [the] state. *Sharon Realty Co. v. Westlake*, Ohio Com. Pl., 188 N.E.2d 318, 323, 25 O.O.2d 322. A public corporation is an instrumentality of the state, founded and owned in the public interest, supported by public funds and governed by those deriving their authority from the state. *York County Fair Ass'n v. South Carolina Tax Commission*, 249 S.C. 337, 154 S.E.2d 361, 362.

A not-for-profit entity (NFP) that is formed for the purpose of performing voluntary services for various segments of society and that is tax exempt (organized for the benefit of the public), supported by the public, and operated on a not-for-profit basis. Most voluntary health and welfare entities concentrate their efforts and expend their resources in an attempt to solve health and welfare problems of our society and, in many cases, those of specific individuals. As a group, voluntary health and welfare entities include those NFPs that derive their revenue primarily from voluntary contributions from the general public to be used for general or specific purposes connected with health, welfare, or community services. For purposes of this definition, the general public excludes governmental entities when determining whether an NFP is a voluntary health and welfare entity.

Basis of Accounting

- 1.06** The focus of this guide is financial statements prepared in accordance with generally accepted accounting principles (GAAP).
- 1.07** Cash-, modified cash-, or tax-basis financial statements can be a viable alternative to GAAP-basis financial statements whenever the NFP is not contractually, legally, or otherwise required to issue GAAP financial statements. Guidance on financial statements prepared on an other comprehensive basis of accounting (OCBOA) is found in the audit, not accounting, literature. AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* (AICPA, *Professional Standards*), addresses special considerations in the application of auditing standards to an audit of financial statements prepared in accordance with a special purpose framework, which is a cash, tax, regulatory, or contractual basis of accounting.
- 1.08** In addition, the AICPA Practice Aid *Accounting and Financial Reporting Guidelines for Cash- and Tax-Basis Financial Statements* provides nonauthoritative guidance on OCBOA financial statements.
- 1.09** This guide is not intended for use in preparing financial statements in accordance with International Financial Reporting Standards (IFRSs). The council of the AICPA has designated the International Accounting Standards Board (IASB) as the body to establish IFRSs for both private and public entities pursuant to Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, ET sec. 202 par. .01), and Rule 203, *Accounting Principles* (AICPA, *Professional Standards*, ET sec. 203 par. .01), of the AICPA Code of Professional Conduct. The IASB does not have a reporting model designed specifically for NFPs; however, the IASB and FASB have indicated that they will jointly consider the applicability of their conceptual framework project to private sector not-for-profit organizations after it completes its work for a conceptual framework for private sector business entities. Paragraph 1.11 discusses reporting when an auditor is engaged to report on the financial statements of a U.S. entity for use outside of the United

States in conformity with accounting principles generally accepted in another country or in accordance with International Standards on Auditing (ISAs).

Level of Service

- 1.10** This guide provides auditing considerations and reporting guidance for CPAs that are engaged to audit and report on financial statements in accordance with generally accepted auditing standards (GAAS) for nonissuers.^{fn2} Many NFPs are required by state regulations, bond covenants, or grantors to have an audit. Other levels of service are offered by CPAs, but those are not the focus of this guide. Appendix A to this chapter, “Understanding Audits, Reviews, and Compilations,” discusses the benefits of an audit and provides a general overview of audit, review, and compilation engagements.
- 1.11** This guide also assumes that the independent auditor will be reporting on financial statements prepared in accordance with GAAP. If an auditor is engaged to report on the financial statements of a U.S. entity for use outside of the United States in conformity with accounting principles generally accepted in another country or in accordance with ISAs, the auditor should be aware of and consider the following additional publications:
- Paragraphs .42–.43 and .A42 of AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*), which discusses auditor’s reports for audits conducted in accordance with both GAAS and another set of auditing standards
 - Paragraph .A9 of AU-C section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor’s Report* (AICPA, *Professional Standards*), which discusses reporting if an entity prepares one set of financial statements in accordance with accounting principles generally accepted in the United States of America and another set of financial statements in accordance with another general purpose framework (for example, IFRSs promulgated by the IASB)
 - AU-C section 910, *Financial Statements Prepared in Accordance With a Financial Reporting Framework Generally Accepted in Another Country* (AICPA, *Professional Standards*)

GAAP for NFPs

- 1.12** FASB ASC is the single authoritative source of U.S. accounting and reporting standards for nongovernmental entities; that is, it is the source of U.S. GAAP for nongovernmental entities. The council of the AICPA has resolved that FASB ASC constitutes accounting principles as contemplated in Rule 203 of the AICPA Code of Professional Conduct.

^{fn2} Not-for-profit entities (NFPs) are not issuers subject to oversight by the Public Company Accounting Oversight Board, thus, auditing standards issued by the Auditing Standards Board apply to audits of NFPs.

- 1.13** NFPs should follow the guidance in all effective provisions of FASB ASC unless the specific provision explicitly exempts NFPs or its subject matter precludes such applicability. FASB ASC 958, *Not-for-Profit Entities*, contains only incremental industry-specific guidance. NFPs should follow that industry-specific guidance and all other relevant guidance contained in other FASB ASC topics that does not conflict with FASB ASC 958.
- 1.14** Most of the guidance in FASB ASC topics 105–899 applies to NFPs, although the application of certain provisions by NFPs may be unclear because those provisions specify the financial statement display of financial statement elements or items without considering the net asset reporting model included in FASB ASC 958. Nevertheless, NFPs are required to follow those effective provisions. FASB ASC 958-10-45-1 states that NFPs should consider the reporting objectives of the guidance when exercising judgment about how to best display elements, such as in which net asset class. Examples of those provisions include the following:
- FASB ASC 205-20, about discontinued operations
 - FASB ASC 225-20, about extraordinary and unusual items
 - FASB ASC 250, *Accounting Changes and Error Corrections*
 - FASB ASC 470-50, about modifications and extinguishments of debt
 - FASB ASC 740, *Income Taxes*
 - FASB ASC 830, *Foreign Currency Matters*
- 1.15** The guidance in FASB ASC topics 905–999 applies to entities operating in certain industries. An example of such guidance is FASB ASC 920, *Entertainment—Broadcasters*. Some NFPs conduct activities^{fn 3} in those industries and should apply the guidance concerning the recognition and measurement of assets, liabilities, revenues, expenses, and gains and losses to the transactions unique to those industries. However, in applying that guidance, NFPs should follow the financial statement display guidance in FASB ASC 958, even though it may conflict with display that would result from applying the other industry’s guidance.
- 1.16** Per FASB ASC 105-10-05-2, if the guidance for a transaction or event is not specified within a source of authoritative GAAP for that entity, an entity shall first consider accounting principles for similar transactions or events within a source of authoritative GAAP for that entity and then consider nonauthoritative guidance from other sources. An

^{fn 3} Such activities may be conducted by (a) for-profit entities owned and consolidated by NFPs, (b) divisions of NFPs, or (c) entire NFPs, such as those operating as not-for-profit broadcasters.

entity shall not follow the accounting treatment specified in accounting guidance for similar transactions or events if that guidance either (a) prohibits the application of the accounting treatment to the particular transaction or event, or (b) indicates that the accounting treatment should not be applied to other transactions or events by analogy.

- 1.17** Accounting and financial reporting practices not included in FASB ASC are nonauthoritative. Sources of nonauthoritative accounting guidance and literature include, for example, practices that are widely recognized and prevalent either generally or in the industry. FASB Concept Statements; AICPA Audit and Accounting Guides; AICPA Issues Papers; IFRSs; pronouncements of professional associations or regulatory agencies; Technical Questions and Answers included in AICPA *Technical Practice Aids*; and accounting textbooks, handbooks, and articles. The appropriateness of other sources of accounting guidance depends on its relevance to particular circumstances, the specificity of the guidance, the general recognition of the issuer or author as an authority, and the extent of its use in practice. For example, FASB Concept Statements would normally be more influential than other sources in this category.
- 1.18** The guidance in FASB ASC that specifically exempts NFPs from its scope includes guidance on earnings per share, reporting comprehensive income, segment disclosure, and variable interest entities.^{fn4} Other financial reporting guidance, such as that concerning common stock, convertible debt, stock purchase warrants, share-based payments, and certain financial instruments with characteristics of both liabilities and equity, typically does not apply to the kinds of entities covered by this guide because NFPs do not have ownership interests similar to business entities. However, the guidance included in the effective provisions of those topics applies to all for-profit entities owned by NFPs, whether owned wholly or in part.

Fund Accounting and Net Asset Classes

- 1.19** *Fund accounting* is a technique used by some NFPs for purposes of internal recordkeeping and managerial control and to help ensure that the use of resources is in accordance with stipulations imposed by donors and other resource providers and with self-imposed limitations designated by those charged with governance. Under fund accounting, resources are classified into funds associated with specific activities and objectives.
- 1.20** *Montgomery's Auditing* notes that

as used in nonprofit accounting, a fund is an accounting entity with a self-balancing set of accounts for recording assets, liabilities, the fund balance, and changes in the fund balance. Separate accounts are maintained for each fund to

^{fn4} In accordance with Financial Accounting Standards Board *Accounting Standards Codification* 810-10-15-17(a), an NFP is subject to the variable interest entities standards only in the unlikely case of an NFP that is used by business reporting entities in a manner similar to a variable interest entity in an effort to circumvent the provisions of the variable interest entities subsections.

ensure that the limitations and restrictions on the use of resources are observed. Though the fund concept involves separate accounting records, it does not entail the physical segregation of resources. Fund accounting is basically a mechanism to assist in exercising control over the purpose of particular resources and amounts of those resources available for use." ^{fn 5}

Fund accounting is discussed further in chapter 16, "Fund Accounting," of this guide.

- 1.21** FASB ASC 958-205-05-7 states that "The Not-for-Profit Entities Topic does not use the terms *fund balance* or *changes in fund balances* because in current practice those terms are commonly used to refer to individual groups of assets and related liabilities rather than to an entity's net assets or changes in net assets taken as a whole..." As discussed in chapter 3, "Financial Statements, Reporting Entity, and General Financial Reporting Matters," of this guide, FASB ASC 958-210-45-1 requires that the amounts for each of three classes of net assets (permanently restricted, temporarily restricted, and unrestricted) be displayed in a statement of financial position. FASB ASC 958-225-45-1 also requires that the amounts of change in each of those classes of net assets be displayed in a statement of activities.
- 1.22** Therefore, reporting by individual funds or fund groups is not required. However, FASB ASC 958-205-45-3 does not preclude providing disaggregated information by individual funds or fund groups, as long as the required aggregated amounts for each of the three classes of net assets are displayed as indicated previously. How an NFP maintains its internal accounting and recordkeeping systems is a matter outside the purview of standard setting.
- 1.23** Some NFPs may continue to use fund accounting for purposes other than reporting in conformity with GAAP, and some may provide disaggregated information in the financial statements beyond the minimum requirements of GAAP. A particular fund balance may fall completely into one of the three net asset classes or may be allocated to more than one net asset class, as discussed in chapter 16.
- 1.24** The accounting and auditing issues concerning each particular asset, liability, or class of net assets (financial statement elements) are not a function of the element's internal classification or financial statement subclassification. Accordingly, this guide is organized by financial statement elements and not by type of fund or groups of funds. Chapter 16 contains a discussion of the relationship of an NFP's fund balances to its net asset classes.

Other Resources for Financial Reporting by NFPs

^{fn 5} Vincent M. O'Reilly, Murray B. Hirsch, Philip L. Defliese, and Henry R. Jaenicke, *Montgomery's Auditing*, 11th ed. (New York: John Wiley & Sons, 1990), 791.

- 1.25** As a complement to this guide, the AICPA issues the Audit Risk Alert *Not-for-Profit Entities Industry Developments* annually. That alert provides an overview of economic and industry conditions, regulatory developments, and recently issued accounting and auditing pronouncements that may affect audits of NFPs. It also includes information about how to obtain many of the publications referred to in this guide and a list of useful Internet sites.
- 1.26** The following AICPA publications also may assist in preparing or auditing financial statements of NFPs:
- The Audit Guide Government Auditing Standards *and Circular A-133 Audits*
 - The Audit Risk Alert Government Auditing Standards *and Circular A-133 Audits*
 - *Not-for-Profit Entities: Checklists and Illustrative Financial Statements*
 - *The AICPA Audit Committee Toolkit: Not-for-Profit Organizations*
 - *Accounting Trends & Techniques—Not-for-Profit Entities*

Chapter 2

General Auditing Considerations

Reserved

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Chapter 3

Financial Statements, the Reporting Entity, and General Financial Reporting Matters

Introduction

3.01 This chapter discusses the following matters:

- Financial statements (that is, the statement of financial position, statement of activities, statement of cash flows, and statement of functional expenses)
- Reporting related entities, including consolidations
- Mergers and acquisitions
- Collaborative arrangements
- The use of fair value measures
- Financials statement disclosures not discussed elsewhere in this guide, including noncompliance with donor restrictions, risks and uncertainties, subsequent events, and related party transactions

3.02 Financial Accounting Standards Board (FASB) *Accounting Standards Codification*TM (ASC) includes the unique standards relating to the general-purpose external financial statements for a not-for-profit entity (NFP) in four subtopics, as follows:

- a. FASB ASC 958-205, about presentation of financial statements
- b. FASB ASC 958-210, about the statement of financial position
- c. FASB ASC 958-225, about the statement of activities
- d. FASB ASC 958-230, about the statement of cash flows

In addition to that industry-specific guidance, an NFP should follow all effective provisions of FASB ASC unless the specific provision explicitly exempts NFPs or its subject matter precludes such applicability. For example, FASB ASC contains presentation topics (FASB ASC 205, *Presentation of Financial Statements*, to FASB ASC 280, *Segment Reporting*), many of which provide guidance for general presentation and display items applicable to NFPs. The guidance in this chapter summarizes many of those unique standards but is not intended as a substitute for reading those topics and subtopics.

- 3.03** FASB ASC 958-205-45-4 specifies that a complete set of financial statements should include a statement of financial position as of the end of the reporting period, a statement of activities and a statement of cash flows for the reporting period, and accompanying notes to financial statements. In addition, a voluntary health and welfare entity^{fn 1} should provide a statement of functional expenses.^{fn 2}
- 3.04** FASB ASC 958-205-45-5 requires that a set of financial statements include, either in the body of the financial statements or in the accompanying notes, information required by generally accepted accounting principles (GAAP) that do not specifically exempt NFPs and information required by applicable specialized accounting and reporting principles and practices. Per FASB ASC 958-205-45-1, the requirements generally are no more stringent than the requirements for business entities. The degree of aggregation and order of presentation of items of assets and liabilities in statements of financial position or of items of revenues and expenses in statements of activities of NFPs, although not specified, generally should be similar to those required or permitted for business entities. Particular formats for a statement of financial position, a statement of activities, or a statement of cash flows are neither prescribed nor prohibited in part because similar prescriptions and proscriptions do not exist for business entities.
- 3.05** FASB ASC 958-205-55 includes illustrations of the required financial statements that illustrate some of the ways in which the requirements can be met.

Statement of Financial Position

- 3.06** FASB ASC 958-210 describes the unique standards relating to a statement of financial position of an NFP. In addition to that industry-specific guidance, an NFP should follow all effective provisions of FASB ASC unless the specific provision explicitly exempts

^{fn 1} The Financial Accounting Standards Board (FASB) *Accounting Standards Codification*TM (ASC) glossary definition of *voluntary health and welfare entity* includes a provision that those not-for-profit entities (NFPs) derive their revenue primarily from voluntary contributions from the general public. It specifies that for purposes of that definition, the *general public* excludes governmental entities when determining whether an NFP is a voluntary health and welfare entity.

^{fn 2} FASB ASC and this guide use certain statement titles and the terms *permanently restricted*, *temporarily restricted*, and *unrestricted net assets*. Other titles and other labels may also be used, pursuant to FASB ASC 958-205-55-2 and FASB ASC 958-210-55-3. The terms *statement of financial position* and *statement of activities* indicate the content and purpose of the respective statements and serve as possible titles for those statements. Other appropriately descriptive titles may also be used. Similarly, a statement of functional expenses might have another appropriately descriptive title. For example, a statement reporting financial position could be called a *balance sheet* as well as a *statement of financial position*. Current practice and the statement's purpose suggest, however, that a statement of cash flows only be titled "Statement of Cash Flows." FASB ASC 958-210-55-3 states that other labels exist for net assets and its classes. For example, *equity* may be used for net assets, and *other* or *not donor-restricted* may be used with care to distinguish unrestricted net assets from the temporarily and permanently restricted classes of net assets.

NFPs or its subject matter precludes such applicability. For example, NFPs should apply the guidance contained in FASB ASC 210, *Balance Sheet*, that does not conflict with the industry guidance.

3.07 FASB ASC 958-210-45-1 requires that a statement of financial position focus on the NFP as a whole and report all of the following amounts:

- Total assets
- Total liabilities
- Total net assets
- Permanently restricted net assets
- Temporarily restricted net assets
- Unrestricted net assets

3.08 FASB ASC 958-210-45-5 describes how classifying assets and liabilities into reasonably homogeneous groups increases the usefulness of information. FASB ASC 958-210-45-6 states that assets need not be disaggregated on the basis of the presence of donor-imposed restrictions on their use; for example, cash available for unrestricted current use need not be reported separately from cash received with donor-imposed restrictions that is also available for current use.^{fn 3} However, cash or other assets received with a donor-imposed restriction that limits their use to long-term purposes should not be classified with cash or other assets that are unrestricted and available for current use. FASB ASC 958-210-45-6 also states that the kind of asset whose use is limited should be described in the notes to the financial statements if its nature is not clear from the description on the face of the statement of financial position.

Effects of Restrictions, Designations, and Other Limitations on Liquidity

3.09 FASB ASC 958-210-45-8 requires that information about the NFP's liquidity be provided by any of the following:

- a. Sequencing assets according to their nearness of conversion to cash and sequencing liabilities according to the nearness of their maturity and resulting use of cash

^{fn 3} FASB ASC 958-205-45-6 notes that assets may be restricted by donors. For example, land could be restricted to use as a public park. Generally, however, restrictions apply to net assets, not to specific assets.

- b. Classifying assets and liabilities as current and noncurrent, as defined by FASB ASC 210-10
 - c. Disclosing in notes to financial statements relevant information about the liquidity or maturity of assets and liabilities, including restrictions on the use of particular assets
- 3.10** Per FASB ASC 958-210-50-1, information about the liquidity or maturity of assets and liabilities, including restrictions on the use of particular items, should be disclosed in notes to financial statements unless that information is provided on the face of the statement of financial position. FASB ASC 958-205-55-7 explains that when an NFP presents a statement of financial position that sequences assets and liabilities based on their relative liquidity, cash and cash equivalents that are held temporarily in permanent endowment funds until suitable long-term investment opportunities are identified are included in the classification long-term investments. Similarly, cash and contributions receivable restricted by donors to investment in land, buildings, and equipment are not included with the line items cash and cash equivalents or contributions receivable. Rather, those items are reported as assets restricted to investment in land, buildings, and equipment and are sequenced closer to land, buildings, and equipment. Similarly, FASB ASC 210-10-45-4 states that the concept of the nature of current assets contemplates the exclusion from that classification of such resources as cash that is designated for expenditure in the acquisition or construction of noncurrent assets or is segregated for the liquidation of long-term debts. Even though not actually set aside in special accounts, funds that are clearly to be used in the near future for the liquidation of long-term debts, payments to sinking funds, or for similar purposes should also, under this concept, be excluded from current assets.
- 3.11** Application of the guidance discussed in paragraphs 3.09–.10 results in certain (a) donor restrictions, (b) governing board designations (which are presumed to reflect management intent), and (c) legal limitations affecting the classification of or disclosures about assets, or both. In meeting the requirements of FASB ASC 958-210 and FASB ASC 210-10-45 to provide information about liquidity, NFP's should consider not only maturity (nearness to conversion to cash or use of cash), but the effects on liquidity of donor-imposed restrictions, management's intent to meet those restrictions, and management's intent to use assets for long-term purposes (such as liquidation of long-term debts, payments to sinking funds, establishment of quasi-endowment funds, and so forth).
- 3.12** For example, if a split-interest agreement is in trust form, such as a unitrust or annuity trust, or if the assets held for a split-interest agreement are required by state law to be separately invested, the NFP should either separately display the asset on the face of the statement of financial position or should display the asset with similar assets of similar liquidity to meet the requirements of FASB ASC 958-210 and FASB ASC 210-10-45. Cash and investments held in the trust should not be combined with cash and investments that are available for operations. Further, if not apparent from the face of the financial

statements, the NFP should disclose the nature and amount of the limitation imposed by a donor restriction, law, or contract in the notes to the financial statements in accordance with paragraphs 6–10 of FASB ASC 958-210-45.

3.13 The Financial Reporting Executive Committee (FinREC) believes if the use of a specific asset is not explicitly limited by a donor restriction, but net assets reflect a donor’s restriction to use the contributed assets for a permanent or term endowment, for purchase of a long-lived asset, or for another noncurrent purpose, the liquidity of the NFP is impacted by its responsibility to hold an appropriate composition of assets to comply with those restrictions. (Paragraphs 3.172–.174 discuss requirements if an NFP has not maintained an appropriate composition of assets to comply with donor-imposed restrictions.) In implementing the guidance in FASB ASC 958-210-45-8 pertaining to presenting information about liquidity, FinREC believes assets identified by the NFP as held to meet a donor restriction for noncurrent purposes should be displayed using any of the following methods:

- If the NFP provides information about liquidity by sequencing assets according to their nearness of conversion to cash (that is, a nonclassified statement of financial position), assets held for meeting donor restrictions that limit use to long-term purposes should be
 - separately displayed on the face of the statement of financial position in a position of longer-term relative liquidity as compared to similar assets available for current operating purposes (that is, using a description that identifies the nature of the asset, such as cash or contributions receivable, but displayed lower), or
 - displayed on the face of the statement of financial position using a separate line item, such as “assets whose use has been limited or restricted,” in a position of relative liquidity consistent with its noncurrent purpose.
- If information about liquidity is provided by classifying assets as current and noncurrent (that is, a classified statement of financial position), assets held for meeting donor restrictions that limit use to long-term purposes should be classified as noncurrent. For example, assets restricted to the payment of long-term debt would be classified as noncurrent to the extent that they exceed the current portion of long-term debt. A separate line item, such as “assets whose use has been limited or restricted,” may be used.

Regardless of which of the preceding methods is used, if the nature of the assets or the related restrictions is not evident from the description on the line item, that information should be disclosed in the notes to the financial statements, as required by paragraphs 6–10 of FASB ASC 958-210-45.

- 3.14** In some cases, assets held to meet a donor restriction are easily identified. In other cases, the identification process may be subjective. For example, if the NFP conducts a fund-raising campaign to build a new building, unconditional promises to give received in response to that campaign are easily identified as assets held to meet a donor restriction for purchase of a building. If cash gifts to the same campaign are invested until needed to make expenditures for the new building, and commingled with the NFP's other investments, a portion of investments may be assigned as assets held to meet a donor restriction for purchase of a building.
- 3.15** In implementing the guidance in FASB ASC 210-10-45-4 pertaining to the classification of current assets, FinREC believes that if the governing board identifies specific assets to be invested or held pursuant to a designation for noncurrent purposes, those assets would be reported in a classified balance sheet outside the current assets section. In a nonclassified balance sheet, those assets would be sequenced with other assets that will be consumed in a similar term. Further, FinREC believes best practice is to report those designated assets separately from donor-restricted assets on the face of the statement of financial position or disclose in the notes to the financial statements the amount of designated assets included in a line item that contains both amounts designated and restricted for noncurrent purposes.
- 3.16** FinREC believes that in preparing consolidated financial statements, best practice is to apply the guidance in paragraphs 3.09–.23 at the reporting-entity (that is, parent) level in consolidated financial statements, focusing on the entity as a whole, as required by FASB ASC 958-210-45-1. Accordingly, assets that are not separately reported or segregated at the subsidiary level (based on the guidance herein) might be required to be separately reported or segregated at the parent level or vice versa. (A related discussion about the classification of net assets in consolidation is presented in paragraphs 3.101–.104.)
- 3.17** The following examples illustrate the conclusions in paragraphs 3.09–.16:
- Paragraph 3.18—A specific asset is restricted by the donor, by law, or by contract.
 - Paragraph 3.19—Cash, receivables, or other assets are restricted by donor, by law, or by contract to use in an ongoing program of the NFP (that is, current operating purposes).
 - Paragraph 3.20—Cash, receivables, or other assets are restricted by donor, by law, or by contract to certain long-term purposes.
 - Paragraph 3.21—Cash, receivables, or other assets are designated by the governing board for long-term purposes.

- Paragraph 3.22—Cash, receivables, or other assets are unrestricted in a subsidiary's financial statements but restricted for long-term purposes in the consolidated financial statements.
- 3.18** Occasionally, specific assets are restricted by donors, by law, or by contract. For example, assume land gifted by a donor is restricted in perpetuity for use as open green space. Such restricted land should be distinguished from land that is not subject to donor-imposed restrictions. Similarly, investments held subject to a split-interest trust agreement should be distinguished from unrestricted investments, as should assets held for a split-interest agreement that is required by state law to be separately invested. Cash required by law or contract to be set aside in compliance with bond sinking fund requirements should be distinguished from cash with no such stipulations. Those restricted assets should be displayed separately on the balance sheet or disclosed in the notes to financial statements in a way that distinguishes them from similar assets that are not subject to those specific asset stipulations.
- 3.19** Cash, receivables, or other assets that are restricted by donor, by law, or by contract to current operating purposes are permitted, but not required, to be reported separately from unrestricted current assets. For example, cash that is received in response to a campaign to support Program A, which is an ongoing program of the donee, is permitted, but not required, to be reported separately from unrestricted current assets. FinREC believes that as long as the restrictions on them are quickly met, the assets do not need to be segregated. Because the restrictions on them are quickly met during the normal course of operations, they generally are available to creditors.
- 3.20** Cash, receivables, or other assets that are restricted by donor, by law, or by contract for certain noncurrent purposes should be reported in a classified balance sheet outside the current assets section or in a nonclassified balance sheet sequenced with other assets that will be consumed in a similar term. For example, if an NFP has cash, investments, or contributions receivable resulting from a capital campaign for a permanent endowment fund or for acquisition of a long-lived asset, those assets should not be displayed with similar assets to be used for current operations. They could be reported under a separate caption, such as "cash and other assets restricted to investment in property and equipment," and displayed near the section of the statement where property and equipment is displayed. Although net assets are either temporarily restricted (purpose or time) or permanently restricted when donor-imposed restrictions limit the use of the assets, it is important to reflect in the asset section of the balance sheet that assets required to be used to satisfy donor restrictions of a long-term nature generally are unavailable to meet current operating obligations.
- 3.21** The governing boards of some NFPs designate resources to be held for long-term purposes, such as debt-service reserves, quasi endowment, or the future acquisition of property and equipment. Consistent with FASB ASC 210-10-45-4(a), if the governing board identifies specific assets to be invested or held pursuant to the designation of net assets for noncurrent purposes, those assets should be reported in a classified balance

sheet outside the current assets section, or in a nonclassified balance sheet sequenced with other assets that will be consumed in a similar term. Accordingly, cash, receivables, or other assets designated for long-term purposes generally are not aggregated on a statement of financial position with cash, receivables, or other assets that are available for current use.

3.22 Cash, receivables, or other assets that are unrestricted in a subsidiary's financial statements may need to be reported as restricted in consolidated financial statements. For example, a voluntary health and welfare entity has a broad mission of helping low income families and is the parent of an NFP that has a mission of running a day care and after-school care center for children in the county. The subsidiary NFP received a gift of a small office building subject to the donor's restriction that it be used for providing day care or after-school care or for the administrative support of those programs. In the separate financial statements of the subsidiary, those assets are not separately reported as restricted assets because the use of the assets is no narrower than the nature of the NFP and the purposes specified in its articles of incorporation and bylaws. However, when the subsidiary NFP is consolidated with its voluntary health and welfare entity parent, the office building would be reported separately with related disclosures because the donor-imposed restriction to use the building for day care, after-school care, or the administrative support of those two programs is narrower than the broad mission of helping low income families of the reporting entity. (Related information about the classification of net assets in consolidation is presented in paragraphs 3.102–.104.)

3.23 For each item on the balance sheet that is segregated because of donor-imposed restrictions, limitations, or board designations, either the face of the financial statements or the notes should disclose the following:

- The nature of the assets comprising the line item (for example, cash, receivables, investments, and so on) (FASB ASC 958-210-45-6)
- The purpose for which the asset is segregated (for example, specific asset is held in perpetuity; held for construction of long-term assets; held for investment in endowment; and so on) (FASB ASC 958-210-45-8)
- The act causing the asset to be segregated (for example, [a] a specific asset is donor restricted, [b] the NFP is maintaining an appropriate composition of assets to fulfill donor restrictions, or [c] the NFP is maintaining an appropriate composition of assets to meet board designations) (FASB ASC 958-210-45-8)

Classification of Net Assets

3.24 Classification of net assets is discussed in paragraphs 9–11 of FASB ASC 958-210-45. The amounts for each of the three net asset classes are based on the existence or absence of donor-imposed restrictions.

- 3.25** The FASB ASC glossary defines *permanently restricted net assets* as the part of net assets of an NFP resulting from the following: (a) contributions and other inflows of assets whose use by the NFP is limited by donor-imposed stipulations that neither expire by passage of time nor can be fulfilled or otherwise removed by the actions of the NFP, (b) other asset enhancements and diminishments subject to the same kinds of stipulations, and (c) reclassifications from or to other classes of net assets as a consequence of donor-imposed stipulations.
- 3.26** The FASB ASC glossary defines *temporarily restricted net assets* as the part of the net assets of an NFP that result from the following: (a) contributions and other inflows of assets whose use by the NFP is limited by donor-imposed stipulations that either expire by passage of time or can be fulfilled and removed by actions of the NFP pursuant to those stipulations, (b) other asset enhancements and diminishments subject to the same kinds of stipulations, and (c) reclassifications from or to other classes of net assets as a consequence of donor-imposed stipulations, their expiration by passage of time, or their fulfillment and removal by actions of the NFP pursuant to those stipulations. Paragraphs 9–10 of FASB ASC 958-210-45 describe various purposes for which net assets might be restricted, such as use in future periods or use for specified purposes.
- 3.27** The FASB ASC glossary defines *unrestricted net assets* as the part of net assets of an NFP that is neither permanently restricted nor temporarily restricted by donor-imposed stipulations. FASB ASC 958-210-45-11 permits information about self-imposed limits, including voluntary resolutions by the governing board to designate a portion of unrestricted net assets (such as board-designated endowments) to be provided in the notes to or on the face of financial statements, provided that the requirement of FASB ASC 958-210-45-1 to display total unrestricted net assets is also met. FASB ASC 958-210-45-7 requires that, if not disclosed in the notes to financial statements, contractual limitations on the use of particular assets (such as cash held on deposit as a compensating balance) should be displayed on the face of the statement of financial position. Paragraphs 1A–1B of FASB ASC 958-205-50 require certain disclosures about board-designated endowment funds.

Statement of Activities

- 3.28** FASB ASC 958-225 describes the unique standards relating to a statement of activities of an NFP. In addition to that industry-specific guidance, an NFP should follow all effective provisions of FASB ASC unless the specific provision explicitly exempts NFPs or its subject matter precludes such applicability. For example, NFPs should apply the guidance contained in FASB ASC 225, *Income Statement*, that does not conflict with the industry guidance.
- 3.29** Paragraphs 1–2 of FASB ASC 958-225-45 require that a statement of activities focus on the NFP as a whole and report the following amounts for the period: the change in net assets, using a descriptive term such as *change in net assets* or *change in equity*; the

change in permanently restricted net assets; the change in temporarily restricted net assets; and the change in unrestricted net assets.

- 3.30** Paragraphs 4–8 of FASB ASC 958-225-45 discuss the classification by net asset class of revenues, expenses, and gains and losses. The determination of the net asset class in which revenues and gains and losses are reported is based on the existence or absence of donor-imposed restrictions and the type of restriction. A statement of activities should report revenues as increases in unrestricted net assets unless the use of the assets received is limited by donor imposed restrictions. All expenses should be reported as decreases in unrestricted net assets. Gains should be reported as increases and losses as decreases in unrestricted net assets unless their use is temporarily or permanently restricted by explicit donor stipulations or by law.
- 3.31** Pursuant to FASB ASC 958-225-45-3, *reclassifications*, which are defined in the FASB ASC glossary as the simultaneous increase of one net asset class and decrease of another, should be reported as separate items. FASB ASC 958-225-45-13 describes the events that require reclassifications of net assets, including donor-imposed restrictions that are fulfilled by the NFP or that expire with the passage of time or the death of a split-interest agreement’s beneficiary.
- 3.32** FASB ASC 958-225-55 illustrates the requirement for the display of an appropriately labeled subtotal within a statement of activities for the change in a class of net assets before the effects of an extraordinary item or discontinued operations. NFPs should apply the appropriate disclosure and display requirements of, among other things, FASB ASC 250, *Accounting Changes and Error Corrections*; FASB 205-20-45 for discontinued operations; and FASB ASC 225-20-45-16 for unusual or infrequently occurring items. Corrections of prior-period errors are not included in change in net assets. Instead, in accordance with FASB ASC 250-10-45, any error in the financial statements of a prior period discovered after the financial statements are issued or are available to be issued should be reported by restating the prior-period financial statements. The cumulative effect of the error on periods prior to those presented should be made to the opening balance(s) of the appropriate class(es) of net assets of the earliest year presented.
- 3.33** The cumulative effect of a change in accounting principle also is not included in change in net assets. Instead, it is reported through retrospective application of the new accounting principle to all prior periods, unless it is impracticable to do so (or transition guidance for a newly issued standard requires otherwise). The cumulative effect of the change to the new accounting principle on periods prior to those presented should be made to the opening balance(s) of the appropriate class(es) of net assets of the earliest year presented. FASB ASC 250 provides examples of display and further information about accounting changes and corrections of errors, including discussions of impracticability and materiality. Paragraph 11.59 provides guidance if an NFP corrects net asset classifications previously reported in prior years’ financial statements.

- 3.34** As noted in FASB ASC 958-205-45-1, particular formats for the statement of activities are neither prescribed nor prohibited, in part because similar prescriptions and proscriptions do not exist for business entities. FASB ASC 958-205-55-11 suggests three ways that items could be sequenced: (a) revenues and gains first, then expenses, then losses; reclassifications, which must be shown separately, are reported with revenues and gains; (b) revenues, expenses, gains and losses, and reclassifications shown last; and (c) certain revenues, less directly related expenses, followed by a subtotal, then other revenues, other expenses, gains and losses, and reclassifications. Those items could be arranged in other ways, and other subtotals may be included.
- 3.35** Pursuant to FASB ASC 958-225-45-9, classifying revenues, expenses, gains, and losses within classes of net assets does not preclude incorporating additional classifications within a statement of activities. For example, within a class or classes of net assets, an NFP may classify items as follows: operating and nonoperating, expendable and nonexpendable, earned and unearned, recurring and nonrecurring, or in other ways.
- 3.36** Paragraphs 9–12 of FASB ASC 958-225-45 discuss reporting a measure of operations. If an intermediate measure of operations, such as an excess or deficit of operating revenues over expenses, is reported in a statement of activities, (a) a note to financial statements should describe the nature of the reported measure of operations or the items excluded from operations if the NFP’s use of the term *operations* is not apparent from the details provided on the face of the statement, and (b) it must be in a financial statement that, at a minimum, reports the change in unrestricted net assets for the period. Some limitations on an NFP’s use of an intermediate measure of operations are imposed by other standards. For example, if a subtotal such as income from operations is presented, it must include
- a. an impairment loss recognized for a long-lived asset (or asset group) to be held and used pursuant to FASB ASC 360-10-45-4,
 - b. any gain or loss recognized on the sale of a long-lived asset (or disposal group) if that asset (or group) is not a component of the NFP pursuant to FASB ASC 360-10-45-5,
 - c. costs associated with an exit or disposal activity that does not involve a discontinued operation pursuant to FASB ASC 420-10-45-3, and
 - d. amortization expenses and impairment losses recognized on intangible assets including goodwill pursuant to FASB ASC 350-30-45-2 and FASB ASC 350-20-45-2.
- 3.37** FinREC believes that in the absence of guidance specific to NFPs, as a best practice, most items that a business entity would report as part of other comprehensive income would be presented by an NFP in the statement of activities outside of an intermediate measure of operations, if one is presented. (Those items are listed in FASB ASC 220-10-

45-10A.) However, unrealized gains and losses on available-for-sale and held-to-maturity securities, although reported in other comprehensive income by a business entity, would be the exception to that suggested practice. Unrealized gains and losses are typically presented as described in paragraphs 4.83–.88 because most NFPs do not classify investments into the three categories used in FASB ASC 320-10. For example, an NFP might report the following in its statement of activities:

Change in unrestricted net assets from operations:	XX,XXX
Foreign currency translation adjustments	X,XXX
Prior service costs or credits associated with pension benefits ^a	X,XXX
Gains or losses associated with pension benefits that are not recognized immediately as a component of net periodic benefit cost ^a	X,XXX
Unrealized gains or losses on endowment investments	X,XXX
Change in unrestricted net assets	<u>\$XX,XXX</u>

^a These two lines may be combined if desired.

When doing so, it is important to remember that all changes for the reporting period are reported as part of (that is, above) change in net assets. Paragraphs 3.32–.33 discuss presentation of corrections of errors and changes in accounting principles.

- 3.38** Classification of revenues, expenses, gains and losses, and reclassifications is discussed in greater detail in subsequent chapters of this guide. Paragraphs 4.85–.88 describe reporting investment return in a statement of activities that includes an intermediate measure of operations. Chapter 13, "Expenses, Gains, and Losses," discusses alternative ways of reporting costs related to sales of goods and services and the direct costs of special events.

Reporting Expenses, Including in a Statement of Functional Expenses

- 3.39** FASB ASC 958-720-05-4 states that to help donors, creditors, and others assess an NFP's service efforts, including the costs of its services and how it uses resources, a statement of activities or notes to financial statements should provide information about expenses reported by their functional classification, such as major classes of program services and supporting activities. In contrast, FASB ASC 958-205-45-6 states that a natural classification of expenses may include expense categories such as salaries, rent, electricity, interest expense, depreciation, awards and grants to others, and professional fees.
- 3.40** FASB ASC 958-205-45-6 provides guidance for presenting a statement of functional expenses, which is useful in associating expenses with service efforts and accomplishments. A statement of functional expenses reports information about expenses by their functional classes, as well as information about expenses by their natural classification in a matrix format in a separate financial statement—statement of functional expenses. To the extent that expenses are reported by other than their natural classification (such as salaries included in cost of goods sold or facility rental costs of

special events reported as direct benefits to donors), they should be reported by their natural classification if a statement of functional expenses is presented. For example, salaries, wages, and fringe benefits that are included as part of the cost of goods sold on the statement of activities should be included with other salaries, wages, and fringe benefits in the statement of functional expenses. In addition, as discussed in FASB ASC 958-205-45-6, expenses that are netted against investment revenues should be reported by their functional classification on the statement of functional expenses (if the NFP presents that statement).

- 3.41** FASB ASC 958-720-45-15 requires that voluntary health and welfare entities provide a statement of functional expenses. Pursuant to FASB ASC 958-720-45-16, other NFPs are encouraged, but not required, to provide information about expenses by their natural expense classification. FinREC has observed diversity in practice in the implementation of these standards, in part because of the diversity in applying the definition of a voluntary health and welfare entity. To achieve consistency of reporting as well as the goal of FASB in encouraging disclosure of expenses by their natural classification, FinREC recommends that all NFPs that are supported by the general public present a statement of functional expenses as a basic financial statement or in the notes to the financial statements.
- 3.42** As a guideline, FinREC suggests that an NFP be presumed to be supported by the general public if contributions are 20 percent to 30 percent or more of total revenue and support, including both cash and in-kind contributions recognized in the financial statements but excluding government support. (Conversely, an NFP that receives contributions of less than 20 percent of total revenue and support is presumed not to be supported by the general public.) If the percentage of contributions to total revenue and support guideline is met, an NFP should consider the facts and circumstances surrounding its contributions. For example, a very large contribution from a single donor might overcome the presumption that an NFP is supported by the general public. Although a statement of functional expenses potentially can be useful to donors of any NFP, FinREC considered an NFP's cost to prepare the statement and have it audited as an additional primary financial statement. To limit the recommendation to situations for which the benefit of the statement of functional expenses is most likely to exceed those costs, FinREC recommends that a statement of functional expenses be presented by NFPs that receives a significant portion of its total revenues and support in the form of contributions from individuals, federated fund-raisers, corporations, and foundations.
- 3.43** Paragraphs 13.37–.58 include information useful in determining the major programs to include in a statement of activities and in a statement of functional expenses. NFPs frequently report similar levels of major classes of program services and supporting activities in their statements of activities and statements of functional expenses.

Statement of Cash Flows

- 3.44** FASB ASC 958-230 describes the unique standards relating to a statement of cash flows of an NFP. In addition to that industry-specific guidance, an NFP should follow all effective provisions of FASB ASC unless the specific provision explicitly exempts NFPs or its subject matter precludes such applicability. For example, NFPs should apply the guidance contained in FASB ASC 230, *Statement of Cash Flows*, that does not conflict with the industry guidance.
- 3.45** FASB ASC 230-10-10-1 explains that the primary purpose of a statement of cash flows is to provide relevant information about the cash receipts and cash payments of an entity during a period. FASB ASC 230-10-45-10 requires that the statement of cash flows classify cash receipts and cash payments as resulting from investing, financing, or operating activities. Exhibit 3-1, “Classification of Cash Flows,” provides examples of cash flows unique to or common to NFPs and their appropriate classification. FASB ASC 958-230-55-5 requires separate disclosure of noncash investing and financing activities (for example, receiving contributions of buildings, securities, or recognized collection items).

Exhibit 3-1

Classification of Cash and Cash Flows

Cash and Cash Equivalents
<ul style="list-style-type: none"> • Cash held temporarily in the long-term investment portfolio (until suitable investments are identified) is excluded from cash and cash equivalents in accordance with Financial Accounting Standards Board Accounting Standards Codification 958-205-55-7 and should be disclosed in the note that defines cash and cash equivalents.
Operating Cash Flows
<ul style="list-style-type: none"> • Unrestricted cash contributions. • Cash receipts resulting from the sale of donated securities that upon receipt are directed for sale and for which the not-for-profit entity (NFP) has the ability to avoid significant investment risks and rewards through near immediate conversion into cash, unless the donor restricted the use of the contributed resource to a long-term purpose. • Agency transactions are generally included as operating activities.
Investing Cash Flows
<ul style="list-style-type: none"> • Gross purchases of investments should be adjusted for amounts payable for investment purchases at period ends to arrive at cash outflows for purchases. • Gross sales of investments should be adjusted for amounts receivable from investment sales at period ends to arrive at cash inflows from sales.
Financing Cash Flows
<ul style="list-style-type: none"> • Securities lending would generally be classified as a financing activity. • Contributions restricted for fixed assets, endowments, and other long-term purposes should be reported as a financing activity; the amount would be the actual cash received, not the change in the contributions receivable.

<ul style="list-style-type: none"> • Changes in cash overdrafts generally are considered financing activities and not as operating activities.
Noncash Transactions
<ul style="list-style-type: none"> • If construction in process and other fixed asset purchases are included in accounts payable at the fiscal year end, they should be disclosed as a noncash transaction and excluded from the change in accounts payable. • Contributions of securities should be disclosed as a noncash transaction and as an adjustment reducing the changes in net assets to arrive at operating cash flows. • Contributions of beneficial interests should be disclosed as a noncash transaction and as an adjustment reducing the changes in net assets to arrive at operating cash flows. • The net change in value for an interest rate swap should be a noncash adjustment to arrive at operating activities. The amount will not equal the amount in the statement of activities if the statement of activities amount includes amounts paid in cash. • Debt refinancing and refundings are disclosed as a noncash activity if no cash is transferred to the NFP's control and it only enters into new terms (for example, change in interest rate, payment terms, and so forth). Any incremental borrowings are financing inflows.

- 3.46** The FASB ASC glossary defines *operating activities* as including all transactions and other events that are not defined as investing or financing activities. Operating activities generally involve producing and delivering goods and providing services. Per FASB ASC 958-230-55-4, operating activities also include cash received and paid in agency transactions.
- 3.47** Some NFPs receive resources in agency transactions, as discussed in chapter 5, "Contributions Received and Agency Transactions." For some of those NFPs, receiving resources as agents may be a primary component of their mission. Because cash flows from operating activities include cash flows from agency transactions, an NFP that acts as an agent as a primary component of its mission might consider presenting the statement of cash flows as the first financial statement in its set of financial statements to emphasize the importance of the information presented in that statement.
- 3.48** FASB ASC 230-10-45-25 encourages entities to report major classes of gross cash receipts and gross cash payments and their arithmetic sum—the net cash flow from operating activities (the direct method). Paragraphs 28–31 of FASB ASC 230-10-45 describe how to determine and report the amount of net cash flow from operating activities indirectly by adjusting the change in (total) net assets to reconcile it to net cash flow from operating activities (the indirect or reconciliation method). That reconciliation of the change in (total) net assets to the net cash flow from operating activities should be provided in a separate schedule if the direct method of reporting net cash flow from operating activities is used.

- 3.49** As discussed in FASB ASC 958-210-45-6, cash received with a donor-imposed restriction that limits its use to long-term purposes should not be classified on a statement of financial position with cash that is unrestricted and available for current use.^{fn 4} FASB ASC 958-230-55-3 explains that when an NFP reports cash received with a donor-imposed restriction that limits its use to long-term purposes in conformity with FASB ASC 958-210-45-6, an adjustment is necessary for the statement of cash flows to reconcile beginning and ending cash and cash equivalents. To report in conformity with FASB ASC 230, the receipt of a cash contribution that is restricted for the purchase of equipment should be reported as a cash flow from financing activities (using a caption such as contributions restricted for purchasing equipment), and it should be simultaneously reported as a cash outflow from investing activities (using a caption such as purchase of assets restricted to investment in property and equipment or, if the equipment was purchased in the same period, purchase of equipment). An adjustment to reconcile the change in net assets to net cash used or provided by operating activities would also be needed if the contributed asset is not classified as cash or cash equivalents on the statement of financial position. When the equipment is purchased in a subsequent period, both the proceeds from the sale of assets restricted to investment in the equipment and the purchase of the equipment should be reported as cash flows from investing activities.
- 3.50** FASB ASC 958-230-55-2 notes that not all assets of NFPs that meet the definition of *cash equivalents* in the FASB ASC glossary are cash equivalents for purposes of preparing statements of financial position and cash flows. Restrictions can prevent them from being included as cash equivalents even if they otherwise qualify. For example, short-term highly liquid investments are not cash equivalents if they are purchased with resources that have donor-imposed restrictions that limit their use to long-term investment. Further, FASB ASC 230-10-45-6 states that an entity should establish a policy concerning which short-term, highly liquid investments that satisfy the definition of cash equivalents are treated as cash equivalents. FASB ASC 230-10-50-1 requires entities to disclose their policy for determining which items are treated as cash equivalents.
- 3.51** For example, an NFP may hold a portion of its endowment portfolio in cash or other instruments with maturities of less than three months and exclude the cash and other instruments from cash and cash equivalents.
- 3.52** Similarly, cash and investments of endowment funds held temporarily until suitable long-term investments are identified may be excluded from cash equivalents.

^{fn 4} Paragraphs 3.09–.23 and 3.50 discuss the classification on a statement of financial position of cash received with donor-imposed restrictions limiting its use to long term purposes.

- 3.53** As discussed in chapter 4, “Cash, Cash Equivalents, and Investments,” NFPs sometimes apply a spending rate to their investment return. The existence of a spending rate does not affect the classification of cash inflows and outflows on statement of cash flows. Sales of investments are investing activities even in circumstances in which the NFP uses the sales proceeds to fund current operations. For example, assume NFP has an endowment of \$10 million and a spending rate of 5 percent (\$500,000). Further, assume interest and dividends are \$200,000 and sales of endowment investments in the current year are \$800,000. In that circumstance, presumably \$300,000 of sales of endowment investments would be used for spending. The NFP should report the full \$800,000 of sales of endowment investments as cash inflows from investing activities.

Comparative Financial Information

- 3.54** FASB ASC 958-205-45-8 provides guidance if NFPs present comparative information for a prior year or years only in total rather than by net asset class.^{fn 5} Such summarized information may not include sufficient detail to constitute a presentation in conformity with GAAP. If the prior year's financial information is summarized and does not include the minimum information required by FASB ASC 958, *Not-for-Profit Entities* (for example, if the statement of activities does not present revenues, expenses, gains, and losses by net asset class), the nature of the prior year information should be described by the use of appropriate titles on the face of the financial statements and in a note to the financial statements. The use of appropriate titles includes a phrase such as with summarized financial information for the year ended June 30, 20PY, following the title of the statement or column headings that indicate the summarized nature of the information. Labeling the prior year summarized financial information for comparative purposes only without further disclosure in the notes to financial statements would not constitute the use of an appropriate title.

- 3.55** An example of a note to the financial statements^{fn 6} that describes the nature of the prior period(s) information would be as follows:

The financial statements include certain prior year summarized comparative information in total but not by net asset class. Such information does not include sufficient detail to constitute a presentation in conformity with GAAP. Accordingly, such information should be read in conjunction with the Organization's financial statements for the year ended June 30, 20PY, from which the summarized information was derived.

- 3.56** When only summarized financial information for the prior year is presented, FinREC encourages management to, at a minimum, provide disclosure in the notes for the effects of significant events upon the summarized financial information presented. There is a

^{fn 5} Chapter 14, "Reports of Independent Auditors," discusses auditors' reports on comparative financial information.

^{fn 6} Because the note discusses information that does not pertain to the current-period financial statements, the note is not considered to be part of the current-period financial statements.

presumption that users of prior year summarized financial information will read the prior year financial statements, including the financial disclosures required by GAAP and that the summarized data will be viewed in that context. Best practice entails providing the disclosures required by GAAP if the summarized financial information contains items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP.

Reporting of Related Entities, Including Consolidation

3.57 FASB ASC 810-10-10-1 states that the purpose of consolidated financial statements is to present, primarily for the benefit of the shareholders and creditors of the parent entity, the results of operations and the financial position of a parent entity and its subsidiaries essentially as if the group were a single entity with one or more branches or divisions. There is a presumption that consolidated financial statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the entities in the group directly or indirectly has a controlling financial interest in the other entities.

3.58 The guidance for reporting of related entities in this chapter is organized as follows:

- Relationships with another NFP
- Relationships with a for-profit entity
- Consolidation of a special-purpose leasing entity

Pursuant to FASB ASC 810-10-15-17, NFPs do not apply the guidance for variable interest entities in FASB ASC 810, *Consolidation*, to their relationships with other entities.

3.59 The appropriate guidance depends upon an initial assessment of whether the related entity is a for-profit entity or an NFP. Using the definition of an NFP from the FASB ASC glossary (see paragraph 1.01 of this guide), an NFP should determine whether the related entity is also an NFP. FinREC believes that often in cases in which an NFP has an interest in an entity with a nonprofit corporation or a nonprofit membership corporation structure, that entity will meet that definition. FinREC believes that often in cases in which an NFP has an interest in an entity with a noncorporate structure (such as a partnership, limited liability partnership, or similar entity), that entity is not an NFP, either because of the existence of ownership interests or because it provides lower costs or other economic benefits directly and proportionally to the owners, members, or participants, or both. After making that determination, the flowcharts in appendix A of this chapter, “Flowcharts,” and exhibit 3-2, “Relationships of a Not-for-Profit Reporting Entity,” can assist in applying the accounting standards.

- 3.60** Chapter 4 provides guidance about reporting ownership of for-profit entities in circumstances in which those entities are not required to be consolidated and the objective is to invest in the entity for investment return (including an objective to realize current income, capital appreciation, or both). If the interest is in an entity that provides goods or services that accomplish the purpose or mission for which the NFP exists or that serves the NFP's administrative purposes, the NFP would follow the guidance in this chapter.
- 3.61** Exhibit 3-2 describes some common relationships with other entities and identifies where these relationships are discussed in this chapter and in FASB ASC. Exhibit 3-2 and this chapter summarize certain guidance in FASB ASC but are not intended as a substitute for reading the guidance itself.

Exhibit 3-2

Relationships of a Not-for-Profit Reporting Entity^a

Relationship	Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Reference	Discussion in This Chapter
<i>Relationships With Not-for-Profit Entities (NFPs)</i>		
The reporting entity is the sole corporate member of an NFP.	Use the guidance in FASB ASC 958-810-25-2 and 954-810-45-3A.	Paragraph 3.64
The reporting entity has a controlling financial interest through direct or indirect ownership of a majority voting interest in the other NFP.	Use the guidance in FASB ASC 958-810-25-2.	Paragraphs 3.64–.65
The reporting entity controls another NFP through a majority voting interest in its board and has an economic interest in that other entity.	Use the guidance in FASB ASC 958-810-25-3.	Paragraphs 3.66–.68
The reporting entity controls an NFP through a form other than majority ownership, sole corporate membership, or majority voting interest in the board of the other entity and has an economic interest in that other entity.	Use the guidance in FASB ASC 958-810-25-4.	Paragraph 3.69
The reporting entity has control over another NFP or an economic interest in the other, but not both.	Use the guidance in FASB ASC 958-810-25-5.	Paragraph 3.70

Relationship	Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Reference	Discussion in This Chapter
The reporting entity receives distributions from a related fund-raising foundation, but it does not control that foundation.	Use the guidance in the “Transfers of Assets to a Not-for-Profit Entity or Charitable Trust that Raises or Holds Contributions for Others” subsections of FASB ASC 958-605.	Paragraphs 5.27–.31
<i>Relationships With For-Profit Entities</i>		
The reporting entity owns a majority of a for-profit entity’s common voting stock.	Use the guidance in the “General” subsections of FASB ASC 810-10 to determine whether that interest constitutes a controlling financial interest.	Paragraphs 3.72–.73
The reporting entity owns 50 percent or less of the common voting stock of an investee and can exercise significant influence over the investee’s operating and financial policies.	Except where the reporting entity elects to report such interests at fair value in accordance with the “Fair Value Option” sections of FASB 825-10, use the equity method of accounting in accordance with FASB ASC 323-10.	Paragraphs 3.75–.78
The reporting entity owns 50 percent or less of the common voting stock of an investee and the reporting entity neither controls nor can exercise significant influence over the investee’s operating and financial policies.	FASB ASC 958-320-35-1 or FASB ASC 958-325-35.	Paragraph 3.79
The reporting entity is the general partner of a for-profit limited partnership or similar entity, such as a limited liability company that has governing provisions that are the functional equivalent of a limited partnership.	Use the guidance in FASB ASC 810-20 to determine whether the general partner within the group controls and, therefore, should consolidate the limited partnership or similar entity. If not required to consolidate, use the equity method, unless that partnership interest is reported at fair value in conformity with the “Fair Value Option” sections of FASB 825-10.	Paragraphs 3.80–.82 and paragraphs 3.86–.88
The reporting entity is a limited partner of a for-profit limited partnership or similar entity that is engaged in activities other than real estate activities.	The Financial Reporting Executive Committee (FinREC) observes that entities typically use by analogy the guidance in FASB ASC 970-323.	Paragraphs 3.83–.88

Relationship	Financial Accounting Standards Board (FASB) <i>Accounting Standards Codification</i> (ASC) Reference	Discussion in This Chapter
The reporting entity has an interest in a limited liability company.	Use the guidance in FASB ASC 323-30-35-3 if the functional equivalent of a limited partnership or FASB ASC 810-10-25-3 if the functional equivalent of a regular corporation. Unless required to consolidate, the reporting entity may elect to report its interest at fair value in accordance with the “Fair Value Option” sections of FASB 825-10.	Paragraphs 3.89–.90
The reporting entity has a noncontrolling interest that constitutes more than a minor interest in a for-profit partnership, limited liability entity, or similar entity engaged in real estate activities.	Except where the reporting entity elects to report such interests at fair value in accordance with the “Fair Value Option” sections of FASB 825-10, use the equity method in accordance with the guidance in FASB ASC 970-323.	Paragraphs 3.91–.94
The reporting entity holds more than 50 percent of the total partnership interest in a limited partnership engaged in real estate activities.	FinREC observes that entities might apply by analogy the guidance in FASB ASC 970-323 and FASB ASC 970-810.	Paragraph 3.95
The reporting entity has a noncontrolling interest that constitutes a minor interest in a for-profit partnership, limited liability entity, or similar entity engaged in real estate activities.	Entities typically apply the guidance in FASB ASC 958-325.	Paragraph 3.96
The reporting entity has an interest in a general partnership.	Except when the reporting entity elects to report such interests at fair value, in accordance with the “Fair Value Option” sections of FASB 825-10, FinREC observes that entities typically use by analogy the guidance in FASB ASC 970-810.	Paragraphs 3.97–.98

Relationship	Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Reference	Discussion in This Chapter
The reporting entity has a contractual management relationship with another entity and that contractual management relationship has a term that is either the entire remaining legal life of the other entity or a period of 10 years or more.	Use the guidance in the “Consolidation of Entities Controlled by Contract” subsections of FASB ASC 810-10 to determine whether the arrangement constitutes a controlling financial interest.	Paragraph 3.74
<i>Relationships With Special Entities</i>		
The reporting entity has a relationship with a variable interest entity (VIE) as described in the “Variable Interest Entities” subsections of FASB ASC 810-10.	Pursuant to FASB ASC 810-10-15-17, NFPs are not subject to the “Variable Interest Entities” subsections of FASB ASC 810-10 unless the NFP is used by a business entity in a manner similar to a VIE in an effort to circumvent the provisions of those standards.	
The reporting entity is engaged in a leasing transaction with a special purpose entity lessor.	Use the guidance in paragraphs 8–10 of FASB ASC 958-810-25 and paragraphs 7–16 of FASB ASC 958-810-55 to determine whether to consolidate the lessor.	Paragraphs 3.99–.100
The reporting entity has entered into a joint operating agreement with another entity. They agree to jointly conduct an activity while sharing the operating results and a residual interest upon dissolution.	If housed in a separate legal entity, use the method of accounting for that entity type; otherwise, use the guidance in FASB ASC 808, <i>Collaborative Arrangements</i> .	Paragraphs 3.135–.136
The reporting entity is a sponsor in a research and development arrangement.	Use the guidance in FASB ASC 810-30.	Paragraph 3.74
The reporting entity has another type of relationship with a special purpose entity.	FinREC observes that entities typically analogize to the guidance in paragraphs 8–10 of FASB ASC 958-810-25 and paragraphs 7–16 of FASB ASC 958-810-55.	
<i>^a As discussed in paragraph 3.60, the guidance in this table applies to relationships with entities that provide goods or services that accomplish the purpose or mission for which the NFP exists or that serve the NFP’s administrative purposes.</i>		

Relationships With Another NFP

3.62 FASB ASC 958-810-05-3 explains that ownership of NFPs may be evidenced in various ways because NFPs may exist in various legal forms, such as corporations issuing stock,

corporations issuing ownership certificates, membership corporations issuing membership certificates, joint ventures, and partnerships, among other forms. FASB ASC 958-810-25-1 states that a relationship with another NFP can take any one of the following forms, which determines the appropriate reporting:

- a. A controlling financial interest through direct or indirect ownership of a majority voting interest or sole corporate membership in the other NFP (see FASB ASC 958-810-25-2)
- b. Control of a related but separate NFP through a majority voting interest in the board of that NFP by means other than ownership or sole corporate membership and an economic interest in that other NFP (see FASB ASC 958-810-25-3)
- c. An economic interest in the other NFP combined with control through means other than those listed in (a)–(c) (see FASB ASC 958-810-25-4)
- d. Either an economic interest in the other NFP or control of the other NFP, but not both (see FASB ASC 958-810-25-5)

3.63 For purposes of applying the guidance for relationships with other NFPs, the FASB ASC glossary defines *control* as the direct or indirect ability to determine the direction of management and policies through ownership, contract, or otherwise. The FASB ASC glossary defines *economic interest* as an NFP's interest in another entity that exists if any of the following criteria are met: (a) the other entity holds or utilizes significant resources that must be used for the unrestricted or restricted purposes of the NFP, either directly or indirectly by producing income or providing services, or (b) the NFP is responsible for the liabilities of the other entity. FASB ASC 958-810-55-6 provides the following examples of economic interests:

- a. Other entities solicit funds in the name of and with the expressed or implied approval of the NFP, and substantially all of the funds solicited are intended by the contributor or are otherwise required to be transferred to the NFP or used at its discretion or direction.
- b. An NFP transfers significant resources to another entity whose resources are held for the benefit of the NFP.
- c. An NFP assigns certain significant functions to another entity.
- d. An NFP provides or is committed to provide funds for another entity or guarantees significant debt of another entity.
- e. An NFP has a right to or a responsibility for the operating results of another entity. Or upon dissolution, the reporting entity is entitled to the net assets or is responsible for any deficit of another entity.

Controlling Financial Interests

- 3.64** FASB ASC 958-810-25-2 states that an NFP with a controlling financial interest in another NFP through direct or indirect ownership of a majority voting interest or sole corporate membership in that other NFP should consolidate that other NFP, unless control does not rest with the majority owner or sole corporate member (for instance, if the other NFP is in legal reorganization or in bankruptcy or if other legal or contractual limitations are so severe that control does not rest with the sole corporate member), in which case consolidation is prohibited, as discussed in FASB ASC 810-10-15-8. See FASB ASC 958-810-25-2A for an example in which control may not rest with the holder of the majority voting interest. (This example is included in the next paragraph.) Sole corporate membership in an NFP, like ownership of a majority voting interest in a for-profit entity, should be considered a controlling financial interest, unless control does not rest with the sole corporate member (for instance, if the other [membership] entity is in bankruptcy or if other legal or contractual limitations are so severe that control does not rest with the sole corporate member).
- 3.65** FASB ASC 958-810-25-2A provides the following example of a situation in which control might not rest with the holder of the majority voting interest. In some situations, certain actions require approval by a supermajority vote of the board. Such voting requirements might overcome the presumption of control by the owner or holder of a majority voting interest. FASB ASC 958-810-55-4A provides the following implementation guidance for that paragraph. An NFP shall exercise judgment in evaluating such situations. If supermajority voting requirements exist—for example, a specified supermajority of the board is needed to approve fundamental actions such as amending the articles of incorporation or dissolving the entity—an NFP should consider whether those voting requirements have little or no effect on the ability to control the other entity’s operations or assets or, alternatively, whether those voting requirements are so restrictive that they call into question whether control rests with the holder of the majority voting interest. Paragraphs 2–14 of FASB ASC 810-10-25 may be helpful in considering whether the inability of the majority voting interest to unilaterally approve certain actions due to supermajority voting requirements is substantial enough to overcome the presumption of control.

Control Combined With an Economic Interest

- 3.66** FASB ASC 958-810-25-3 states that in the case of control of a related but separate NFP through a majority voting interest in the board of the other NFP by means other than ownership or sole corporate membership and an economic interest in other such organizations, consolidation is required, unless control does not rest with the holder of the majority voting interest, in which case consolidation is prohibited. An NFP has a majority voting interest in the board of another NFP if it has the direct or indirect ability to appoint individuals that together constitute a majority of the votes of the fully constituted board (that is, including any vacant board positions).

- 3.67** FASB ASC 958-810-55-5 provides the following example of a majority voting interest in the board of another entity:

Entity B has a five-member board, and a simple voting majority is required to approve board actions. Entity A will have a majority voting interest in the board of Entity B if Entity A has the ability to appoint three or more of Entity B's board members. If three of Entity A's board members, employees, or officers serve on the board of Entity B but Entity A does not have the ability to require that those members serve on the Entity B board, Entity A does not have a majority voting interest in the board of Entity B.

- 3.68** Technical Questions and Answers (TIS) section 6140.10, "Consolidation of Political Action Committee" (AICPA, *Technical Practice Aids*), provides the following example:

An NFP may be related to another NFP that performs political activities that the reporting entity does not wish to perform, perhaps because performing those activities may threaten the reporting entity's tax exempt status, the reporting entity is precluded from conducting such activities, or for other reasons. For example, a membership entity may establish and sponsor a political action committee (PAC) whose mission is to further the interests of the membership entity. The resources held by the PAC are used for the purposes of the membership entity and the governing board of the PAC is appointed by the board of the membership entity. In the circumstances described, both control and economic interest are present and the PAC should be consolidated. Control through a majority voting interest in the board of the PAC exists because the governing board of the PAC is appointed by the board of the membership entity. An economic interest exists because the PAC holds significant resources that must be used for the purposes of the membership entity.

- 3.69** FASB ASC 958-810-25-4 states that control of a related but separate NFP in which the reporting entity has an economic interest may take forms other than majority ownership interest, sole corporate membership, or majority voting interest in the board of the other NFP; for example, control may be through contract or affiliation agreement. In circumstances such as these, consolidation is permitted but not required, and the reporting entity should disclose the following information required by FASB ASC 958-810-50-2 if it does not present consolidated financial statements:

- a. Identification of the other NFP and the nature of its relationship with the reporting entity that results in control
- b. Summarized financial data of the other NFP, which shall include the following information:
 - i. Total assets, liabilities, net assets, revenue, and expenses

- ii. Resources that are held for the benefit of the reporting entity or that are under its control

- c. The disclosures required by paragraphs 1–6 of FASB ASC 850-10-50

Control or Economic Interest, But Not Both

- 3.70** FASB ASC 958-810-25-5 states that the existence of control or an economic interest, but not both, precludes consolidation. Pursuant to FASB ASC 958-810-50-3, the reporting entity should disclose the information about related parties required by paragraphs 1–6 of FASB ASC 850-10-50 for these relationships.

Relationships With a For-Profit Entity

- 3.71** FASB ASC 958-810-15-4 lists the locations of guidance for reporting relationships between NFPs and for-profit entities. Paragraphs 3.72–.100 provide a brief summary of that guidance but are not intended as a substitute for reading the referenced subtopics.

Controlling Financial Interests

- 3.72** FASB ASC 958-810-15-4(a) states that an NFP with a controlling financial interest in a for-profit entity through direct or indirect ownership of a majority voting interest in that entity should apply the guidance in the “General” subsections of FASB ASC 810-10. Per FASB ASC 810-10-15-8, the usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one reporting entity, directly or indirectly, of more than 50 percent of the outstanding voting shares of another entity is a condition pointing toward consolidation. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders, or by court decree. However, when applying the guidance in FASB ASC 810-10, NFPs are not subject to the guidance for variable interest entities.
- 3.73** FASB ASC 810-10-15-10(a)(1) provides an exception if control does not rest with the majority owner. For instance, a majority-owned subsidiary should not be consolidated if any of the following are present: (a) the subsidiary is in legal reorganization; (b) the subsidiary is in bankruptcy; (c) the subsidiary operates under foreign exchange restrictions, controls, or other governmentally-imposed uncertainties that are so severe that they cast significant doubt on the parent’s ability to control the subsidiary; and (d) the rights of noncontrolling shareholder(s) are so restrictive that it is questioned whether control rests with the majority owner. The guidance in paragraphs 2–14 of FASB ASC 810-10-25 should be applied in assessing the impact of consolidation on noncontrolling shareholder approval or veto rights.
- 3.74** Additional guidance for determining whether a controlling financial interest exists is located as follows:

- a. Per FASB ASC 810-30-15, if the reporting entity has a research and development arrangement in which all of the funds for the research and development activities are provided by the sponsor, the reporting entity should follow the guidance in FASB ASC 810-30 to determine whether and how the sponsor should consolidate that arrangement. Per FASB ASC 810-10-15-17, NFPs do not apply tests to determine whether the research and development entity is determined to be a VIE.
- b. Per FASB ASC 810-10-15-3(c), if the reporting entity has a contractual management relationship with another entity, the reporting entity should use the guidance in the “Consolidation of Entities Controlled by Contract” subsections of FASB ASC 810-10 to determine whether the arrangement constitutes a controlling financial interest. Per FASB ASC 810-10-15-17, NFPs do not apply tests to determine whether the other entity is a VIE.

Noncontrolling Interests in Voting Stock

- 3.75** FASB ASC 958-810-15-4(c) states that an NFP that owns 50 percent or less of the voting stock in a for-profit business entity should apply the guidance in FASB ASC 323-10 unless that investment is reported at fair value in conformity with the guidance described in FASB ASC 958-810-15-4(e).
- 3.76** FASB ASC 323-10 requires that the equity method of accounting be used if investments in common stock or in-substance common stock (or both common stock and in-substance common stock), including investments in common stock of joint ventures, give the investor the ability to exercise significant influence over operating and financial policies of an investee, even though the investor holds 50 percent or less of the common stock or in-substance common stock (or both common stock and in-substance common stock).
- 3.77** *Significant influence* is defined by paragraphs 6–11 of FASB ASC 323-10-15. Determining the ability of an investor to exercise significant influence is not always clear and applying judgment is necessary to assess the status of each investment. An investment of less than 20 percent of the voting stock of an investee should lead to a presumption that an investor does not have the ability to exercise significant influence unless such ability can be demonstrated. Conversely, an investment (direct or indirect) of 20 percent or more of the voting stock of an investee should lead to a presumption that, in the absence of predominant evidence to the contrary, an investor has the ability to exercise significant influence over an investee. However, this presumption can be overcome in certain instances. FASB ASC 323-10-15-6 provides indications of significant influence that could exist even if the investor owns less than 20 percent of the voting stock. Paragraphs 10–11 of FASB ASC 323-10-15 provide examples of indications that an investor may be unable to exercise significant influence. Additionally, according to FASB ASC 323-10-25-2, the limitations under which a majority-owned subsidiary should not be consolidated, as discussed in paragraph 3.73, should also be applied as limitations to the use of the equity method.

- 3.78** An NFP that would otherwise be required to use the equity method may be permitted to report at fair value by making an election pursuant to FASB ASC 825-10-25-1 (the fair value option).
- 3.79** If the NFP's ownership of voting stock in a for-profit business entity is not sufficient to result in a controlling financial interest or significant influence, the NFP may be required to report its interest in the for-profit business entity at fair value in conformity with FASB ASC 958-320-35-1. That guidance applies to equity securities with a readily determinable fair value, other than consolidated subsidiaries and investments reported under the equity method. If the voting stock does not have a readily determinable fair value and the ownership is not sufficient to result in a controlling financial interest or significant influence, the investment is within the scope of FASB ASC 958-325. For more information, see paragraph 4.37. Alternatively, the NFP can report the individual investment at fair value if it makes an election pursuant to FASB ASC 825-10-25-1 (the fair value option).

Limited Partnerships and Similar Entities

- 3.80** FASB ASC 958-810-15-4(b) states that an NFP that is a general partner of a for-profit limited partnership or a similar entity (such as a limited liability company that has governing provisions that are the functional equivalent of a limited partnership) should apply the guidance in FASB ASC 810-20 unless that partnership interest is an investment within the scope of FASB ASC 958-325 and the NFP has elected to report all other investments at fair value. (See paragraph 3.60 for a discussion of which relationships with for-profit entities are discussed in chapter 4 of this guide.).
- 3.81** FASB ASC 810-20 discusses the potential consolidation of limited partnerships and similar entities. FASB ASC 810-20-25-3 states that the general partners in a limited partnership are presumed to control a limited partnership regardless of the extent of the general partners' ownership interest in the limited partnership. Paragraphs 4–20 of FASB ASC 810-20-25 provide guidance for purposes of assessing whether the limited partners' rights might preclude a general partner from controlling a limited partnership. For example, the general partner might not control a limited partnership in either of the two following circumstances:
- The limited partners have the substantive ability to dissolve the partnership or otherwise remove the general partner without cause (referred to as substantive kick-out rights, which are further defined in paragraphs 8–10 of FASB ASC 810-20-25).
 - The limited partners have the ability to effectively participate in significant decisions that would be expected to be made in the ordinary course of the limited partnership's business (referred to as participating rights).

Paragraphs 10–11 of FASB ASC 810-20-25 state that if the presumption of control by the general partner(s) is overcome, each of the general partners would account for its investment in the limited partnership using the equity method of accounting.

- 3.82** Alternatively, if the presumption of control by the general partner(s) is overcome, an NFP that is a general partner of a for-profit limited partnership or similar entity may report the partnership interest at fair value (instead of the equity method) if it makes an election pursuant to FASB ASC 825-10-25-1 (the fair value option).
- 3.83** If instead an NFP is a limited partner in a for-profit limited partnership, the accounting depends upon the type of activities conducted by the limited partnership. If the limited partnership is engaged in real estate activities, refer to the standards discussed in paragraphs 3.91–.96. If the limited partnership is engaged in activities other than real estate, practice is diverse. Some NFPs apply the guidance in FASB ASC 970-323 even though they are not required to do so. That guidance is summarized in paragraphs 3.84–.88.
- 3.84** If an NFP is a limited partner that holds more than 50 percent of the total partnership interest, it might analogize to the guidance in FASB ASC 970-323-25-8, and it would be guided in accounting for its investment by the principles for investments in subsidiaries in FASB ASC 810. If the general partner(s) is not in control, a limited partner that is in control of the major operating and financial policies of the partnership should consolidate the limited partnership unless one of the conditions in FASB ASC 810-10-15(a)(i) is present. When applying the guidance in FASB ASC 810, NFPs apply the guidance without considering whether the entity is possibly a VIE.
- 3.85** If an NFP is a limited partner with a noncontrolling interest and the limited partnership is engaged in activities other than real estate, the NFP might analogize to the guidance in FASB ASC 970-323-25-6, which states that the equity method of accounting is generally appropriate for accounting by limited partners for their noncontrolling investments in limited partnerships. However, the NFP may elect to report that investment at fair value, in accordance with the “Fair Value Option” sections of FASB ASC 825-10. If a limited partner’s interest is so minor that the limited partner has virtually no influence over partnership operating and financial policies, accounting for the investment using the guidance in FASB ASC 958-325 may be appropriate.
- 3.86** For example, NFP A sets up a limited partnership with 2 other NFPs (NFP B and NFP C) to form a shared services entity for computing services. NFP A is the general partner and has an 80 percent interest. NFP B and NFP C each have a 10 percent interest, including a right to or responsibility for the partnership’s operating results. NFP A (the general partner) should consolidate the limited partnership unless the presumption of its control is overcome by the rights of the limited partners. If NFP A is in control, FinREC recommends that NFP B and NFP C apply the equity method of accounting by analogy to the guidance in FASB ASC 970-323-25-6. Alternatively, NFP B or NFP C may report at

fair value instead of the equity method by making an election pursuant to the “Fair Value Option” subsections of FASB ASC 825-10.

- 3.87** If NFP B and NFP C have substantive kick-out or participating rights, the presumption of NFP A’s control is overcome, and NFP A should report using the equity method. If one of the limited partners is in control of the major operating and financial policies of the partnership, FinREC recommends that that controlling limited partner consolidate the limited partnership by analogy to the guidance in FASB ASC 970-323-25-8. FinREC also recommends that the noncontrolling limited partner(s) use the equity method by analogy to the guidance in FASB ASC 970-323-25-6. Alternatively, any noncontrolling limited partner may report at fair value instead of the equity method by making an election pursuant to the “Fair Value Option” subsections of FASB ASC 825-10.
- 3.88** Note that the accounting in the preceding example would remain the same even if NFP A (the general partner) had a 5 percent interest and NFP B and NFP C each had a 47.5 percent interest. It is the combination of the facts that (a) NFP A controls the decisions that would be expected to be made in the ordinary course of the limited partnership's business and (b) neither NFP B nor NFP C has substantive kick-out rights or participating rights, that determines the accounting—not the percentage interest in the limited partnership.

Limited Liability Companies

- 3.89** Some limited liability companies have governing provisions that are the functional equivalent of a regular corporation. Pursuant to FASB ASC 810-10-25-3, the guidance in FASB ASC 810-10 is used to determine whether an interest in that type of limited liability company should be consolidated. Those standards are described briefly in paragraphs 3.72–.73.
- 3.90** Other limited liability companies maintain a specific ownership account for each investor—similar to a partnership capital account structure—and are the functional equivalent of a limited partnership. Pursuant to FASB ASC 958-810-15-4(b), an NFP that is a general partner of that type of limited liability company should apply the guidance in FASB ASC 810-20 unless that partnership interest is an investment within the scope of FASB ASC 958-325 and the NFP has elected to report all other investments at fair value. (See paragraph 3.60 for a discussion of which relationships with for-profit entities are discussed in chapter 4 of this guide.) Those standards for a general partner are described in paragraphs 3.80–.82. If the NFP has a noncontrolling investment, FASB ASC 323-30-35-3 requires that the investment be viewed as similar to an investment in a limited partnership for purposes of determining whether it should be accounted for using the cost method or the equity method. For a real estate limited partnership, those standards are described briefly in paragraphs 3.91–.96. For noncontrolling interests in limited partnerships that are engaged in activities other than real estate, those standards are described briefly in paragraph 3.85.

Real Estate Partnerships and Similar Real Estate Entities

- 3.91** FASB ASC 958-810-15-4(d) states that an NFP with a more than minor interest in a for-profit real estate partnership, a for-profit real estate limited liability company, or similar for-profit real estate entity shall report its noncontrolling interest in such an entity using the equity method in accordance with the guidance in FASB ASC 970-323 unless that interest is reported at fair value by making an election pursuant to the “Fair Value Option” subsections of FASB ASC 825-10. An NFP should apply the guidance in FASB ASC 970-323-25-2 to help determine whether its interest in a for-profit real estate partnership, for-profit real estate limited liability company, or similar for-profit real estate entity is a controlling interest or a noncontrolling interest. An NFP should apply the guidance in FASB ASC 323-30-35-3 to determine whether a limited liability company should be viewed as similar to a partnership, as opposed to a corporation, for purposes of determining whether noncontrolling interests in a for-profit real estate limited liability company or a similar entity should be accounted for in accordance with FASB ASC 970-323 or FASB ASC 323-10. However, pursuant to FASB ASC 810-10-15-17, when applying the guidance in FASB ASC 970-323, NFPs apply the guidance without considering whether the for-profit real estate entity is possibly a VIE.
- 3.92** Although not registrants, NFPs might analogize to the guidance in FASB ASC 323-30-S99-1 to determine what is more than a minor interest. FASB ASC 323-30-S99-1 states that the Securities and Exchange Commission staff understands that practice generally has viewed investments of more than 3 percent to 5 percent to be more than minor.
- 3.93** FASB ASC 970-323-25-2 states that a noncontrolling investor in a real estate general partnership should account for its investment by the equity method and should be guided by the provisions of FASB ASC 323, *Investments—Equity Method and Joint Ventures*. FASB ASC 970-810-25-3 requires that the general partners of a real estate limited partnership apply the equity method of accounting to their interests in either of the following circumstances: (1) if the presumption of control by the general partners is overcome by the rights of the limited partners, or (2) if the presumption of control by the general partners is not overcome by the rights of the limited partners and no single general partner controls the limited partnership. An NFP that would otherwise be required to use the equity method may be permitted to report at fair value by making an election pursuant to FASB ASC 825-10-25-1 (the fair value option).
- 3.94** NFP D establishes a limited partnership with 2 other NFPs (NFP E and NFP F). The limited partnership buys a building in which all 3 will house their computer labs. NFP D is the general partner and has a 10 percent interest. NFP E and NFP F each have 45 percent interests including a right to and responsibility for the partnership operating results, but the limited partners do not have substantive kick-out or participating rights. As the general partner, NFP D should consolidate the limited partnership as discussed in paragraphs 3.80–.81. NFP E and NFP F should apply the equity method of accounting in accordance with FASB ASC 958-810-15-4(d). Alternatively, NFP E or NFP F may report at fair value in conformity with the fair value option described in FASB ASC 825-10.

- 3.95** An NFP that is a limited partner that holds more than 50 percent of the total partnership interest might apply the guidance in FASB ASC 970-323 and FASB ASC 970-810 even though it is not required to do so. That guidance states that a limited partner that holds more than 50 percent of the total partnership interest should be guided in accounting for its investment by the principles for investments in subsidiaries in FASB ASC 810. That is, if a limited partner is in control of the major operating and financial policies of the partnership, it should consolidate the limited partnership unless 1 of the conditions in FASB ASC 810-10-15(a)(i) is present. When applying the guidance in FASB ASC 810, NFPs apply the guidance without considering whether the entity is possibly a VIE.
- 3.96** However, if a limited partner's interest is so minor that the limited partner has virtually no influence over partnership operating and financial policies, that limited partner is, in substance, in the same position with respect to the investment as an investor that owns a minor common stock interest in a corporation, and, accordingly, accounting for the investment using the guidance in FASB ASC 958-325 may be appropriate.

General Partnerships

- 3.97** An NFP that is a partner in a general partnership might apply the guidance in FASB ASC 970-810 even though it is not required to do so. FASB ASC 970-810 provides consolidation guidance for partners of general partnerships engaged in real estate activities. FASB ASC 970-810-25-1 states that a general partnership that is directly or indirectly controlled by an investor is, in substance, a subsidiary of the investor. FASB ASC 970-810-25-2 states that a noncontrolling investor in a general partnership should account for its investment by the equity method and be guided by the provisions of FASB ASC 323. Alternatively, the reporting entity may elect to report that noncontrolling interest at fair value, in accordance with the “Fair Value Option” sections of FASB ASC 825-10.
- 3.98** For example, NFP G and NFP H hold their annual meetings at the same time and in the same city. In order to save costs, they create a general partnership to conduct their meetings, negotiating better rates with the hotel and realizing other synergies. Though they share equally in the decision-making, NFP G has a 70 percent ownership account and NFP B has a 30 percent ownership account. Neither NFP G nor NFP H has control because they share equally in decision-making and therefore neither entity should consolidate the general partnership. If they analogize to the guidance in FASB ASC 970-810-25-2, the NFPs would apply the equity method to their general partnership interests. Alternatively, the NFPs might elect to report their interests at fair value in accordance with the “Fair Value Option” sections of FASB ASC 825-10. (See paragraph 3.136 for a similar example involving an unincorporated joint venture.)

Consolidation of a Special-Purpose Leasing Entity

- 3.99** FASB ASC 958-810-25-8 states that an NFP lessee shall consolidate a special-purpose entity lessor (SPE) if all of the following conditions are met:

- a. Substantially all of the activities of the SPE involve assets that are to be leased to a single lessee.
 - b. The expected substantive residual risks and substantially all the residual rewards of the leased asset(s) and the obligation imposed by the underlying debt of the SPE reside directly or indirectly with the lessee through means such as any of the following:
 - i. The lease agreement.
 - ii. A residual value guarantee through, for example, the assumption of first-dollar-of-loss provisions.
 - iii. A guarantee of the SPE's debt.
 - iv. An option granting the lessee a right to either (a) purchase the leased asset at a fixed price or at a defined price other than fair value determined at the date of exercise, or (b) receive any of the lessor's sales proceeds in excess of a stipulated amount.
 - c. The owner (or owners) of record of the SPE has not made an initial substantive residual equity capital investment that is at risk during the entire lease term. This criterion shall be considered met if the majority owner (or owners) of the lessor is not an independent third party, regardless of the level of capital investment.
- 3.100** FinREC believes that 3 percent is the minimum acceptable investment to qualify as an initial, substantive, residual equity capital investment. A greater 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 percent is needed. Additional information about the application of the preceding criteria and guidance for consolidation of the SPE is located in FASB ASC 958-840.

Consolidated Financial Statements

- 3.101** FASB ASC 810-10-25-15 states that the industry-specific guidance in FASB ASC that is applicable to a subsidiary should be retained in consolidation of that subsidiary. For example, if a hospital is a subsidiary of a university, the hospital specific guidance for reporting patient revenues and investments is retained in the consolidated statements. Likewise, the specialized guidance for the insurance industry (FASB ASC 944, *Financial Services—Insurance*) is retained when a wholly owned captive insurance company is consolidated with its parent. Further, if an NFP parent has a controlling financial interest in a for-profit subsidiary, and that subsidiary has interests in other for-profit entities, the subsidiary should consider the guidance in FASB ASC 810, including the “Variable Interest Entity” subsections, when evaluating those interests for consolidation.

Consolidation of an NFP

- 3.102** In circumstances in which the net assets of two or more NFPs are combined into a single set of financial statements as parent and subsidiary, the definitions of unrestricted, temporarily restricted, and permanently restricted net assets should be applied from the perspective of the reporting entity as a whole, looking through the existence of separate entities. This may result in classifications for the reporting entity that differ from classifications in the separate financial statements. (Similarly, classification of net assets should be considered from the reporting entity perspective when the net assets of a financially interrelated recipient entity are included in the financial statements of its beneficiary NFP and when the net assets of NFPs under common control are included in combined financial statements.) A related discussion about the presentation of restrictions on assets in consolidation is included in paragraphs 3.16 and 3.22.
- 3.103** All or a portion of a subsidiary's unrestricted net assets might need to be reported as restricted net assets in the consolidated financial statements. In a subsidiary's separately issued financial statements, net assets are reported as unrestricted if the donor stipulations pertaining to the use of the contributed assets are no more specific than broad limits resulting from the nature of the NFP, the environment in which the NFP operates, and the purposes specified in the NFP's articles of incorporation or bylaws (or comparable documents for an unincorporated association). In the consolidated financial statements, however, the unrestricted net assets of the subsidiary arising from contributions (or investment income on donor-restricted endowment funds) would be reported as temporarily restricted net assets if in fact donor restrictions limit the use of the gift to a purpose narrower than that of the reporting entity. For example, a membership association has a subsidiary foundation that has as its sole mission to provide scholarships. Donors make unrestricted contributions to the subsidiary with the intent that the subsidiary use the contributions to support its mission, including granting scholarships and incurring fund-raising and general and administrative expenses. The gifts to the subsidiary are therefore classified as increases in unrestricted net assets in the separately issued financial statements of the subsidiary. However, when the subsidiary's financial statements are consolidated with those of the membership association, the classification of the net assets of the subsidiary would be changed to reflect that they are temporarily restricted net assets from the perspective of the consolidated financial statements. Likewise, investment income on donor-restricted endowment funds of the subsidiary would be reported as temporarily restricted net assets in the consolidated financial statements if they were required to be used for scholarships.
- 3.104** Similarly, but less likely, all or a portion of a subsidiary's temporarily restricted net assets might need to be reported as unrestricted net assets in the consolidated financial statements. In the subsidiary's separately issued financial statements, net assets are reported as restricted if donor restrictions limit the use of the contributed assets to a purpose more specific than broad limits resulting from the nature of the NFP, the environment in which the NFP operates, and the purposes specified in the NFP's articles of incorporation or bylaws (or comparable documents for an unincorporated association).

In the consolidated financial statements, however, the restricted net assets of the subsidiary arising from contributions (or investment income on donor-restricted endowment funds) would be reported as unrestricted net assets if in fact those donor restrictions are no more specific than broad limits resulting from the nature of the reporting entity, the environment in which it operates, and so on. For example, an NFP adoption agency has a subsidiary whose mission is to raise funds for various children's causes, including adoption, foster care, and parental training. If donors restrict their contributions for adoption services, the subsidiary classifies them as increases in restricted net assets. However, when the subsidiary's financial statements are consolidated with those of the adoption entity, the classification of the net assets of the subsidiary would be changed to reflect that they are unrestricted net assets from the perspective of the reporting entity, which remains primarily an adoption agency.

- 3.105** In addition, when the net assets of two or more NFPs are combined into a single set of financial statements as parent and subsidiary, there is no noncontrolling interest in the NFP subsidiary, even if the NFP parent has less than a complete interest. FASB ASC 958-810-25-6 provides the following example:

An NFP may appoint 80 percent of the board of the other NFP. For NFPs other than health care entities (that is, within the scope of FASB ASC 954, *Health Care Entities*), if the conditions for consolidation in paragraphs 2–4 of FASB ASC 958-810-25 are met, the basis of that consolidation would not reflect a noncontrolling interest for the portion of the board that the reporting entity does not control because there is no ownership interest other than the interest of the reporting entity.

- 3.106** FASB ASC 958-810-50-1 requires that if consolidated financial statements are presented, the reporting entity (parent) should disclose any restrictions made by entities outside of the reporting entity on distributions from the controlled NFP (subsidiary) to the parent and any resulting unavailability of the net assets of the subsidiary for use by the parent.
- 3.107** NFPs that otherwise would be prohibited from presenting consolidated financial statements under paragraph 3.70, but that presented consolidated financial statements prior to December 1994 in conformity with the guidance in AICPA Statement of Position 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, may continue to do so.

Consolidation of a For-Profit Entity

- 3.108** NFPs typically provide varying levels of detail in presenting information about for-profit subsidiaries, ranging from (a) full consolidated amounts with no discrete information about the for-profit subsidiary to (b) consolidating financial statements providing the same level of detail about the for-profit subsidiary as would be presented in the for-profit subsidiary's separately issued financial statements. FinREC believes that in determining the relevance of the for-profit subsidiary, and therefore the most meaningful manner of

presenting information about it in consolidated financial statements, best practice is for NFPs to consider the following factors:

- The size of the for-profit subsidiary in relation to the NFP parent. The larger the for-profit subsidiary is in relation to the NFP, the more likely it is that discrete information about the for-profit subsidiary would be meaningful to financial statement users.
- The activities of the for-profit subsidiary in relation to the mission of the NFP parent. The more marginal the activities of the for-profit subsidiary are to the mission of the NFP, the more likely it is that discrete information about the for-profit subsidiary would be meaningful to financial statement users.
- The need for creditors to have separate information about the for-profit subsidiary. If the assets of a for-profit subsidiary are encumbered (for example, by mortgages, contracts, or other matters), it may be meaningful to include discrete information about the for-profit subsidiary's total assets, equity, and changes in equity, similar to the disclosures required to be reported by business entities pursuant to FASB ASC 280.

3.109 FinREC believes that NFPs should present such information in a manner that is most meaningful to financial statement users. FinREC recommends that a similar level of detail be included in each of the statement of financial position, the statement of activities, and the statement of cash flows. In circumstances in which the statement of financial position and the statement of activities include discrete information about a for-profit subsidiary, however, FinREC believes it may be meaningful for the statement of cash flows to include a similar level of detail about operating cash flows (that is, discrete information about the for-profit subsidiary), but display fully consolidated cash flows pertaining to investing and financing activities.

3.110 Paragraphs 3.111–.116 provide three examples of the guidance discussed in paragraphs 3.108–.109. These examples present one manner of displaying consolidated information; other presentations may also be appropriate.

Example A

3.111 NFP Trade Association creates a wholly owned for-profit subsidiary (For-Profit Training Facility) to provide continuing professional education to its members. For-Profit Training Facility subsidiary incurs debt in order to build a classroom building. The debt is secured solely by a mortgage on For-Profit Training Facility's assets. NFP Trade Association's mission includes providing training to its members. Although members could obtain training from other service providers, the training is integral to NFP Trade Association's overall mission.

3.112 If For-Profit Training Facility is material to the overall financial position of NFP Trade Association, it may be most meaningful to report For-Profit Training Facility's assets, liabilities, revenues, expenses, and cash flows as part of the overall activities of NFP Trade Association, without discrete information presented on the face of the financial statements about For-Profit Training Facility. It may be most meaningful for the notes to the financial statements to include any material disclosures that relate only to the For-Profit Training Facility, such as to disclose any collateral-based debt for which the For-Profit Training Facility is obligated or any assets restricted solely for the use of the Facility.

Example B

3.113 NFP College creates a wholly owned for-profit subsidiary, For-Profit Day Care Center, that operates a day care center for the benefit of its students and faculty. The College does not use the day care center as a teaching resource for its students. For-Profit Day Care Center has no outstanding debt.

3.114 Because the day care center provides services to students, but is peripheral and incidental to the mission of the college, it may be most meaningful to report the assets, liabilities, activities, and cash flows of For-Profit Day Care Center in a manner similar to an auxiliary operation in the college's financial statements. (Auxiliary operations typically are reported on the statement of activities with one line for total revenues and one line for total expenses; the statement of financial position and statement of cash flows do not separate information associated with auxiliary operations.) Alternatively, it may be meaningful to present the operations of the day care center separately on the statement of activities.

Example C

3.115 NFP Community Organization received a contribution of 100 percent of the voting common stock of a For-Profit Plastics Company. The terms of the contribution agreement state that For-Profit Plastics Company's net income may be used for NFP Community Organization's general operations. NFP Community Organization is not involved in the day-to-day management of For-Profit Plastics Company.

3.116 If For-Profit Plastics Company is material to NFP Community Organization's financial statements, it may be meaningful to report the assets, liabilities, activities, and cash flows of For-Profit Plastics Company separately from those of NFP Community Organization. Acceptable methods of doing so include, but are not limited to, presenting (a) consolidating financial statements, or (b) consolidated financial statements with note disclosure of the assets, liabilities, net assets, activities, and cash flows of For-Profit Plastics Company.

Noncontrolling Interests

3.117 FASB ASC 958-810-45-1 describes how to report noncontrolling interests in the equity (net assets) of consolidated subsidiaries within the appropriate class(es) of net assets. Noncontrolling interests of consolidated subsidiaries should be reported as a separate component of the appropriate class of net assets in the consolidated statement of financial position of an NFP. That amount should be clearly identified and described (for example, as noncontrolling ownership interest in subsidiaries) to distinguish it from the components of net assets of the parent, which includes the parent's controlling financial interest in its subsidiaries. The effects of donor-imposed restrictions, if any, on a partially owned subsidiary's net assets should be reported in accordance with FASB ASC 958-205 and 958-320. Paragraphs 17–25 of FASB ASC 958-810-55 illustrate one way in which the consolidated financial statements of an NFP might satisfy the presentation and disclosure requirements for noncontrolling interests in a consolidated subsidiary and subsequent changes in ownership interests of that subsidiary.

3.118 In accordance with FASB ASC 958-810-50, the consolidated financial statements should provide a schedule of changes in consolidated net assets attributable to the parent and the noncontrolling interest. The schedule is typically included in notes to the consolidated financial statements, although it may appear on the face of financial statements, if practicable. That schedule should reconcile beginning and ending balances of the parent's controlling interest and the noncontrolling interests for each class of net assets for which a noncontrolling interest exists during the reporting period. At a minimum, the schedule includes the following:

- A performance indicator, if the reporting entity is an NFP health care entity (as described in FASB ASC 954-10-15)
- Amounts of discontinued operations
- Amounts of extraordinary items
- Changes in ownership interests in a subsidiary, including investments by and distributions to noncontrolling interests acting in their capacity as owners, which shall be reported separate from any revenues, expenses, gains, or losses and outside any measure of operations, if reported
- An aggregate amount of all other changes in unrestricted net assets (or other net asset classes, if restricted) for the period

An example of the schedule appears in FASB ASC 958-810-55-25.

Parent-Only and Subsidiary-Only Financial Statements

3.119 FASB ASC 810-10-45-11 states that parent-entity financial statements may be needed in addition to consolidated financial statements and that consolidating financial statements, in which one column is used for the parent and other columns for particular subsidiaries

or groups of subsidiaries, often are an effective means of presenting the pertinent information. However, consolidated financial statements are the general-purpose financial statements of a parent having one or more subsidiaries; thus, parent-entity financial statements are not a valid substitute for consolidated financial statements. TIS section 1400.32, “Parent-Only Financial Statements and Relationship to GAAP” (AICPA, *Technical Practice Aids*), states that if consolidation is required under GAAP, no circumstances exist in which an entity may present parent-only financial statements without presenting related consolidated financial statements and claim that the parent-only financial statements are in conformity with GAAP. For example, if, as a condition of a legal or regulatory agreement, an NFP is required to submit parent-only financial statements without related consolidated financial statements as financial statements prepared in accordance with a special-purpose framework (as that term is used in AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* [AICPA, *Professional Standards*]), the parent-only financial statements are not in accordance with GAAP. FinREC observes that GAAP does not preclude the issuance of subsidiary-only financial statements. Care should be taken, however, to include all disclosures required by FASB ASC 850, *Related Party Disclosures*, and other relevant GAAP.

Combined Financial Statements

- 3.120** FASB ASC 810-10-55-1B provides guidance for circumstances in which combined financial statements of commonly controlled entities would be useful. It states that there are circumstances in which combined financial statements (as distinguished from consolidated financial statements) of commonly controlled entities are likely to be more meaningful than their separate financial statements. For example, combined financial statements would be useful if one individual owns a controlling financial interest in several entities that are related in their operations. Combined financial statements might also be used to present the financial position and the results of operations of entities under common management. FASB ASC 810-10-45-10 states that if combined statements are prepared for a group of related entities, such as a group of commonly controlled entities, intra-entity transactions and profits or losses should be eliminated, and noncontrolling interests, foreign operations, different fiscal periods, or income taxes, shall be treated in the same manner as in consolidated statements. (Paragraphs 3.101–.118 discuss presentation of consolidated financial statements.)

Mergers and Acquisitions

- 3.121** FASB ASC 958-805 provides guidance on a transaction or other event in which an NFP that is the reporting entity combines with one or more other NFPs, businesses, or nonprofit activities. Paragraphs 3.122–.134 summarize the guidance in FASB ASC 958-805, but are not a substitute for reading that subtopic.
- 3.122** FASB ASC 958-805-25-1 requires that an NFP determine whether that transaction or other event is a merger of NFPs or an acquisition by an NFP by applying the definitions.

FASB ASC 958-805-55-1 states that ceding control to a new NFP is the sole definitive criterion for identifying a merger, and one entity obtaining control over the other is the sole definitive criterion for an acquisition. Paragraphs 1–31 of FASB ASC 958-805-55 provide guidance on distinguishing between a merger and an acquisition. FASB ASC 958-805-55-6 discusses some of the more common characteristics that distinguish a merger from an acquisition by an NFP. It states:

For example, one entity appointing significantly more of the governing board of the newly formed entity, retaining significantly more of its key senior officers, or retaining its bylaws, operating policies, and practices substantially unchanged is more likely to be a feature of an acquisition than of a merger. Similarly, the relative financial strength and relative size of the participants in the combination may help to determine whether one participant is able to dominate the process leading to the combination. For example, if one entity is financially strong and the other is experiencing financial difficulty, the stronger entity may be able to dominate the transaction, which would indicate that the transaction is an acquisition rather than a merger. Similarly, a participant that is substantially larger than each of the others in terms of revenues, assets, and net assets may be able to dominate the transaction. However, relative size, like relative financial strength and the other indicators discussed, is only one characteristic that may help to distinguish between a merger and an acquisition in particular situations—none of the indicators, by itself, is determinative. As discussed in FASB ASC 958-805-55-1, ceding of control is the sole definitive criterion for a merger.

Merger of Not-for-Profit Entities

- 3.123** The FASB ASC glossary defines *merger of not-for-profit entities* as a transaction or other event in which the governing bodies of two or more NFPs cede control of those entities to create a new NFP. FASB ASC 958-805-25 requires that the NFP resulting from a merger (the new entity) account for the merger by applying the carryover method described in the “Merger of Not-for-Profit Entities” subsections of FASB ASC 958-805.
- 3.124** Applying the carryover method requires combining the assets and liabilities recognized in the separate financial statements of the merging entities as of the merger date (or that would be recognized if the entities issued financial statements as of that date), with certain adjustments. The new NFP does not recognize additional assets or liabilities, such as internally developed intangible assets, that GAAP did not require or permit the merging entities to recognize. However, if a merging entity’s separate financial statements are not prepared in accordance with GAAP, those statements should be adjusted to GAAP before the new entity recognizes the assets and liabilities. The new NFP should carry forward at the merger date the merging entities’ classifications and designations of their assets and liabilities unless one of the exceptions in FASB ASC 958-805-25-9 applies. Those exceptions are for certain modifications in contracts as a result of the merger and for conforming accounting policies to reflect a consistent method of accounting.

Acquisition by a Not-for-Profit Entity

- 3.125** The FASB ASC glossary defines *acquisition by a not-for-profit entity* as a transaction or other event in which an NFP acquirer obtains control of one or more nonprofit activities or businesses and initially recognizes their assets and liabilities in the acquirer's financial statements. An NFP should account for each acquisition of a business or nonprofit activity by applying the acquisition method described in the "Acquisition by a Not-for-Profit Entity" subsections of FASB ASC 958-805. That acquisition method is the same as the acquisition method described in FASB ASC 805, *Business Combinations*; however, FASB ASC 958-805 includes guidance on aspects of the items that are unique or especially significant to an NFP.
- 3.126** Pursuant to FASB ASC 805-10-05-4 as modified by FASB ASC 958-805-25, the following are steps for applying the acquisition method:
- a. Identifying the acquirer
 - b. Identifying the acquisition date
 - c. Recognizing the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree
 - d. Recognizing goodwill acquired or a contribution received, including consideration transferred
- 3.127** FASB ASC 805-10-25-4 requires that one of the combining entities be identified as the acquirer. The guidance on control and consolidation of NFPs should be used to identify the acquirer: For an NFP acquirer other than a health care entity the guidance to be used is the guidance in FASB ASC 958-810, including the guidance referenced in FASB ASC 958-810-15-4. (Consolidation of NFPs is discussed beginning at paragraph 3.57.) If that guidance does not clearly indicate which of the combining entities is the acquirer, the factors in paragraphs 42–46 of FASB ASC 958-805-55 should be considered in making that determination.
- 3.128** Paragraphs 6–7 of FASB ASC 805-10-25 require that the acquirer identify the acquisition date, which is the date on which it obtains control of the acquiree. The date on which the acquirer obtains control of the acquiree generally is the date on which the acquirer legally transfers the consideration (if any), acquires the assets, and assumes the liabilities of the acquiree—the closing date. In addition, FASB ASC 958-805-25-17 states that the date on which an NFP acquirer obtains control of an NFP with sole corporate membership generally also is the date on which the acquirer becomes the sole corporate member of that entity.

- 3.129** FASB ASC 805-20 requires that as of the acquisition date, the acquirer recognize, separately from goodwill, the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree.^{fn 7}
- 3.130** In conformity with FASB ASC 958-805-30-6(b), an NFP acquirer determines the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with FASB ASC 805-20 and FASB ASC 958-805. Most assets and liabilities are measured at fair value. However, FASB ASC 805-20-25-16 notes that there are limited exceptions to the recognition and measurement principles applicable to business combinations, including acquisitions by an NFP. The limited exceptions are specified in paragraphs 16–28 of FASB ASC 805-20-25, paragraphs 12–23 of FASB ASC 805-20-30, and paragraphs 11–26 of FASB ASC 958-805-25. Examples of items that are either not recognized or are measured at an amount other than their acquisition-date fair values include income taxes, employee benefits, assets held for sale, collections, conditional promises to give, donor relationships, and certain assets and liabilities arising from contingencies.
- 3.131** Next, in conformity with FASB ASC 958-805-30-6(a), an NFP acquirer determines the aggregate of the following:
- a. The consideration transferred measured at its acquisition-date fair value (see paragraphs 10–13 of FASB ASC 958-805-30)
 - b. The fair value of any noncontrolling interest in the acquiree
 - c. In an acquisition by an NFP achieved in stages, the acquisition-date fair value of the acquirer’s previously held equity interest in the acquiree
- 3.132** If the amount determined in accordance with FASB ASC 958-805-30-6(a) is greater than the amount determined in accordance with FASB 958-805-30-6(b), an NFP acquirer should determine whether the operations of the acquiree as part of the combined entity are expected to be predominantly supported by contributions and returns on investments. If they are not in conformity with FASB ASC 958-805-25-28, an NFP acquirer should recognize goodwill as of the acquisition date, measured as of the acquisition date as the excess of FASB ASC 958-805-30-6(a) over FASB 958-805-30-6(b). (Accounting for goodwill after acquisition is discussed in chapter 7, “Other Assets.”) If instead the operations of the acquiree as part of the combined entity are expected to be predominantly supported by contributions and returns on investments, FASB ASC 958-805-25-29 states that an NFP acquirer should recognize a separate charge in its statement

^{fn 7} Reporting noncontrolling interests in financial statements is discussed in chapter 11, “Net Assets and Reclassification of Net Assets.”

of activities as of the acquisition date, measured as the excess of FASB ASC 958-805-30-6(a) over FASB 958-805-30-6(b), rather than goodwill. *Predominantly supported* by means that contributions and returns on investments are expected to be significantly more than the total of all other sources of revenues.

- 3.133** If the amount determined in accordance with FASB ASC 958-805-30-6(b) is greater than the amount determined in accordance with FASB 958-805-30-6(a), FASB ASC 958-805-25-31 requires an NFP acquirer to recognize the inherent contribution received. The inherent contribution is measured as the excess of the amount in FASB ASC 958-805-30-6b over the amount in FASB ASC 958-805-30-6(a). The inherent contribution is reported as a separate credit in the statement of activities as of the acquisition date and, in accordance with FASB ASC 958-805-45-6, is classified on the basis of the type of restrictions imposed on the related net assets. FASB ASC 958-805-45-6 states that those restrictions include restrictions imposed on the net assets of the acquiree by a donor before the acquisition and those imposed by the donor of the business or nonprofit activity acquired, if any. Donor-restricted contributions are reported as restricted support even if the restrictions are met in the same reporting period in which the acquisition occurs. That is, the acquirer should not apply the reporting exception in FASB ASC 958-605-45-4 (see paragraph 5.84) to restricted net assets acquired in an acquisition.

Disclosures

- 3.134** FASB ASC 958-805-50 requires an NFP to disclose information that enables users of its financial statements to evaluate the nature and financial effect of a merger of NFPs or an acquisition by an NFP. If acquisitions are individually immaterial but are material collectively, the NFP should disclose the required information in the aggregate. Disclosures are also required if an acquisition date is after the reporting date but before the financial statements are issued or available for issue. If the initial accounting for an acquisition by an NFP is incomplete, the NFP should disclose information that enables users of its financial statements to evaluate the financial effects of adjustments recognized in the current reporting period that relate to acquisitions that occurred in the current or previous reporting periods.

Collaborative Arrangements

- 3.135** FASB ASC 808 provides display and disclosure guidance for a collaborative arrangement. The FASB ASC glossary defines a *collaborative arrangement* as a contractual arrangement that involves a joint operating activity (see FASB ASC 808-10-15-7) that involves two (or more) parties who are both (a) active participants in the activity (see paragraphs 8–9 of FASB ASC 808-10-15), and (b) exposed to significant risks and rewards dependent on the commercial success of the activity (see paragraphs 10–13 of FASB ASC 808-10-15). A collaborative arrangement within the scope of FASB ASC 808 is not primarily conducted through a separate legal entity created for that activity. FASB ASC 808-10-45-1 states that an entity should not apply the equity method of accounting to the activities of a collaborative arrangement. Per FASB ASC 808-10-15-

3, the guidance in FASB ASC 808 does not apply to arrangements for which the accounting is specifically addressed within the scope of other authoritative accounting literature.

- 3.136** For example, two unrelated NFPs hold their annual meetings at the same time and in the same city. In order to save costs, they merge their meetings via an unincorporated joint venture, negotiating better rates with the hotel and realizing other synergies. They share equally in the decision-making and net proceeds from the meeting. In accordance with FASB ASC 808-10-45, each NFP should report costs incurred and revenue generated from transactions with third parties (that is, parties that do not participate in the arrangement) in its respective statement of activities on a gross basis if it is deemed to be the principal participant for a given transaction. The guidance in FASB ASC 605-45 should be used to determine which participant in the collaborative arrangement is the principal participant. (See paragraph 3.98 for a similar example involving a general partnership.)

The Use of Fair Value Measures

- 3.137** The use of fair value measures is pervasive in the preparation of financial statements. Among other uses, fair value is used in the following items:

- Measurement of noncash contributions received (discussed in chapter 5)
- Measurement of financial assets held as an agent (discussed in chapter 5)
- Measurement of the contribution portion of a split-interest agreement (discussed in chapter 6, "Split-Interest Agreements and Beneficial Interests in Trusts")
- Measurement of a beneficial interest in a trust (discussed in chapters 5 and 6)
- Measurement of certain investments (discussed in chapter 4 and chapter 8, "Programmatic Investments")
- Measurement of derivative instruments (discussed in chapter 4)
- Disclosures about the fair value of financial instruments (discussed in chapter 4)
- Measurement of impairment losses for long-lived assets (discussed in chapter 9, "Property, Plant, and Equipment")
- Measurement of asset retirement obligations (discussed in chapter 9)
- Measurement of a guarantee obligation (discussed in chapter 10, "Debt and Other Liabilities")

- Measurement of exit and disposal costs (discussed in chapter 10)
- Measurement of nonmonetary transactions in conformity with FASB ASC 845, *Nonmonetary Transactions*
- Measurement of transfers of financial assets in conformity with FASB ASC 860, *Transfers and Servicing*
- Measurement of a financial asset or financial liability for which an election is made pursuant to FASB ASC 815-15-25 or the “Fair Value Option” subsections of FASB ASC 825-10 (discussed in paragraphs 3.168–.170)

3.138 FASB ASC 820, *Fair Value Measurement*, defines *fair value*, establishes a framework for measuring fair value, and requires disclosures about fair value measurements. The following paragraphs summarize FASB ASC 820 but are not a substitute for the reading FASB ASC 820 itself. FASB ASC 820-10-15 states that, with certain exceptions, the guidance in FASB ASC 820 applies when GAAP requires or permits fair value measurements or disclosures about fair value measurements. It also applies to measurements, such as fair value less costs to sell, based on fair value or disclosures about those measurements.

3.139 To assist practitioners, in October 2011, the AICPA issued the white paper, *Measurement of Fair Value for Certain Transactions of Not-for-Profit Entities*. The white paper discusses fair value measurement for the following types of transactions:

- Unconditional promises to give cash or other financial assets
- Beneficial interests in trusts
- Split-interest agreements

Excerpts from the white paper are incorporated into chapters 5 and 6.

Definition of *Fair Value*

3.140 The FASB ASC glossary defines *fair value* as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. FASB ASC 820-10-20 defines the *principal market* as the market with the greatest volume and level of activity for the asset or liability and the *most advantageous market* as the market that maximizes the amount that would be received to sell the asset or minimizes the amount that would be paid to transfer the liability, after taking into account transaction costs and transportation costs. Although an NFP must be able to access the

market, it does not need to be able to sell the particular asset or transfer the particular liability on the measurement date to be able to measure fair value on the basis of the price in that market.

- 3.141** FASB ASC 820-10-35-6C states that even when there is no observable market to provide pricing information about the sale of an asset or the transfer of a liability at the measurement date, a fair value measurement assumes that a transaction takes place at that date, considered from the perspective of a market participant that holds the asset or owes the liability. That assumed transaction establishes a basis for estimating the price to sell the asset or to transfer the liability.
- 3.142** The definition of fair value focuses on the price that would be received to sell the asset or paid to transfer the liability (an *exit price*), not the price that would be paid to acquire the asset or received to assume the liability (an *entry price*). Conceptually, entry prices and exit prices are different. However, FASB ASC 820-10-30-3 explains that, in many cases, a transaction price (entry price) will equal the exit price and, therefore, will represent the fair value of the asset or liability at initial recognition. FASB ASC 820-10-30-3A provides conditions for which a transaction price might not represent the fair value of an asset or a liability.
- 3.143** One such condition is if the transaction price includes transaction costs (costs that result directly from and are essential to a transaction and that would not have been incurred by the entity had it not decided to sell the asset or transfer the liability). FASB ASC 820-10-35-9B states that the price in the principal (or most advantageous) market should not be adjusted for transaction costs. Transaction costs are not a characteristic of the asset or liability measured. However, as noted in FASB ASC 820-10-35-9C, if location is a characteristic of the asset (as might be the case, for example, for a commodity), the price in the principal (or most advantageous) market should be adjusted for the costs, if any, that would be incurred to transport the asset from its current location to that market. That is, transaction costs do not include costs that would be incurred to transport an asset from its current location to its principal (or most advantageous) market.

Fair Value of Nonfinancial Assets

- 3.144** Paragraphs 10A–14 of FASB ASC 820-10-35 provide guidance for the fair value measurement of nonfinancial assets. A fair value measurement of a nonfinancial asset takes into account a market participant’s ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use, considering the use of the asset that is physically possible, legally permissible, and financially feasible at the measurement date. An NFP may not intend to use the nonfinancial asset according to its highest and best use; nevertheless, the NFP should measure the fair value of a nonfinancial asset assuming its highest and best use by market participants.

3.145 FASB ASC 820-10-35-10E states that the highest and best use for an asset is established by one of two valuation premises. A nonfinancial asset might provide maximum value to market participants through its use in combination with other assets as a group (as installed or otherwise configured for use) or in combination with other assets and liabilities (for example, a business). If so, a nonfinancial asset's fair value should be based on the price that would be received in a current transaction to sell the asset assuming that the asset would be used with other assets or with other assets and liabilities and that those assets and liabilities (that is, its complementary assets and the associated liabilities) would be available to market participants. Alternatively, a nonfinancial asset might provide maximum value to market participants on a standalone basis. If the highest and best use of the asset is to use it on a standalone basis, the fair value of the asset is the price that would be received in a current transaction to sell the asset to market participants that would use the asset on a standalone basis.

Fair Value of Liabilities

3.146 Paragraphs 16–18C of FASB ASC 820-10-35 provide guidance for the fair value measurement of liabilities. The fair value of a liability reflects the effect of nonperformance risk (the risk that an entity will not fulfill an obligation). Nonperformance risk is assumed to be the same before and after the transfer of the liability. Because nonperformance risk includes (but may not be limited to) a reporting entity's own credit risk, an NFP should take into account the effect of its credit standing and any other factors that might influence the likelihood that the obligation will or will not be fulfilled when measuring the fair value of a liability. If the fair value option is elected for a liability issued with an inseparable third-party credit enhancement (for example, debt that is issued with a contractual third-party guarantee), FASB ASC 825-10-25-13 states the unit of accounting for the liability does not include the effects of the third-party credit enhancement when the issuer of the liability measures or discloses the fair value of the liability.

Valuation Techniques

3.147 To measure fair value, an NFP should use valuation techniques that are appropriate in the circumstances and for which sufficient data are available, maximizing the use of relevant observable inputs and minimizing the use of unobservable inputs. Three widely used valuation techniques are the market approach, cost approach, and income approach. An NFP should use valuation techniques consistent with one or more of those approaches to measure fair value. Paragraphs 3A–3G of FASB ASC 820-10-55 describe those valuation techniques, as follows:

- The market approach uses prices and other relevant information generated by market transactions involving identical or comparable (that is, similar) assets, liabilities, or a group of assets and liabilities, such as a business. Valuation techniques consistent with the market approach include matrix pricing and often use market multiples derived from a set of comparables.

- The income approach converts future amounts (for example, cash flows or income and expenses) to a single current (that is, discounted) amount. When the income approach is used, the fair value measurement reflects current market expectations about those future amounts. Valuation techniques consistent with the income approach include present value techniques, option-pricing models, and the multiperiod excess earnings method.
- The cost approach reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost). Fair value is determined based on the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence.

3.148 FASB ASC 820-10-35-25B explains that in some cases, a single valuation technique will be appropriate (for example, when valuing an asset or a liability using quoted prices in an active market for identical assets or liabilities). In other cases, multiple valuation techniques will be appropriate (for example, that might be the case when valuing a reporting unit). If multiple valuation techniques are used to measure fair value, the results (that is, respective indications of fair value) should be evaluated considering the reasonableness of the range of values indicated by those results. A fair value measurement is the point within that range that is most representative of fair value in the circumstances. Example 3 (paragraphs 35–41) of FASB ASC 820-10-55 illustrates the use of multiple valuation techniques.

3.149 Valuation techniques used to measure fair value should be applied consistently. However, a change in a valuation technique or its application is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. Such a change would be accounted for as a change in accounting estimate in accordance with the provisions of FASB ASC 250.

Present Value Techniques

3.150 Paragraphs 4–20 of FASB ASC 820-10-55 provide guidance on present value techniques. Those paragraphs neither prescribe the use of one specific present value technique nor limit the use of present value techniques to the three techniques discussed therein. They say that a fair value measurement of an asset or liability using present value techniques should capture the following elements from the perspective of market participants as of the measurement date: an estimate of future cash flows, expectations about possible variations in the amount and timing of the cash flows, the time value of money, the price for bearing the uncertainty inherent in the cash flows (risk premium), other factors that market participants would take into account in the circumstances, and in the case of a liability, the nonperformance risk relating to that liability, including the reporting entity's (obligor's) own credit risk.

3.151 FASB ASC 820-10-55-6 provides the general principles that govern any present value technique, as follows:

- Cash flows and discount rates should reflect assumptions that market participants would use in pricing the asset or liability.
- Cash flows and discount rates should consider only factors attributed to the asset (or liability) being measured.
- To avoid double counting or omitting the effects of risk factors, discount rates should reflect assumptions that are consistent with those inherent in the cash flows. For example, a discount rate that reflects expectations about future defaults is appropriate if using the contractual cash flows of a loan, but is not appropriate if the cash flows themselves are adjusted to reflect possible defaults.
- Assumptions about cash flows and discount rates should be internally consistent. For example, nominal cash flows (that include the effects of inflation) should be discounted at a rate that includes the effects of inflation.
- Discount rates should be consistent with the underlying economic factors of the currency in which the cash flows are denominated.

3.152 Present value techniques differ in how they adjust for risk and in the type of cash flows they use. For example, the discount rate adjustment technique (also called the traditional present value technique) uses a risk-adjusted discount rate and contractual, promised, or most likely cash flows. In contrast, expected present value techniques use the probability-weighted average of all possible cash flows (referred to as expected cash flows). The traditional present value technique and two methods of expected present value techniques are discussed more fully in paragraphs 4–20 of FASB ASC 820-10-55.

3.153 This guide includes guidance about measuring assets (promises to give and beneficial interests in trusts) and liabilities (split-interest obligations) using traditional present value techniques. That guidance is not intended to suggest that the income approach is the only one of the three approaches that is appropriate in the circumstances, nor is it intended to suggest that the traditional present value technique described in the guide is preferred over other present value techniques. Rather, the inclusion of that guidance in the guide merely reflects that prior to the issuance of the framework for fair value measurement, present value techniques were specifically mentioned in the standards as appropriate for measuring promises to give cash and beneficial interests in trusts, and the guide had been drafted reflecting those standards. In conforming this guide to the framework for fair value measurement, guidance that previously specified the use of the traditional present value technique was modified to indicate that the technique was a possible technique to consider for fair value measurement.

The Fair Value Hierarchy

3.154 FASB ASC 820 emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability (referred to as *inputs*). Paragraphs 37–54B of FASB ASC 820-10-35 establish a fair value hierarchy that distinguishes between (1) inputs that are developed using market data, such as publicly available information about actual events or transactions, and that reflect the assumptions that market participants would use when pricing the asset or liability (observable inputs) and (2) inputs for which market data are not available and that are developed using the best information available about the assumptions that market participants would use when pricing the asset or liability (unobservable inputs). Valuation techniques used to measure fair value should maximize the use of observable inputs and minimize the use of unobservable inputs.

3.155 The fair value hierarchy in FASB ASC 820 characterizes into three levels the inputs to valuation techniques used to measure fair value. The three levels, which are described in paragraphs 40–54A of FASB ASC 820-10-35, are as follows:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. An active market is 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. A quoted price in an active market provides the most reliable evidence of fair value and should be used without adjustment to measure fair value whenever available, except as discussed in FASB ASC 820-10-35-41C.
- Level 2 inputs are inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a level 2 input must be observable for substantially the full term of the asset or liability. Adjustments to level 2 inputs will vary depending on factors specific to the asset or liability. An adjustment to a level 2 input that is significant to the entire measurement might result in a fair value measurement categorized within level 3 of the fair value hierarchy if the adjustment uses significant unobservable inputs. Level 2 inputs include the following:
 - 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 (for example, interest rates and yield curves observable at commonly quoted intervals, volatilities, and credit spreads)

— Inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs)

- Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs should be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. In developing unobservable inputs, the reporting entity need not undertake exhaustive efforts to obtain information about market participant assumptions. However, a reporting entity should take into account all information about market participant assumptions that is reasonably available. Unobservable inputs are developed using the best information available about the assumptions that market participants would use when pricing the asset or liability.

3.156 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, FASB ASC 820-10-35-37A states that 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.

3.157 As discussed in FASB ASC 820-10-35-38, the availability of relevant inputs and their relative subjectivity might affect the selection of appropriate valuation techniques. However, the fair value hierarchy prioritizes the inputs to valuation techniques, not the valuation techniques used to measure fair value. For example, a fair value measurement developed using a present value technique might be categorized within level 2 or level 3, depending on the inputs that are significant to the entire measurement and the level of the fair value hierarchy within which those inputs are categorized.

Additional Guidance For Fair Value Measurement in Special Circumstances

3.158 FASB ASC 820-10-35 provides additional guidance for fair value measurements in the following circumstances:

- Measuring fair value of liabilities held by other parties as assets (paragraphs 16B–16D of FASB ASC 820-10-35)
- Measuring fair value when the volume or level of activity for an asset or a liability has significantly decreased (paragraphs 54C–54H of FASB ASC 820-10-35)
- Identifying transactions that are not orderly (paragraphs 54I–54J of FASB ASC 820-10-35)
- Using quoted prices provided by third parties (paragraphs 54K–54M of FASB ASC 820-10-35)

- Measuring the fair value of investments in certain entities that calculate net asset value per share or its equivalent (paragraphs 59–62 of FASB ASC 820-10-35)
- Effects of restrictions on fair value measurements (paragraphs 18B and 38A of FASB ASC 820-10-35 and paragraphs 51–55 of FASB ASC 820-10-55)

Liabilities Held by Other Parties as Assets

3.159 When a quoted price for the transfer of an identical or a similar liability is not available and the identical item is held by another party as an asset, an NFP should measure the fair value of the liability from the perspective of a market participant that holds the identical item as an asset at the measurement date. An NFP should adjust the quoted price of the liability held by another party as an asset only if there are factors specific to the asset that are not applicable to the fair value measurement of the liability. An NFP should ensure that the price of the asset does not reflect the effect of a restriction preventing the sale of that asset. FASB ASC 820-10-35-16D includes some factors, including a third-party credit enhancement, that may indicate that the quoted price of the asset should be adjusted.

Decrease in Market Activity

3.160 If there has been a significant decrease in the volume or level of activity for the asset or liability in relation to normal market activity for the asset or liability (or similar assets or liabilities), further analysis of the transactions or quoted prices is needed. A decrease in the volume or level of activity on its own may not indicate that a transaction price or quoted price does not represent fair value. However, if a reporting entity determines that a transaction or quoted price does not represent fair value (for example, there may be transactions that are not orderly), an adjustment will be necessary if the reporting entity uses those transactions or prices as a basis for measuring fair value. That adjustment may be significant to the fair value measurement in its entirety. Adjustments also may be necessary in other circumstances (for example, when a price for a similar asset requires significant adjustment to make it comparable to the asset being measured or when the price is stale). Further, if there has been a significant decrease in the volume or level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate (for example, the use of a market approach and a present value technique).

Transactions That Are Not Orderly

3.161 When measuring fair value, an NFP should take into account transaction prices for orderly transactions. If evidence indicates that a transaction is not orderly, an NFP should place little, if any, weight (compared with other indications of fair value) on that transaction price. When an NFP does not have sufficient information to conclude whether particular transactions are orderly, it should place less weight on those transactions when compared with other transactions that are known to be orderly.

Quoted Prices Provided by Third Parties

- 3.162** An NFP may use quoted prices provided by third parties, such as pricing services or brokers, if it has determined that those prices are developed in accordance with FASB ASC 820. More weight should be given to quotes provided by third parties that represent binding offers than to quotes that are indicative prices. Less weight (when compared with other indications of fair value that reflect the results of transactions) should be placed on quotes that do not reflect the result of transactions.

Investments in Entities That Calculate Net Asset Value per Share

- 3.163** An NFP is permitted, as a practical expedient, to estimate the fair value of an investment using its net asset value per share (or its equivalent, such as member units or an ownership interest in partners' capital to which a proportionate share of net assets is attributed), if the net asset value per share of the investment (or its equivalent) is calculated in a manner consistent with the measurement principles of FASB ASC 946, *Financial Services—Investment Companies*, as of the measurement date. Paragraph 4.42 provides additional information about the circumstances in which this practical expedient is permitted.

Effects of Restrictions

- 3.164** FASB ASC 820-10-55-51 states that the effect of a restriction on the sale or use of an asset by a reporting entity will differ depending on whether the restriction would be taken into account by market participants when pricing the asset. Example 6 (paragraphs 51–55) of FASB ASC 820-10-55 illustrates that restrictions that are a characteristic of the asset and, therefore, would be transferred to market participants, are the only restrictions reflected in fair value. Donor restrictions that are specific to the donee are reflected in the classification of net assets, not in the measurement of fair value.
- 3.165** FASB ASC 820-10-35-38A states that if a market participant would take into account the effect of a restriction on the sale of an asset when estimating the price for the asset, an NFP would adjust the quoted price to reflect the effect of that restriction. If the asset is measured based on a quoted price that is a level 2 input, and the adjustment is an unobservable input that is significant to the entire measurement, the measurement would be categorized within level 3 of the fair value hierarchy.
- 3.166** Paragraphs 16D and 18B of FASB ASC 820-10-35 state that when measuring the fair value of a liability, an NFP should not include a separate input or an adjustment to other inputs relating to a restriction that prevents the transfer of the item. The effect of a restriction is either implicitly or explicitly included in the other inputs to the fair value measurement.

Disclosures

3.167 Paragraphs 1–8 of FASB ASC 820-10-50 require disclosures about assets and liabilities measured at fair value on a recurring or nonrecurring basis in the statement of financial position after initial recognition. The quantitative disclosures required should be presented in a tabular format. The disclosures do not apply to the initial measurement of an asset or liability at fair value. For assets and liabilities that are measured at fair value in the statement of financial position after initial recognition, an NFP should disclose information to help users of its financial statements assess the valuation techniques and inputs used to develop those measurements. For recurring fair value measurements using significant unobservable inputs (level 3), an NFP should disclose information to help users assess the effects of the measurements on changes in net assets. To meet those objectives an NFP should consider all of the following, and disclose additional information necessary to meet the objectives:

- The level of detail necessary to satisfy the disclosure requirements
- How much emphasis to place on each of the various requirements
- How much aggregation or disaggregation to undertake
- Whether users of financial statements need additional information to evaluate the quantitative information disclosed

Certain of the disclosures in FASB ASC 820-10-50 apply only to public entities, including NFPs that are conduit bond obligors for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).

Fair Value Option

3.168 The “Fair Value Option” subsections of FASB ASC 825-10 permit an entity to irrevocably elect fair value as the initial and subsequent measure for many financial instruments and certain other items, with changes in fair value recognized in the statement of activities as those changes occur. Paragraphs 4–6 of FASB ASC 815-15-25 similarly permit an elective fair value re-measurement for any hybrid financial instrument that contains an embedded derivative, if that embedded derivative would otherwise have to be separated from its debt host contract in conformity with FASB ASC 815-15. An election is made on an instrument-by-instrument basis (with certain exceptions), generally when an instrument is initially recognized in the financial statements.

3.169 The “Fair Value Option” subsection of FASB ASC 825-10-15 describes the financial assets and liabilities for which the option is available. Most financial assets and financial liabilities are eligible to be recognized using the fair value option, as are firm commitments for financial instruments and certain nonfinancial contracts. Specifically excluded from eligibility are investments in other entities that are required to be consolidated, employer’s and plan’s obligations under postemployment, postretirement

plans, and deferred compensation arrangements (or assets representing overfunded positions in those plans), financial assets and liabilities recognized under leases, deposit liabilities of depository institutions, and financial instruments that are, in whole or in part, classified by the issuer as a component of shareholder's equity. Additionally, the election cannot be made for most nonfinancial assets and liabilities or for current or deferred income taxes.

- 3.170** FASB ASC 825-10-45 and FASB ASC 825-10-50 establish presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. Entities should report assets and liabilities that are measured using the fair value option in a manner that separates those reported fair values from the carrying amounts of similar assets and liabilities measured using another measurement attribute. To accomplish that, an entity should either (a) report the aggregate carrying amount for both fair value and nonfair value items on a single line, with the fair value amount parenthetically disclosed, or (b) present separate lines for the fair value carrying amounts and the nonfair value carrying amounts.

Financial Statement Disclosures Not Considered Elsewhere

- 3.171** Financial statement disclosures are generally discussed in this guide in connection with the specific financial statement items to which they pertain. This section discusses disclosures that are unique to NFPs and that are not discussed elsewhere in this guide.

Noncompliance With Donor-Imposed Restrictions

- 3.172** NFPs report amounts for each of three classes of net assets. Noncompliance with donor-imposed restrictions may result in net assets being reported other than in accordance with donor-imposed restrictions. If net assets are reported other than in accordance with donor-imposed restrictions, the financial statements are not presented in conformity with GAAP. Consistent with FASB ASC 958-205-45-2 and the conclusions in TIS section 6140.23, "Changing Net Asset Classifications Reported in a Prior Year" (AICPA, *Technical Practice Aids*), individual net asset classes, rather than net assets in the aggregate (total net assets), are relevant in determining whether an NFP's classifications in financial statements is appropriate. Further, paragraph 106 of FASB Concept No. 6, *Elements of Financial Statements*, states that because donor-imposed restrictions affect the types and levels of service an NFP can provide, whether an NFP has maintained certain classes of net assets may be more significant than whether it has maintained net assets in the aggregate.
- 3.173** An NFP may not be in compliance with donor-imposed restrictions, including requirements that it maintain an appropriate composition of assets (usually cash and marketable securities in amounts needed to comply with all donor restrictions). Such noncompliance could result in a material contingent liability, a material loss of future revenue, or could cause the NFP to be unable to continue as a going concern. FASB ASC

958-450-50-2 requires noncompliance with donor-imposed restrictions to be disclosed if either of the following is true: (a) there is a reasonable possibility that a material contingent liability has been incurred at the date of the financial statements, or (b) there is at least a reasonable possibility that the noncompliance could lead to a material loss of revenue or could cause an entity to be unable to continue as a going concern. If the noncompliance results from an NFP's failure to maintain an appropriate composition of assets in amounts needed to comply with all donor restrictions, the amounts and circumstances should be disclosed.

- 3.174** As discussed in paragraph 10.96 of this guide, noncompliance with donor-imposed restrictions may require accrual of a liability in conformity with FASB ASC 450-20. FASB ASC 450, *Contingencies*, provides further guidance for accruing and disclosing contingent liabilities. Paragraph .A21 of AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* (AICPA, *Professional Standards*), addresses the potential financial consequences of illegal acts that could lead to a material loss of revenue. AU-C section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*), contains broad guidance on disclosures when there is a substantial doubt about an entity's ability to continue as a going concern.

Risks and Uncertainties

- 3.175** FASB ASC 275, *Risks and Uncertainties*, requires entities to include in their financial statements information about the following:

- The nature of their operations
- Use of estimates in the preparation of financial statements

In addition, if specified disclosure criteria are met, it requires entities to include in their financial statements disclosures about the following:

- Certain significant estimates
- Current vulnerability due to certain concentrations

FASB ASC 958-605-55-70 includes an example of a vulnerability of concentration of risk because of reliance on major donors. FASB ASC 275-10-55 includes other examples of disclosures that may be pertinent for NFPs.

Subsequent Events

- 3.176** FASB ASC 855, *Subsequent Events*, establishes standards for accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. In accordance with FASB ASC 855-10-25, an NFP should recognize in the financial statements the effects of all subsequent events that

provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. An NFP should not recognize subsequent events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after the balance sheet date but before financial statements are issued or are available to be issued. Instead, nonrecognized subsequent events are disclosed if they are of such a nature that they must be disclosed to keep the financial statements from being misleading.

- 3.177** FASB ASC 855-10-50-1 requires the disclosure of the date through which an NFP has evaluated subsequent events and whether that date is the date the financial statements were issued or the date the financial statements were available to be issued. The FASB ASC glossary states that “Financial statements are considered issued when they are widely distributed to shareholders and other financial statement users for general use and reliance in a form and format that complies with GAAP.” The FASB ASC glossary also states that

Financial statements are considered available to be issued when they are complete in a form and format that complies with GAAP and all approvals necessary for issuance have been obtained, for example, from management, the board of directors, and/or significant shareholders. The process involved in creating and distributing the financial statements will vary depending on an entity’s management and corporate governance structure as well as statutory and regulatory requirements.

- 3.178** FASB ASC 855-10-25-1A requires that a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets) evaluate subsequent events through the date the financial statements are issued. All other entities should evaluate subsequent events through the date that the financial statements are available to be issued.
- 3.179** Because of their use of conduit debt that trades in public markets, some NFPs fall into the class of entities that are required to evaluate subsequent events through the issuance date of their financial statements. If an NFP does not have conduit debt that trades in a public market, it is required to evaluate subsequent events up through the date the financial statements are available to be issued.

Related Party Transactions

- 3.180** The FASB ASC glossary defines *related parties* as including the following:

- a. Affiliates of the entity (An *affiliate* is defined in the FASB ASC glossary as a party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an entity.)
- b. Entities for which investments in their equity securities would be required, absent the election of the fair value option under the “Fair Value Option” subsection of

FASB ASC 825–10–15, to be accounted for by the equity method by the investing entity

- c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management
- d. Principal owners of the entity and members of their immediate families
- e. Management of the entity and members of their immediate families
- f. Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests
- g. Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests

3.181 As noted in paragraph 2.35, disclosure of related party transactions is one of an NFP’s possible responses to regulators’ concerns about whether the governing board members of not-for-profit organizations are meeting their stewardship responsibilities. For purposes of applying the glossary’s definition of related parties for purposes of complying with the requirements of FASB ASC 850, related parties of NFPs might include, but are not limited to, the following:

- Officers, board members, founders, substantial contributors, and their immediate family members
- Members of any related party’s immediate family
- Parties providing concentrations in revenues and receivables
- Supporting organizations (such as 509[a][3] organizations)
- Financially interrelated entities
- Certain national and local affiliates that don’t necessarily meet the definition of affiliate in FASB ASC ^{fn8}

^{fn8} FASB ASC 850-10-20 defines an *affiliate* as "a party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an entity."

- Other entities whose officers, governing board members, owners, or employees are members of the NFP's governing board or senior management, if those individuals have significant influence to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests

3.182 NFPs should disclose the following:

- Material related party transactions, other than compensation arrangements, expense allowances, and other similar items in the ordinary course of business (FASB ASC 850-10-50-1)
- If the reporting entity and one or more other entities are under common ownership or management control and the existence of that control could result in operating results or financial position of the reporting entity that are significantly different from those that would have been obtained if the entities were autonomous, the nature of the control relationship should be disclosed even though there are no transactions between the entities (FASB ASC 850-10-50-6)

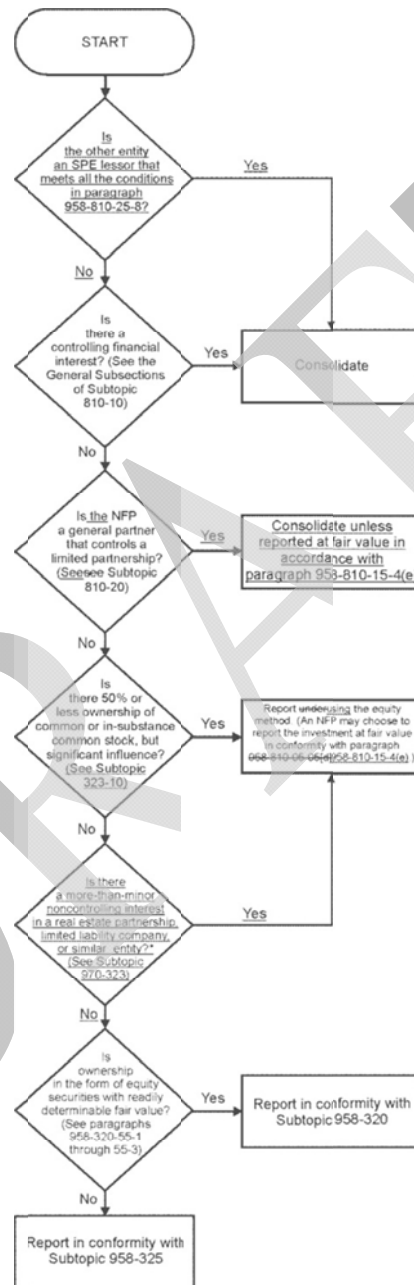
3.183 Examples of related party transactions and circumstances that may be required to be disclosed include but are not limited to the following:

- The NFP receives material contributions from related parties (disclosure required by FASB ASC 850-10-50-1). (FinREC believes the NFP need not identify by name the party making the contribution.)
- The NFP has significant concentrations of revenues and receivables from related parties (disclosure required by FASB ASC 850-10-50-1, in addition to disclosures about current vulnerability due to certain concentrations, as required by FASB ASC 275, which is discussed in paragraph 3.175. And in addition to required disclosures about significant concentrations of credit risk arising from all financial instruments, required by paragraphs 20–22 of FASB ASC 825-10-50, as discussed in paragraph 4.90).
- The NFP accepts obligations associated with contributions from related parties, such as gift annuities payable to related parties or environmental remediation liabilities associated with real estate donated by related parties (disclosures required by FASB ASC 850-10-50-1).
- The NFP is a religious organization that is commonly controlled by an ecclesiastical body (disclosures required by FASB ASC 850-10-50-6).
- The NFP leases office space from a governing board member (disclosures required by FASB ASC 850-10-50-1).

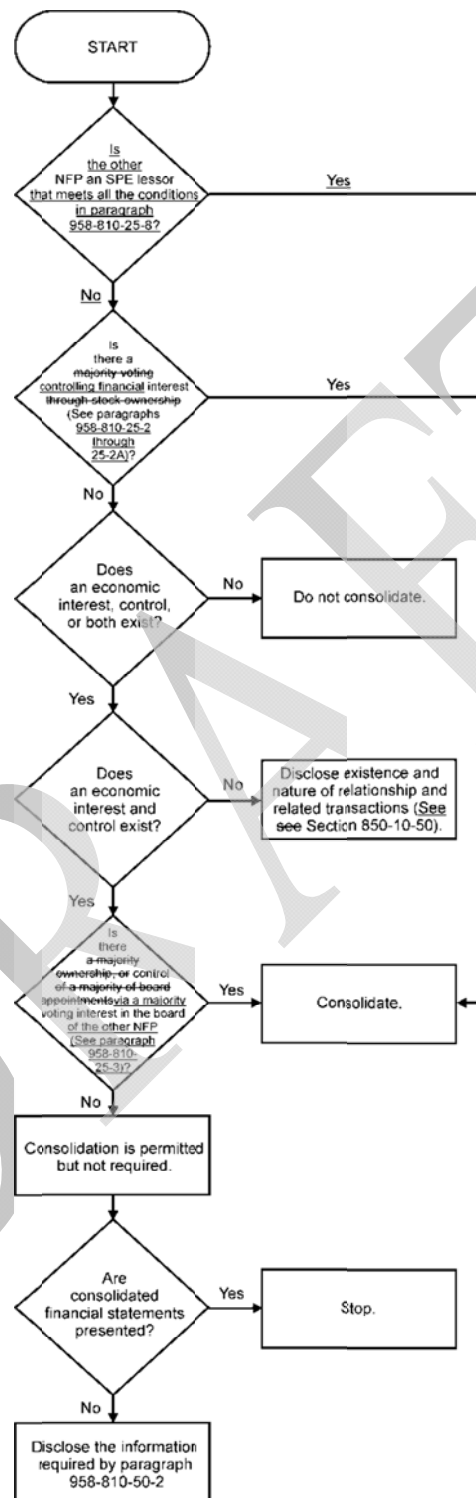
- The NFP uses legal services provided by a firm in which an officer's immediate family member is a person of influence, such as a partner (disclosures required by FASB ASC 850-10-50-1).
- The NFP purchases printing services from a printing shop owned by a governing board member of the NFP (disclosures required by FASB ASC 850-10-50-1).
- The NFP purchases supplies from a company for which one of the NFP's governing board members is a governing board member (disclosures required by FASB ASC 850-10-50-1).
- The NFP loans money to a founder or significant donor (disclosures required by FASB ASC 850-10-50-1).
- The NFP loans money to the spouse or immediate family member of a founder or significant donor (disclosures required by FASB ASC 850-10-50-1).
- A national NFP provides financial consulting to a local affiliate, either for a fee or for no fee (or one brother-sister organization provides consulting to another, either for a fee or for no fee) (disclosures required by FASB ASC 850-10-50-1 and FASB ASC 850-10-50-6).
- The NFP is a foundation established by a for-profit corporation and the foundation's bylaws provide that the for-profit corporation appoints the foundation's board (disclosures required by FASB ASC 850-10-50-1 and FASB ASC 850-10-50-6).
- The reporting NFP makes grants to an independent NFP whose executive director is a governing board member of the reporting NFP (disclosures required by FASB ASC 850-10-50-1).

Appendix A — Flowcharts

Ownership of a For-Profit Entity



Relationship With Another Not-for-Profit Entity



Chapter 4

Cash, Cash Equivalents, and Investments

Cash and Cash Equivalents

- 4.01** Like for-profit enterprises, not-for-profit entities (NFPs) hold cash balances to meet payments arising in the ordinary course of operations and payments for unanticipated contingencies. These balances may be held as cash or cash equivalents. Cash includes currency on hand and deposits held by financial institutions that can be added to or withdrawn without limitation, such as demand deposits. NFPs may invest excess cash in cash equivalents (such as Treasury bills, commercial paper, and money-market mutual funds) to earn greater returns.
- 4.02** The Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary defines *cash equivalents* as
- short-term, highly liquid investments that have both of the following characteristics: (a) readily convertible to known amounts of cash [and] (b) so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. Generally, only investments with original maturities of three months or less qualify under that definition. Original maturity means original maturity to the entity holding the investment. For example, both a three-month U.S. Treasury bill and a three-year Treasury note purchased three months from maturity qualify as cash equivalents. However, a Treasury note purchased three years ago does not become a cash equivalent when its remaining maturity is three months. Examples of items commonly considered to be cash equivalents are Treasury bills, commercial paper, money market funds, and federal funds sold (for an entity with banking operations).
- 4.03** Investments that would otherwise meet the preceding definition may not meet the definition of a cash equivalent if they are subject to donor restrictions, governing board designations, and other limitations on use. For example, NFPs may hold cash and cash equivalents of permanent endowment funds temporarily until suitable long-term investment opportunities are identified. As stated in FASB ASC 958-320-45-10 and illustrated in FASB ASC 958-205-55-7, that cash may be included in the classification *long-term investments* on a statement of financial position rather than as *cash*. The effects of donor restrictions, governing board designations, and other limitations on the classification of cash and cash equivalents are discussed further in paragraphs 3.09–.23 and 3.50. In addition, cash held temporarily by a custodian for investment purposes may be included as part of investments in a statement of financial position rather than as cash.
- 4.04** Some NFPs deposit funds with a related entity, such as a local organization depositing funds with its national headquarters or a church depositing funds with its denominational

body. The Financial Reporting Executive Committee (FinREC) believes that funds deposited by an NFP in a related entity's cash account under a centralized cash management arrangement generally would not be classified as cash and cash equivalents in the NFP's financial statements unless the NFP has legal title to the cash on deposit. Generally, legal title in a cash account is evidenced by the cash or cash equivalent being deposited in a demand deposit account at a bank or other financial institution in the NFP's name. An NFP's deposit in a cash pool generally is not a short-term highly-liquid investment, as contemplated in the definition of a *cash equivalent* in paragraph 4.02; rather, the deposit is considered a loan, and the NFP would classify the deposit in the cash pool as a receivable from a related entity.

Investments

- 4.05** NFPs acquire various kinds of investments by contribution or purchase. This chapter provides accounting and auditing guidance concerning the initial recognition and measurement, investment income and expenses, the measurement attributes used for subsequent valuation, unrealized and realized gains and losses, and financial statement display and disclosure. Many of the requirements under generally accepted accounting principles in these areas are the same as those for for-profit entities. Accordingly, this chapter focuses on those issues that are unique to NFPs.

Scope

- 4.06** This chapter does not discuss the standards for investments in consolidated subsidiaries. A requirement to consolidate precludes reporting an investment at fair value with one exception, which is discussed in paragraph 4.20. The standards for consolidation are discussed in chapter 3, "Financial Statements, the Reporting Entity, and General Financial Reporting Matters," because the investee is part of the reporting entity. NFPs can use exhibit 3-2, "Relationships of a Not-for-Profit Reporting Entity," to assist with the determination of which investees are required to be consolidated.
- 4.07** This chapter provides guidance about reporting investments. If an investment is in the form of an ownership interest in another entity, this chapter provides guidance if the objective is to invest in the entity for investment return (including an objective to realize current income, capital appreciation, or both) and the other entity is not required to be consolidated. If the interest is in an entity that provides goods or services that accomplish the purpose or mission for which the NFP exists or that serves the NFP's administrative purposes, the NFP would follow the guidance in chapter 3.
- 4.08** When an interest in another entity is owned with the objective of investment return, FinREC believes that often the investee is a for-profit entity. An investee owned with the objective of investment return typically would not meet the FASB ASC glossary definition of an NFP (see paragraph 1.01). The investee typically provides lower costs or other economic benefits directly and proportionally to its owners, members or participants, or it has ownership interests, or both.

- 4.09** Although the valuation (measurement) guidance in this chapter applies to investments held by the NFP as trustee or other fiscal agent under a split-interest agreement, reporting the changes in valuation and reporting investment income earned on those split-interest gifts, including investments held in trust by others, are discussed more fully in chapter 6, "Split-Interest Agreements and Beneficial Interests in Trusts."
- 4.10** Investments that are made with a primary purpose of furthering the mission-related objectives of the NFP rather than the production of current income or capital appreciation are discussed in chapter 8, "Programmatic Investments."

Initial Recognition and Measurement of Investments

- 4.11** Pursuant to FASB ASC 958-320-30-1 and FASB ASC 958-325-30-1, investments included within the scope of FASB ASC 958-320 and FASB ASC 958-325 are initially measured at their acquisition cost (including brokerage and other transaction fees) if they are purchased and are initially measured at fair value if they are received as a contribution or through an agency transaction. Pursuant to FASB ASC 815-10-30, all derivative instruments are measured initially at fair value. Investments that are accounted for under the equity method generally are measured initially at cost pursuant to FASB ASC 323-10-30, although FASB ASC 970-323-30 provides more specific guidance for real estate ventures, and FASB ASC 323-10-30-2 requires initial measurement at fair value for a retained investment in the common stock of an investee (including a joint venture) in a deconsolidation transaction.
- 4.12** Paragraphs 3.137–.167 discuss FASB ASC 820, *Fair Value Measurement*, which defines *fair value*, establishes a framework for measuring fair value, and requires disclosures about fair value measurements.

Valuation of Investments Subsequent to Acquisition

- 4.13** For purposes of the discussion of subsequent measurement, investments are divided into the following four broad categories:
- Investments in equity securities with readily determinable fair values (other than consolidated subsidiaries and equity securities reported under the equity method) and all investments in debt securities, which are investments that are subject to the requirements of FASB ASC 958-320.
 - Investments that are accounted for under the equity method, which are investments that are subject to the requirements of FASB ASC 323-10, FASB ASC 323-30, and FASB ASC 970-323, including certain investments in common stock, partnerships, limited liability partnerships, and limited liability corporations.

- Investments in derivative instruments that are subject to the requirements of FASB ASC 815, *Derivatives and Hedging*. If an investment would otherwise be in the scope of FASB ASC 958-320 and it has within it an embedded derivative that is subject to FASB ASC 815, the host contract (as described in FASB ASC 815-15-05-1) remains within the scope of FASB ASC 958-320.
 - Other investments, which are those included in the scope of FASB ASC 958-325. Those investments include, among others, certain investments in real estate, mortgage notes that are not debt securities, venture capital funds, certain partnership interests, oil and gas interests, and certain equity securities that do not have a readily determinable fair value. Other investments do not include investments described in the preceding three bullets or investments in consolidated subsidiaries.
- 4.14** Exhibit 4-1, “Investments of a Not-for-Profit Reporting Entity,” describes some common investments and identifies where they are discussed in this chapter and in FASB ASC. Exhibit 4-1 and this chapter summarize certain guidance in FASB ASC but are not a substitute for reading the guidance itself.
- 4.15** NFPs can choose to report certain investments at fair value under the following elections:
- An NFP may elect to report “other investments” at fair value in accordance with FASB ASC 958-325-35. That election requires that the same measurement attribute be used for all “other investments” excluding those for which the NFP chose, at a specified election date, to measure at fair value pursuant to FASB ASC 815-15-25 or the “Fair Value Option” subsections of FASB ASC 825-10. The election applies to the investments described in FASB ASC 958-325-15.
 - An NFP may elect to measure an investee entity at fair value pursuant to the “Fair Value Option” subsections of FASB ASC 825-10. That election can be made only at the specified election dates described in paragraphs 4–5 of FASB ASC 825-10-25 and apply only to the financial instruments described in paragraphs 4–5 of FASB ASC 825-10-15.
- 4.16** Because there is industry-specific guidance for other investments in FASB ASC 958-325-35, an NFP cannot use by analogy the guidance in FASB ASC 970, *Real Estate—General*, for partnerships that are owned with the objective of total return (that is, as an investment). An NFP uses the guidance in FASB ASC 970 for investments only as required by FASB ASC 958-810-15-4(d); that is, only for a noncontrolling interest in a for-profit real estate partnership, limited liability company, or similar entity that constitutes more than a minor interest, and then only if the NFP has not elected to report that investment at fair value. (However, if the partnership is not held for investment, such as a partnership that provides goods or services that accomplish the purpose or mission for which the NFP exists or that serves the NFP’s administrative purposes, the NFP may be permitted to analogize to FASB ASC 970, as discussed in chapter 3.)

Exhibit 4-1

Investments of a Not-for-Profit Reporting Entity^a

Relationship	Financial Accounting Standards Board (FASB) <i>Accounting Standards Codification</i> (ASC) Reference	Discussion in This Chapter
<i>Relationships With Entities Held for Investment</i>		
The reporting entity owns 50 percent or less of the common voting stock of an investee and the reporting entity neither controls nor can exercise significant influence over the investee's operating and financial policies. The stock is an equity security that has a readily determinable fair value.	FASB ASC 958-320-35-1	Paragraph 4.17
The reporting entity owns 50 percent or less of the common voting stock of an investee and the reporting entity neither controls nor can exercise significant influence over the investee's operating and financial policies. The stock does not have a readily determinable fair value.	FASB ASC 958-325-35	Paragraph 4.37
The reporting entity owns debt securities that are not derivative instruments.	FASB ASC 958-320-35-1	Paragraph 4.17
The reporting entity owns 50 percent or less of the common voting stock of an investee and can exercise significant influence over the investee's operating and financial policies.	If the reporting entity elects to report such interests at fair value, ^b measure at fair value, If the reporting entity elects to report "other investments" at cost or lower of cost or market, use the equity method of accounting in accordance with FASB ASC 323-10.	Paragraphs 4.18–.19

Relationship	Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Reference	Discussion in This Chapter
<p>The reporting entity is the general partner of a for-profit limited partnership or similar entity, such as a limited liability company that has governing provisions that are the functional equivalent of a limited partnership.</p>	<p>If the not-for-profit entity has made an election to use fair value for all “other investments,” in accordance with FASB ASC 958-325-35, the interest is reported at fair value. Otherwise, use the guidance in FASB ASC 810-20 to determine whether the general partner within the group controls and, therefore, should consolidate the limited partnership or similar entity. If not required to consolidate, use the equity method as required by FASB ASC 810-20-25 unless the partnership interest is reported at fair value in conformity with the “Fair Value Option” sections of FASB 825-10.</p>	<p>Paragraphs 4.20–.22</p>
<p>The reporting entity is a limited partner of a for-profit limited partnership or similar entity that is engaged in activities other than real estate activities.</p>	<p>FASB ASC 958-325-35</p>	<p>Paragraphs 4.23–.25 and 4.37</p>
<p>The reporting entity has an interest in a limited liability company.</p>	<p>Apply the guidance in FASB ASC 323-30-35-3 to determine whether the limited liability company should be viewed as similar to a partnership, as opposed to a corporation, for purposes of determining whether noncontrolling interests in a limited liability company or a similar entity should be accounted for in accordance with FASB ASC 970-323 or FASB ASC 323-10.</p>	<p>Paragraphs 4.26–.27</p>
<p>The reporting entity has a noncontrolling interest that constitutes <i>more than</i> a minor interest in a for-profit partnership, limited liability entity, or similar entity engaged in real estate activities.</p>	<p>If the reporting entity elects to report such interests at fair value,^b measure at fair value. If the reporting entity elects to report “other investments” at cost or lower of cost or market, use the equity method in accordance with the guidance in FASB ASC 970-323.</p>	<p>Paragraphs 4.23–.25</p>

Relationship	Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Reference	Discussion in This Chapter
The reporting entity holds more than 50 percent of the total partnership interest in a limited partnership engaged in real estate activities.	FASB ASC 958-325-35	Paragraph 4.37
The reporting entity has a noncontrolling interest that constitutes a minor interest in a for-profit partnership, limited liability entity, or similar entity engaged in real estate activities.	FASB ASC 958-325-35	Paragraph 4.37
The reporting entity has an interest in a general partnership.	FASB ASC 958-325-35	Paragraph 4.37
The reporting entity holds derivative instruments that are within the scope of FASB ASC 815.	FASB ASC 815	Paragraphs 4.28–.36
The reporting entity has an interest in an investment pool.		Paragraphs 4.57–.63
<p>^a As discussed in paragraph 4.07, the guidance in this exhibit applies when an ownership interest in another entity is an investment. See exhibit 3-2 for relationships with entities that provide goods or services that accomplish the purpose or mission for which the not-for-profit entity (NFP) exists or that serve the NFP’s administrative purposes.</p> <p>^b The election to report at fair value refers to the election to report “other investments” at fair value in accordance with FASB ASC 958-325-35 or the election pursuant to the “Fair Value Option” subsections of FASB ASC 825-10. As discussed in paragraph 4.15, the scope sections of those subtopics indicate the types of investments for which the elections are available.</p>		

Equity Securities With Readily Determinable Fair Value (Other Than Consolidated Subsidiaries and Equity Securities Reported Under the Equity Method) and All Debt Securities

- 4.17** FASB ASC 958-320-35-1 requires that investments in equity securities with readily determinable fair value and all investments in debt securities be measured at fair value in the statement of financial position. FASB ASC 958-320 does not apply to the investments described in FASB ASC 958-320-15-3, including investments in consolidated subsidiaries and investments required to be accounted for by the equity method.

Investments That Are Accounted for Under the Equity Method or a Fair Value Election

Investments in Common Stock and In-Substance Common Stock

- 4.18** Investments in common stock and in-substance common stock of for-profit entities should be reported under the equity method if required by FASB ASC 323-10. FASB ASC 323-10 requires that the equity method of accounting be used if investments in common stock or in-substance common stock (or both common stock and in-substance common stock), including investments in common stock of joint ventures, give the investor the ability to exercise significant influence over operating and financial policies of an investee, even though the investor holds 50 percent or less of the common stock or in-substance common stock (or both common stock and in-substance common stock). (For additional information, see paragraphs 3.75–.77.) However, NFPs that choose to report all “other investments” at fair value in conformity with FASB ASC 958-325-35 (paragraph 4.37) or that make an election to report an investment at fair value pursuant to the “Fair Value Option” subsections of FASB ASC 825-10 may do so instead of applying the equity method of accounting to investments covered by this paragraph.
- 4.19** The FASB ASC glossary defines *in-substance common stock* as an investment in an entity that has risk and reward characteristics that are substantially similar to that entity's common stock. The characteristics of in-substance common stock are discussed in paragraphs 13–14 of FASB ASC 323-10-15. Paragraphs 1–18 of FASB ASC 323-10-55 provide examples applying the characteristics to various investments.

Limited Partnerships and Similar Entities

- 4.20** If the NFP is the general partner of a limited partnership or similar entity (such as a limited liability company that has governing provisions that are the functional equivalent of a limited partnership) and the NFP has elected to report all “other investments” at fair value in accordance with FASB ASC 958-325-35, the interest is reported at fair value. In other words, in this situation only, the industry-specific guidance in FASB ASC 958-325-35 is applied rather than the general requirement to consolidate.
- 4.21** If, instead, the NFP is the general partner of a limited partnership or similar entity and has not elected to report all “other investments” at fair value in accordance with FASB ASC 958-325-35, FASB ASC 810-20 requires consolidation unless the general partner does not control the limited partnership. For example, the general partner might not control a limited partnership in either of the two following circumstances:
- The limited partners have the substantive ability to dissolve the partnership or otherwise remove the general partner without cause (referred to as substantive kick-out rights, which are further defined in paragraphs 8–10 of FASB ASC 810-20-25).
 - The limited partners have the ability to effectively participate in significant decisions that would be expected to be made in the ordinary course of the limited partnership's business (referred to as participating rights).

If the limited partners have substantive kick-out rights or participating rights, the NFP that is the general partner would account for its investment using the equity method unless the general partnership interest is reported at fair value in conformity with the “Fair Value Option” subsections of FASB ASC 825-10. (For additional information, see paragraphs 3.80–.82 and 3.86–.88.)

- 4.22** For example, NFP A forms a for-profit limited partnership with NFP B and NFP C to acquire a building that none of the founding NFPs will use in a mission-related activity; rather, the building will be used to generate current income and, eventually, capital appreciation. NFP A is the general partner. It is NFP A’s policy to report all “other investments” at fair value in accordance with FASB ASC 958-325-35. Because NFP A has that policy, it reports its general partner interest at fair value. If NFP A did not have that policy, it would consolidate the limited partnership per FASB ASC 810-20, unless the presumption of control is overcome by the rights of the limited partners. If NFP B or NFP C has substantive kick-out or participating rights, the presumption of control is overcome, and the NFP A would report its interest using the equity method; however, NFP A may report that investment at fair value in conformity with the “Fair Value Option” subsections of FASB ASC 825-10, as an alternative to the equity method.
- 4.23** If the NFP is a limited partner in a limited partnership or similar entity and has elected to report all “other investments” at fair value in accordance with FASB ASC 958-325-35, the limited partnership interest is reported at fair value.
- 4.24** If the NFP is a limited partner in a limited partnership or similar entity and has not elected to report all “other investments” at fair value in accordance with FASB ASC 958-325-35, the accounting depends upon the type of activities conducted by the limited partnership. If the limited partnership is engaged in real estate activities, refer to the standards discussed in paragraphs 3.91–.94. If the limited partnership is engaged in activities other than real estate, the limited partnership interest is an “other investment” to be accounted for at cost or lower or cost or market in accordance with FASB ASC 958-325-35; however, an NFP that is a limited partner may report that investment at fair value in conformity with the “Fair Value Option” subsections of FASB ASC 825-10 without jeopardizing the requirement to use the same measurement attribute for all “other investments.” (Reporting “other investments” is discussed more fully in paragraph 4.37.)
- 4.25** The NFP invests in Private Equity LLP. NFP is a 10 percent limited partner. The limited partnership interest is an “other investment” within the scope of FASB ASC 958-325. Because of that guidance, NFP cannot analogize to the guidance for noncontrolling interests in limited partnerships engaged in real estate activities. NFP uses the guidance in FASB ASC 958-325-35 and reports at either fair value or cost or lower of cost or market, depending on its policy for reporting all “other investments.” Alternatively, an NFP that is a limited partner may report that investment at fair value in conformity with the “Fair Value Option” subsections of FASB ASC 825-10 without jeopardizing the requirement to use the same measurement attribute for all “other investments.” (Reporting “other investments” is discussed more fully in paragraph 4.37.)

- 4.26** If the investment is in a limited liability company, FASB ASC 958-810-15-4(d) states that an NFP should apply the guidance in FASB ASC 323-30-35-3 to determine whether a limited liability company should be viewed as similar to a partnership, as opposed to a corporation, for purposes of determining whether noncontrolling interests should be accounted for in accordance with FASB ASC 970-323 or FASB ASC 323-10. FASB ASC 323-30-35-3 states that if a limited liability company maintains a specific ownership account for each investor—similar to a partnership capital account structure—it should be viewed as similar to an investment in a limited partnership.
- 4.27** If the investment in the limited liability company is viewed as similar to an investment in a limited partnership and the NFP is a general partner, see paragraphs 4.20–.22. If similar to an investment in a limited partnership and the NFP is a limited partner, see paragraphs 4.23–.25. If, instead, the investment in the limited liability company is viewed as similar to an investment in a corporation, then the NFP would use the standards in FASB ASC 810-10 (which are discussed in paragraphs 3.72–.74) to determine if the interest is a controlling interest that should be consolidated. If it is not a controlling interest, then the guidance in FASB ASC 323-10 would be used to determine if the noncontrolling interest should be reported by the equity method (as discussed in paragraphs 4.18–.19). If the entity is not required to be reported by the equity method, then the standards in FASB ASC 958-320-35 apply if the interest is an equity security with a readily determinable fair value; if it is not, the standards in FASB ASC 958-325-35 apply. An NFP that has a noncontrolling interest in a limited liability company may report that investment at fair value in conformity with the “Fair Value Option” subsections of FASB ASC 825-10 without jeopardizing the requirement to use the same measurement attribute for all “other investments.” (Reporting “other investments” is discussed more fully in paragraph 4.37.)

Derivative Instruments

- 4.28** Options, futures, forwards, and swaps are common examples of derivative instruments. Investments in convertible debt securities are an example of an instrument with an embedded derivative. Unique to NFPs are embedded derivatives related to certain split interest agreements, as discussed in paragraphs 6.34–.39. Accounting and reporting of investments in derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives), is subject to the requirements of FASB ASC 815. A brief summary of FASB ASC 815 is provided in this chapter but is not a substitute for the reading FASB ASC 815.
- 4.29** Paragraphs 83–139 of FASB ASC 815-10-15 define a *derivative financial instrument*. FASB ASC 815-10-15-83 states that a *derivative instrument* is a financial instrument or other contract with all of the following characteristics:
- a. Underlying, notional amount, payment provision. The contract has both of the following terms, which determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required:

- i. One or more underlyings and
 - ii. One or more notional amounts or payment provisions, or both.
 - b. Initial net investment. The contract requires no initial net investment or an initial investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
 - c. Net settlement. The contract can be settled net by any of the following means:
 - i. Its terms implicitly or explicitly require or permit net settlement,
 - ii. It can readily be settled net by a means outside the contract, or
 - iii. It provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.
- 4.30** The FASB ASC glossary defines an *underlying* as a variable that, along with either a notional amount or a payment provision, determines the settlement of a derivative instrument. Per paragraphs 88–89 of FASB ASC 815-10-15, an underlying usually is one or a combination of the following:
- a. A security price or security price index
 - b. A commodity price or commodity price index
 - c. An interest rate or interest rate index
 - d. A credit rating or credit index
 - e. An exchange rate or exchange rate index
 - f. An insurance index or catastrophe loss index
 - g. A climatic or geological condition (such as temperature, earthquake severity, or rainfall), another physical variable, or a related index
 - h. The occurrence or nonoccurrence of a specified event (such as a scheduled payment under a contract)

However, an underlying may be any variable whose changes are observable or otherwise objectively verifiable. An underlying may be a price or rate of an asset or liability but is not the asset or liability itself.

- 4.31** The FASB ASC glossary defines a *notional amount* as a number of currency units, shares, bushels, pounds, or other units specified in a derivative instrument. Sometimes other names are used. For example, the notional amount is called a *face amount* in some

contracts. Per FASB ASC 815-10-15-92, the settlement of a derivative instrument with a notional amount is determined by interaction of that notional amount with the underlying. The interaction may be simple multiplication, or it may involve a formula with leverage factors or other constants. The FASB ASC glossary states that a *payment provision* specifies a fixed or determinable settlement to be made if the underlying behaves in a specified manner.

4.32 FASB ASC 815-10-05-4 explains that an entity should recognize derivative instruments, including certain derivative instruments embedded in other contracts, as assets or liabilities in the statement of financial position and measure them at fair value. If certain conditions are met, an entity may elect, under FASB ASC 815, to designate a derivative instrument in any one of the following ways:

- a. A hedge of the exposure to changes in the fair value of a recognized asset or liability or of an unrecognized firm commitment that are attributable to a particular risk (referred to as a fair value hedge)
- b. A hedge of the exposure to variability in the cash flows of a recognized asset or liability, or of a forecasted transaction, that is attributable to a particular risk (referred to as a cash flow hedge)
- c. A hedge of the foreign currency exposure of any one of the following:
 - i. An unrecognized firm commitment (a foreign currency fair value hedge)
 - ii. An available-for-sale security (a foreign currency fair value hedge)
 - iii. A forecasted transaction (a foreign currency cash flow hedge)
 - iv. A net investment in a foreign operation

FASB ASC 815-30-15-2 states that NFPs and other entities that do not report earnings are not permitted to use cash flow hedge accounting because they do not report earnings separately. Cash flow hedge accounting is not discussed in the guide because most NFPs do not take advantage of the specialized accounting for hedging.

4.33 FASB ASC 815-10-25-1 and FASB ASC 815-10-35-1 require that investments in derivative instruments be reported as either assets or liabilities depending on the rights or obligations under the contracts and should be subsequently remeasured at fair value. Similarly, an embedded derivative shall be separated from the host contract and accounted for as a derivative instrument pursuant to FASB ASC 815-10 if and only if all of the criteria in FASB ASC 815-15-25-1 are met.

4.34 The accounting for changes in the fair value of a derivative (that is, gains and losses) depends on the intended use of the derivative and the resulting designation. The changes

in fair value of derivative instruments or hedged items are classified as unrestricted unless their use is temporarily or permanently restricted by donors or by law.^{fn1}

- 4.35** FASB ASC 815-10-35-3 states that an NFP should recognize the gain or loss on a derivative instrument as a change in net assets in the period of change unless the derivative instrument qualifies for the specialized accounting for a fair value hedge or a hedge of the foreign currency exposure of a net investment in a foreign operation.
- 4.36** One of the most common uses of derivatives by NFPs is a variable rate debt with a variable-to-fixed interest rate swap, which is a *cash flow hedge*. Cash flow hedge accounting is not available to NFPs in accordance with FASB ASC 815-30-15-2. Therefore, as required by FASB ASC 815-10-35-1, a variable-to-fixed rate swap should be recorded as either an asset or liability and the changes in its fair value recorded in unrestricted net assets in the period in which the change in value occurs. As noted in FASB ASC 815-10-45-8, FASB ASC 815 does not provide guidance about the classification in the statement of activities of a derivative instrument's gains or losses. As a result, the change in the fair value of the derivative instrument and payments to or receipts from the counterparty to the swap might be classified as interest expense, other income, general and administrative expense, other losses, or an expense that is allocated among the functional expense categories similar to interest expense. The variable rate debt should be reported in subsequent periods using the interest method in FASB ASC 835-30-35, and its carrying value should not be changed by any gains or losses on the derivative instrument, in accordance with FASB ASC 815-10-35-3. Payments at the variable rate on the debt are interest expense and should be allocated among the functional expense categories. Disclosures about this interest rate swap are required by FASB ASC 815-10-50.

Other Investments

- 4.37** Other investments are described in paragraph 4.13. FASB ASC 958-325-35 provides the standards for subsequent measurement of other investments held by NFPs. Guidance concerning the carrying amounts of other investments subsequent to acquisition differs depending upon the type of NFP, as follows:
- Per paragraphs 1–2 of FASB ASC 958-325-35, institutions of higher education, including colleges, universities, and community or junior colleges, should subsequently report other investments at either of the following measures: (a) current market value or fair value or (b) carrying value (that is, those that were acquired by purchase are reported at cost and those that were contributed other

^{fn 1} Paragraph 4.83 discusses an alternative accounting policy for circumstances in which temporary restrictions on investment income and gains are met in the same period in which they are recognized.

investments are reported at their fair value at the date of the gift). However, the carrying value should be adjusted if there has been an impairment of value that is not considered to be temporary. The same measurement attribute should be used for all other investments excluding those for which the institution chose, at a specified election date, to measure at fair value pursuant to FASB ASC 815-15-25 or the “Fair Value Option” subsections of FASB ASC 825-10. (For more information about the election to report at fair value, see paragraphs 3.168–.170.) Investments in wasting assets are usually reported net of an allowance for depreciation or depletion if reported at carrying value.

- Per paragraphs 3–4 of FASB ASC 958-325-35, voluntary health and welfare entities should report other investments at either of the following measures: (a) carrying value (that is, cost if purchased and fair value at the date of the contribution if contributed) or (b) market value. The same measurement attribute should be used for all other investments excluding those for which the voluntary health and welfare entity chose, at a specified election date, to measure at fair value pursuant to FASB ASC 815-15-25 or the “Fair Value Option” subsections of FASB ASC 825-10. (For more information about the election to report at fair value, see paragraphs 3.168–.170.) If other investments are not equity securities and the market value of the portfolio of those investments is below the recorded amount, it may be necessary to reduce the carrying amount of the portfolio to market or to provide an allowance for decline in market value. If it can reasonably be expected that the voluntary health and welfare entity will suffer a loss on the disposition of an investment, an impairment loss should be recognized in the period in which the decline in value occurs.
- Per paragraphs 6–7 of FASB ASC 958-325-35, NFPs that are not colleges, universities, voluntary health and welfare entities, or health care entities should report other investments using one of the following measures: (a) fair value or (b) the lower of cost or fair value. The same measurement attribute should be used for all other investments excluding those for which the NFP chose, at a specified election date, to measure at fair value pursuant to FASB ASC 815-15-25 or the “Fair Value Option” subsections of FASB ASC 825-10. (For more information about the election to report at fair value, see paragraphs 3.168–.170.) If other investments are not equity securities and are carried at the lower of cost or market value, declines in the value of those investments should be recognized if their aggregate market value is less than their carrying amount, recoveries of aggregate market value in subsequent periods should be recorded in those periods subject only to the limitation that the carrying amount should not exceed the original cost.
- Notwithstanding the preceding bullet points, if other investments are equity securities that are reported at cost (carrying value), all NFPs, regardless of type, should apply paragraphs 8–13 of FASB ASC 958-325-35 to determine if an impairment loss should be recognized. In conformity with FASB ASC 320-10-35-17, NFPs do not apply tests for other-than-temporary impairment to debt

securities unless the NFP reports a performance indicator as defined in FASB ASC 954-205-45 (health care entities).

Decline in Fair Value After the Date of the Financial Statements

- 4.38** FASB ASC 855-10-55-2 states that changes in the fair value of assets or liabilities (financial or nonfinancial) after the balance sheet date but before the financial statements are issued or are available to be issued should not be recognized as of the reporting date. Some nonrecognized subsequent events may be of such a nature that they must be disclosed to keep the financial statements from being misleading. For such events, FASB ASC 855-10-50-2 requires that an NFP disclose the nature of the event and an estimate of its financial effect (or a statement that such an estimate cannot be made).

Fair Value Measurements

- 4.39** FASB ASC 820 defines *fair value*, establishes a framework for measuring fair value, and requires disclosures about fair value measurements. Paragraphs 3.137–.167 summarize FASB ASC 820 but are not a substitute for reading FASB ASC 820 itself.
- 4.40** For many investments held by NFPs, quoted prices for identical investments are available in active markets at the measurement date (level 1 inputs). For investments without quoted prices in active markets, quoted prices for similar investments in active markets or quoted prices for identical or similar assets in markets that are not active (level 2 inputs) may need to be used, possibly with adjustments. For example, U.S. Treasury securities trade at what is called “on the run” and “off the run.” A recently issued U.S. Treasury security will trade “on the run” for a period of time after issuance and can be measured using a quoted price in an active market at the measurement date (level 1). If, after the U.S. Treasury issues new securities of the same duration, investors stop trading the earlier issue and start trading in the newer issue, the market for the earlier issues (referred to as “off the run”) become inactive. A common way to price off-the-run U.S. Treasury securities is by using the yield curves on the newer issues (that is, level 2 inputs). Unobservable inputs (level 3) are used to measure fair value to the extent that observable inputs are not available.
- 4.41** FASB ASC 820-10-35-44 states that if an NFP holds a position in a single investment and the investment is traded in an active market, the fair value of the investment should be measured within Level 1 as the product of the quoted price for an individual investment and the quantity held by the NFP. That is the case even if a market’s normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price. In other words, the quoted price should not be adjusted because of the size of the position relative to trading volume (blockage factor). As noted in FASB ASC 820-10-35-36B, a blockage factor that adjusts because of the size of the investor’s position relative to trading volume is not permitted in a fair value measurement.

- 4.42** Some NFPs invest in alternative investments, such as hedge funds, private equity funds, real estate funds, venture capital funds, offshore fund vehicles, and funds of funds, that provide their investors with a net asset value per share (or its equivalent such as member units or an ownership interest in partners' capital to which a proportionate share of net assets is attributed). If those investments do not have readily determinable fair values and they have a net asset value that has been calculated in a manner consistent with FASB ASC 946, *Financial Services—Investment Companies*, paragraphs 59–62 of FASB ASC 820-10-35 permit a reporting entity, as a practical expedient, to estimate the fair value of an investment within the scope of paragraphs 4–5 of FASB ASC 820-10-15 using the net asset value per share (or its equivalent, such as member units or an ownership interest in partners' capital to which a proportionate share of net assets is attributed) of the investment, if the net asset value per share of the investment (or its equivalent) is calculated in a manner consistent with the measurement principles of FASB ASC 946 as of the reporting entity's measurement date. An NFP is not permitted to estimate the fair value of an investment using the net asset value per share of the investment (or its equivalent) as a practical expedient if, as of the measurement date, it is probable that the NFP will sell the investment for an amount different from the net asset value per share (or its equivalent). A sale is considered probable only if all of the criteria in FASB ASC 820-10-35-62 have been met as of the measurement date. FASB ASC 820-10-50-6A requires certain disclosures for these investments, regardless of whether net asset value is used as a practical expedient.
- 4.43** Technical Questions and Answers (TIS) sections 2220.18–.26 (AICPA, *Technical Practice Aids*) are intended to assist reporting entities in applying the provisions of FASB ASC 820 discussed in the preceding paragraph. TIS section 2220.27, “Determining Fair Value of Investments When the Practical Expedient Is Not Used or Is Not Available” (AICPA, *Technical Practice Aids*), assists reporting entities in determining the fair value of investments in circumstances in which the practical expedient (net asset value) is not used or is not available. TIS sections 2220.18–.27 are reproduced in appendix A of this chapter.

Investment Income and Expenses

- 4.44** Investment revenue, which is often referred to as investment income, includes dividends, interest, rents, royalties, and similar payments on assets held as investments. Per FASB ASC 958-320-45-2, dividend, interest, and other investment income should be reported in the period earned as increases in unrestricted net assets unless the use of the assets received is limited by donor-imposed restrictions. Donor restricted investment income should be reported as an increase in temporarily restricted net assets or permanently restricted net assets, depending on the type of restriction.^{fn 2}

^{fn 2} See footnote 1.

- 4.45** For example, if there are no donor-imposed restrictions on the use of the income, it should be reported as an increase in unrestricted net assets. On the other hand, a donor may stipulate that a gift be invested in perpetuity with the income to be used to support the NFP without restriction or to support a specified program or capital expenditure. The initial gift creates permanently restricted net assets. Unless the NFP elects the alternative accounting policy described in paragraph 4.83 or there is a donor's explicit restriction to the contrary, the investment income of a donor-restricted endowment fund increases temporarily restricted net assets. As discussed further in paragraphs 4.70–.71, the income and gains of a donor-restricted endowment fund are temporarily restricted (time restricted) until appropriated for expenditure, and are also purpose restricted if the donor specified the income be used for support of a donor-specified program or capital expenditure.
- 4.46** FASB ASC 958-225-45-14 specifies that a statement of activities should report the gross amounts of revenues and expenses. It also notes, however, that investment revenues may be reported net of related expenses, such as custodial fees and internal and external investment advisory costs, provided that the amount of the expenses is disclosed either in the statement of activities or in notes to financial statements.
- 4.47** FinREC observes diversity in the types of costs that have been included as related expenses, which are referred to herein as investment expenses. Investment expenses include, but are not limited to, the costs of the following activities if conducted by the NFP or directly on its behalf:
- Investment advice (includes advice provided by employees as well as third parties)
 - Investment acquisition due diligence
 - Custodian services
 - Other administrative activities in connection with investments
 - Other professional services in connection with investment activities, such as legal and accounting services
 - Interim and year-end monitoring
 - Valuation procedures and processes
- 4.48** In some circumstances, NFPs have investments that involve several layers of activity. FinREC recommends that an NFP include in investment expenses only the costs of activities conducted by the NFP or directly on its behalf to generate an investment return. Accordingly, if activities in the preceding list are conducted by or on behalf of entities in which the NFP invests, the costs of those activities generally would not be included in investment expense.

- 4.49** For example, assume an NFP provides money to Hedge Fund, a limited partnership, in exchange for a limited partnership interest. The NFP pays a 2 percent advisory fee to Broker for identifying and recommending Hedge Fund. Further, assume Hedge Fund Manager, the General Partner of Hedge Fund, receives as compensation from Hedge Fund 2 percent of average assets managed, plus a performance fee of 20 percent of the total return of Hedge Fund; and that the compensation is deducted from Hedge Fund's returns before remitting amounts to the limited partners. Hedge Fund invests in a mix of investments that includes several other hedge funds, publicly traded equity securities, private equity securities, publicly traded debt, and real estate partnerships. Some of the entities in which Hedge Fund invests conduct investment activities as described in paragraph 4.47. The NFP may or may not be aware of such activities and their costs, which may be (a) remitted as discrete amounts from 1 entity to another or (b) embedded in total return on investment and therefore deducted (with or without disclosure of amounts) before remitting returns to the investor. The NFP would report as investment expense only the amounts it pays directly—that is, the 2 percent advisory fee paid to Broker. None of the other amounts in this example would be reported by the NFP as investment expense.
- 4.50** As another example, assume an NFP hires a Money Manager to manage the NFP's investments. The NFP directly pays Money Manager as compensation 2 percent of average assets managed, plus a performance fee of 20 percent of the total return on investments managed. In addition, Money Manager charges the NFP custodial fees and other administrative charges in connection with the activities that Money Manager conducts to generate an investment return for NFP. Money Manager invests the NFP's money in a mix of investments that includes several hedge funds, publicly traded equity securities, private equity securities, publicly traded debt, and real estate partnerships. Some of the entities in which Money Manager invests conduct investment activities as described in paragraph 4.47. The NFP may or may not be aware of such activities and their costs, which may be (a) remitted as discrete amounts from 1 entity to another or (b) embedded in total return on investment and therefore deducted (with or without disclosure of amounts) before remitting returns to Money Manager. The NFP would report as investment expense the amounts paid to Money Manager as compensation (that is, 2 percent of average assets managed; the performance fee of 20 percent of the total return on investments managed) and custodial fees and other administrative charges paid to Money Manager in connection with activities Money Manager conducts to generate an investment return for the NFP. None of the other amounts in this example would be reported by the NFP as investment expense.
- 4.51** Further, FinREC recommends that to the extent investment expenses include the costs of activities conducted by employees, the amounts should include employee benefit, occupancy, and other related costs. In some circumstances, it is impracticable to measure and allocate all employee benefit, occupancy, and other related costs pertaining to investment activities conducted by employees. Considerations about which costs should be measured and allocated, such as considerations about materiality and the costs and

benefits of developing and providing the information, are the same as considerations about cost allocations in other circumstances.

- 4.52** FASB ASC 958-205-45-6 requires that expenses that are netted against investment revenues should be reported by their functional classification on the statement of functional expenses (if the NFP presents that statement). Further, to the extent that expenses are reported by other than their natural classification (such as salaries included in cost of goods sold or facility rental costs of special events reported as direct benefits to donors), FASB ASC 958-205-45-6 requires that they be reported by their natural classification if a statement of functional expenses is presented. Accordingly, if investment expenses are netted against investment revenues and the NFP presents a statement of functional expenses, investment expenses should be reported by their natural classification as part of management and general expenses on the statement of functional expenses.

Unrealized and Realized Gains and Losses

- 4.53** Unrealized gains and losses arise from changes in the fair value of investments, exclusive of dividend and interest income recognized but not yet received and exclusive of any write-down of the carrying amount of investments for impairment. Unrealized gains and losses are recognized in some circumstances (for example, when the investments are carried at fair value), but not in others (for example, when the investments are carried at cost). Paragraph 4.37, however, provides guidance pertaining to circumstances in which unrealized losses on investments carried at cost should be recognized.
- 4.54** Realized gains and losses arise from selling or otherwise disposing of investments. If realized gains and losses arise from selling or otherwise disposing of investments for which unrealized gains and losses have been recognized in the statement of activities of prior reporting periods, the amount reported in the statement of activities as gains or losses upon the sale or other disposition of the investments should exclude the amount that has previously been recognized in the statement of activities. However, the components of that gain or loss may be reported as the realized amount (the difference between amortized cost and the sales proceeds) and the unrealized amount recognized in prior reporting periods. Exhibit 4-2 illustrates this reporting.

Exhibit 4-2

Facts

1. In 20X1, a not-for-profit entity with a December 31 year end purchases an equity security with a readily determinable fair value for \$5,000.
2. At December 31, 20X1, the fair value of the security is \$7,000.
3. During 20X2, the security is sold for \$11,000.

Reporting Gains and Losses

- 20X1 Recognize a \$2,000 gain and adjust the carrying value to \$7,000. (The reported gain equals \$7,000 fair value less \$5,000 carrying value.)
- 20X2 Recognize a \$4,000 gain and adjust the carrying value to zero. (The gain may be reported as the net of \$11,000 selling price less the \$7,000 carrying value at the time the security was sold. Alternatively, the gain may be displayed as the realized gain of \$6,000 [\$11,000 selling price less \$5,000 cost] less the \$2,000 unrealized gain previously recognized.)

- 4.55** To the extent that they are recognized, FASB ASC 958-320-45-1 requires that investment gains and losses should be reported in the statement of activities as increases or decreases in unrestricted net assets unless their use is temporarily or permanently restricted by explicit donor stipulations or by law.^{fn 3}

Investments Held as an Agent

- 4.56** The guidance in paragraphs 4.44–.55 does not apply to investments held by an NFP as an agent. Pursuant to FASB ASC 958-320-25-3, FASB ASC 958-320-35-3, FASB ASC 958-325-25-2, and FASB ASC 958-325-35-16, an NFP is holding an investment as an agent if it has little or no discretion in determining how the investment income, unrealized gains and losses, and realized gains and losses resulting from those investments will be used. Investment activities of investments held by an NFP as an agent should be reported as agency transactions and, therefore, as changes in assets and liabilities rather than as changes in net assets. Paragraphs 5.07–.21 include guidance concerning distinguishing contributions from agency transactions, including transactions in which a donor grants variance power and those in which the donor transfers the assets to a financially interrelated entity.

Investment Pools

Self-Managed Investment Pools

^{fn 3} See footnote 1.

4.57 An NFP may pool part or all of its investments (including investments arising from contributions with different kinds of restrictions) for portfolio management purposes. The number and the nature of the pools may vary from NFP to NFP. When an NFP establishes a pool, the NFP assigns ownership interests (typically through unitization) to the various funds^{fn4} investing in the pool (sometimes referred to as participants) based on the market value of the cash and securities placed in the pool by each fund. The NFP uses current market value to determine the number of units allocated to additional assets placed in the pool by the funds and to amounts withdrawn (redeemed) from the pool by the funds. Investment income and realized gains and losses (and any recognized unrealized gains and losses) are allocated equitably to the funds based on the number of units assigned to each.

Investment Pools Managed by a Financially Interrelated Entity

4.58 If the NFP and the entity that manages the investment pool are financially interrelated entities, as described in the FASB ASC glossary and in FASB ASC 958-20-15-2, the NFP (which is the specified beneficiary) would account for its investment in the pool as part of its interest in the pool manager (which is the recipient entity). FASB ASC 958-20-25-2 requires that if a beneficiary and recipient entity are financially interrelated entities, the beneficiary should recognize its interest in the net assets of the recipient entity. Recognizing an interest in the net assets of the recipient entity and adjusting that interest for a share of the change in net assets of the recipient entity is similar to the equity method, which is described in FASB ASC 323-10. Financially interrelated entities are discussed further in paragraphs 5.27–.31.

Investment Pools Managed by Third Parties

4.59 Instead of the self-managed investment pools discussed in paragraph 4.57 or the pools managed by financially interrelated entities discussed in paragraph 4.58, some NFPs invest in a pool that is managed by another entity. (If that pool is managed by an entity that is consolidated with the reporting entity, it is a self-managed pool, not a third-party pool.) Examples of circumstances in which an NFP transfers some or all of its investments to a pool that is held and invested by a third-party entity include the following:

- Community foundations—Some NFPs transfer their endowment and other assets to investment pools managed by community foundations. Community foundations sometimes refer to these arrangements as agency endowments.

^{fn 4} Fund accounting segregates assets, liabilities, and fund balances into separate accounting entities (funds) associated with specific activities, donor-imposed restrictions, or objectives. Each fund has a self-balancing set of accounts consisting of assets, liabilities, fund balance and, when appropriate, revenue and expense or expenditure accounts. Chapter 16, “Fund Accounting,” provides additional information.

- Colleges and universities—NFPs such as alumni clubs and supporting foundations may participate in a pool of investments handled and managed by a related college or university.
- National organizations and their local organizations—NFPs (commonly referred to as local organizations) that are affiliated with or otherwise related to a national organization with a similar mission may have deposits or investments held by the national organization on its behalf. (If the national and local organizations are consolidated, the pool is considered a self-managed investment pool.)

Most investment pools are managed in a manner similar to a mutual fund or a hedge fund, whereby the investing entity receives units or shares (equity ownership) in the pool and may withdraw or purchase additional shares either monthly or quarterly, at net asset value. In a few investment pools, NFPs own identifiable investments (similar to a brokerage account). The accounting for investment pools depends upon the type of rights the NFP investor has (units, shares, or identifiable investments) and the relationship of the NFP investor to the NFP pool manager.

4.60 This guide discusses three common structures for investment pools:

- The interest in the investment pool is akin to an interest in a mutual fund or a unit in a hedge fund. Some of these interests may be in trust form.
- The interest in the investment pool is like a brokerage account, in that investments are specifically identified in the name of each investor entity.
- The interest in the investment pool is effectively a deposit with a money-market fund.

4.61 If the NFP’s interest in a third party’s investment pool is akin to an interest in a mutual fund or a unit in a hedge fund, the NFP’s investment asset is that particular unit or share interest. By analogy to the guidance in FASB ASC 320-10-55-9, which states that it is not appropriate to look through an investment in a limited partnership interest, venture capital entity, or a mutual fund to the underlying securities it owns, FinREC believes that the NFP would not look through to the investment pool’s specific underlying investments in reporting. TIS section 2220.19, “Unit of Account” (AICPA, *Technical Practice Aids*), states the appropriate unit of account is the interest in the investee fund itself, not the underlying investments within the investee pool, because the reporting entity owns an undivided interest in the whole of the investee fund portfolio and typically lacks the ability to dispose of individual assets and liabilities in the investee pool portfolio. If the NFP is neither consolidated with the pool manager nor financially interrelated with it, the NFP would recognize its rights to the assets held by the pool manager as a beneficial interest in an identifiable pool of assets from a transfer described in FASB ASC 958-605-25-33(d). FASB ASC 958-605-30-14 and 958-605-35-3 state that if a beneficiary has an unconditional right to receive all or a portion of the specified cash flows from a charitable

trust or other identifiable pool of assets, the beneficiary should measure and subsequently remeasure that beneficial interest at fair value. If the investment pool meets the criteria specified in paragraphs 4–5 of FASB ASC 820-10-15, the net asset value per unit or share may be used as a practical expedient to measure the fair value of the NFP’s interest. (That practical expedient is discussed in paragraph 4.42.)

- 4.62** If the NFP’s interest in the third party’s investment pool is like a brokerage account (in that investments are specifically identified in the name of each investor entity), FinREC believes that the NFP would report as though it held the investment directly, including making financial statement disclosures. This reporting is similar to reporting investments held on an NFP’s behalf by a broker.
- 4.63** In circumstances in which the NFP’s interest in the third party’s investment pool is effectively money on deposit in a money-market fund or bank, whether that deposit is classified as cash, a cash equivalent, or an investment depends on facts and circumstances. As noted in paragraph 4.04, FinREC believes that funds deposited by an NFP in a related entity’s cash account under a centralized cash management arrangement generally would not be classified as cash and cash equivalents in the NFP’s financial statements unless the NFP has legal title to the cash on deposit (that is, the cash is deposited in a demand deposit account at a bank or other financial institution in the NFP’s name). In many cases, an interest in a third-party’s investment pool is subject to some withdrawal restrictions. TIS section 1100.15, “Liquidity Restrictions” (AICPA, *Technical Practice Aids*), states that withdrawal restrictions should be considered in determining whether assets meet the definition of cash equivalents and when determining the sequencing of assets on the balance sheet (or classification as current assets) or disclosures in the notes to financial statements providing relevant information about the liquidity or maturity of assets.

Endowment Funds

- 4.64** The FASB ASC glossary defines an *endowment fund* as

an established fund of cash, securities, or other assets to provide income for the maintenance of a not-for-profit entity (NFP). The use of the assets of the fund may be permanently restricted, temporarily restricted, or unrestricted. Endowment funds generally are established by donor-restricted gifts and bequests to provide either of the following:

- a. A permanent endowment, which is to provide a permanent source of income
- b. A term endowment, which is to provide income for a specified period.

Alternatively, an NFP’s governing board may earmark a portion of its unrestricted net assets as a board-designated endowment fund.

- 4.65** The term *endowment* is sometimes used to refer to the aggregate of all gifts received for endowment purposes combined with all board-designated endowment funds that are managed collectively for investment. (Additionally, some NFPs pool excess operating cash with endowment cash for investing, but that does not make that operating cash an endowment or a board-designated endowment.) This discussion does not use the term in that manner. Instead, this discussion focuses on each endowment fund individually—the assets, liabilities, and net assets associated with an NFP’s fiduciary responsibilities to use assets in accordance with donor-imposed restrictions. Depending on a donor’s stipulations, an endowment fund may be created by a single gift agreement with a single donor, or it may be created to combine gifts of many donors that have the same donor-imposed restrictions on investment and use.
- 4.66** The FASB ASC glossary defines a *donor-restricted endowment fund* as an endowment fund that is created by a donor stipulation requiring investment of the gift in perpetuity or for a specified term. Some donors may require that a portion of income, gains, or both be added to the gift and invested subject to similar restrictions.
- 4.67** FASB ASC 958-205-45-14 states that
- when classifying an endowment fund, each source—original gift, gains and losses, and interest and dividends—must be evaluated separately. Each source is unrestricted unless its use is temporarily or permanently restricted by explicit donor stipulations or by law. Thus, an endowment fund that is created by a governing board from unrestricted net assets is classified as unrestricted because all three sources are free of donor restrictions. If an endowment fund is created by a donor, the donor may have placed different restrictions on each of the three sources. Generally, classification of the original gifts and the income earned by endowments is straightforward because usually donors explicitly state any time or purpose restrictions on those two sources. Determining how to classify gains on endowments may not be as easy because agreements with donors often are silent on how gains should be used and whether losses must be restored immediately from future gains, or not at all.
- 4.68** FASB ASC 958-205-45-28 and FASB ASC 958-205-45-33 provide guidance for determining the permanently restricted portion of a donor-restricted endowment fund. Those paragraphs state that
- an NFP that is subject to an enacted version of the Uniform Prudent Management of Institutional Funds Act (UPMIFA) shall classify a portion of a donor-restricted endowment fund of perpetual duration as permanently restricted net assets. The amount classified as permanently restricted shall be either (a) the amount of the fund that must be retained permanently in accordance with explicit donor stipulations (see paragraphs 958-605-45-3 through 45-4) or (b) the amount of the fund that, in the absence of explicit donor stipulations, the NFP’s governing board

determines must be retained (preserved) permanently consistent with the relevant law (see paragraph 958-205-45-21).

In states that have enacted a version of the Uniform Management of Institutional Funds Act of 1972 (UMIFA) or states whose relevant law is based on trust law, it is generally understood that at least the amount of the original gift(s) and any required accumulations is not expendable, although the value of the investments purchased may occasionally fall below that amount. Future appreciation of the investments generally restores the value to the required level. In states that have enacted its provisions, UMIFA describes “historic dollar value” as the amount that is not expendable.

- 4.69** As discussed in paragraphs 15.50–.55, a form of UPMIFA is the law for the management of donor-restricted endowment funds in all states but Pennsylvania. UPMIFA replaced the prior legislation, UMIFA. One of the primary differences between UPMIFA and its predecessor is the elimination of the concept of historic dollar value. Under UMIFA, asset growth and income of an endowment could be appropriated for program purposes, subject to the rule that a fund could not be spent below its historic dollar value. *Historic dollar value* was defined as the amount of original contributions to the fund, any additional gifts to the fund, and any additions to historic dollar value made pursuant to the donor’s gift instrument. UPMIFA provides more guidance on what is prudent spending, making the need for a spending floor unnecessary. Instead, subject to the intent of the donor expressed in the gift instrument (and in some states, a rebuttable presumption of imprudence), an NFP may appropriate for expenditure or accumulate so much of an endowment fund as it determines is prudent after considering the factors in the law. Thus, FASB ASC 958-205-45-28 requires that the governing board make a determination that the law does not. UPMIFA does not define an amount that must be retained permanently, but for accounting purposes the governing board must determine the amount of the fund that, in the absence of explicit donor stipulations, must be retained permanently. For accounting purposes, most NFPs continue to embrace historic dollar value as the permanently restricted portion of a donor-restricted endowment fund.
- 4.70** FASB ASC 958-205-05-9 notes that because donor stipulations and laws vary, NFPs must assess the relevant facts and circumstances for their endowment gifts and their relevant laws to determine if net appreciation on endowments is available for spending or is permanently restricted. Paragraphs 16–21A of FASB ASC 958-205-45 discuss the classification of net appreciation (net gains) of an endowment fund. In a state with UPMIFA-based legislation, in the absence of a donor’s explicit restriction to the contrary, gains on the investments of a donor-restricted endowment fund are temporarily restricted (time restricted) until appropriated for expenditure, and are also purpose restricted if the use of the endowment’s income is restricted as to purpose. (As noted in FASB ASC 958-205-05-10, subsection 4(a) of UPMIFA states that, unless stated otherwise in the gift instrument, the assets in an endowment fund are donor-restricted assets until appropriated for expenditure by the institution; in states with legislation that includes similar language, that subsection creates a time restriction.) For example, if a donor stipulates that net gains

be added to the principal of its gift until that endowed gift plus accumulated gains increases to a specified dollar level, the gains are permanently restricted. Similarly, if a donor states that a specific investment security must be held in perpetuity, the gains and losses on that security are subject to that same permanent restriction unless the donor specifies otherwise. However, if a donor allows the NFP to choose suitable investments, the gains are not permanently restricted unless the donor or the law requires that an amount be retained permanently.

- 4.71** In a state that has enacted a version of UPMIFA, legal limitations may state that, “unless stated otherwise in the gift instrument, the assets in an endowment fund are donor-restricted assets until appropriated for expenditure by the institution” (subsection 4(a) of UPMIFA). FASB ASC 958-205-45-30 states that for each donor-restricted endowment fund for which the restriction described in subsection 4(a) of UPMIFA applies, an NFP should classify the portion of the fund that is not classified as permanently restricted net assets as temporarily restricted net assets (time restricted) until appropriated for expenditure by the NFP. Pursuant to FASB ASC 958-205-45-31, in the absence of interpretation of the phrase “appropriated for expenditure” in subsection 4(a) of UPMIFA by legal or regulatory authorities (for example, court decisions or interpretations by state attorneys general), appropriation for expenditure is deemed to occur upon approval for expenditure, unless approval is for a future period, in which case appropriation is deemed to occur when that period is reached. Approval for expenditure may occur through different means within and across NFPs. For example, expenditures could be approved as part of a formal, annual budget. Expenditures also could be approved during the year as unexpected needs arise (such as for emergency relief efforts).
- 4.72** FASB ASC 958-205-25-31 states that upon appropriation for expenditure, the time restriction expires to the extent of the amount appropriated and, in the absence of any purpose restrictions, results in a reclassification of that amount to unrestricted net assets. If the fund is also subject to a purpose restriction, the reclassification of the appropriated amount to unrestricted net assets would not occur until that purpose restriction also has been met, in accordance with the guidance beginning in FASB ASC 958-205-45-9. Pursuant to FASB ASC 958-205-45-11, temporarily restricted net assets with time restrictions are not available to support expenses until the time restrictions have expired. Reclassifications upon the expiration of restrictions are discussed further in paragraphs 11.29–.51.
- 4.73** Pursuant to FASB ASC 958-205-45-29, the amount of permanently restricted net assets is not reduced by an NFP’s appropriations from the fund. Thus, if an appropriation is made when a donor-restricted endowment fund has no temporarily restricted net assets, there is no reclassification to make. However, in the accounting records of the donor-restricted endowment fund, the fund would redeem investments and report a transfer to the operating fund (or other fund) in which the appropriated amount is to be spent. The deficit balance of the donor-restricted endowment fund would be reflected in unrestricted net assets. FinREC believes that, similar to the guidance in FASB ASC 958-205-45-24, if appropriations reduce the assets of a donor-restricted endowment fund below the

permanently restricted net assets amount, future investment income or gains that restore the fair value of the assets of the endowment fund to the required level should be classified as increases in unrestricted net assets. This accounting for future investment income and gains is similar to accounting for future gains if investment losses reduce the assets of a donor-restricted endowment fund below the level required by the donor stipulations or law, as discussed in the next paragraph.

- 4.74** Paragraphs 22–27 of FASB ASC 958-205-45 discuss the classification of losses of an endowment fund. In the absence of donor stipulations or law to the contrary, losses on the investments of a donor-restricted endowment fund shall reduce temporarily restricted net assets to the extent that donor-imposed temporary restrictions on net appreciation of the fund have not been met before a loss occurs. Any remaining loss shall reduce unrestricted net assets. Per FASB ASC 958-205-45-29, the amount of permanently restricted net assets is not reduced by losses on the investments of the fund. If losses reduce the assets of a donor-restricted endowment fund below the level required by the donor stipulations or law, gains that restore the fair value of the assets of the endowment fund to the required level shall be classified as increases in unrestricted net assets.
- 4.75** After the fair value of the assets of the endowment fund equals the required level, gains that are restricted by the donor should be classified as increases in temporarily restricted net assets or permanently restricted net assets, depending on the donor's restrictions on the endowment fund.
- 4.76** FinREC believes that, in determining whether a loss or appropriation is reported as a deficit in the net assets of a donor-restricted endowment fund, the calculation should be done on a fund-by-fund basis, rather than in the aggregate for all donor-restricted endowment funds. This approach is consistent with UPMIFA; the commissioners' comments to the definition of an endowment fund in the act state that Section 4 (which is titled "Appropriation for Expenditure or Accumulation of Endowment Fund; Rules of Construction") must be applied to individual funds and cannot be applied to a group of funds that may be managed collectively for investment purposes. This approach also is consistent with the fact set and example disclosure paragraphs 31–52 of FASB ASC 958-205-55, which refer the fair value of assets associated with individual donor-restricted endowment funds falling below the level that the donor or the state's UPMIFA requires.
- 4.77** FASB ASC 958-205-55-1 states that how an enacted version of UPMIFA will be interpreted and enforced in a particular state will become clearer with the passage of time. Because the legislation is recently enacted, no case law currently exists for its interpretation. In the meantime, NFPs could look to other sources, such as the discussion that occurred in the legislative committees leading to the law adopted in a particular state, announcements from the state attorney general, a consensus of learned lawyers in the state, or similar information, to help them understand what the law requires. In the absence of new legislation, clarifying court decisions, additional guidance issued by the state attorney general, or similar developments, the governing board's interpretation of the relevant law should be consistent from year to year.

- 4.78** Because so few states have UMIFA-based law or have endowment law based on trust law, those standards for classification of donor-restricted endowment funds are not discussed in this guide. They are located in paragraphs 33–35 of FASB ASC 958-205-45.

Financial Statement Presentation

Cash and Cash Equivalents

- 4.79** A statement of financial position should include a separate line item for "Cash" or "Cash and Cash Equivalents." As noted in paragraphs 3.09–.23, cash and cash equivalents received with donor-imposed stipulations restricting the use of the cash contributed to long-term purposes and cash set aside for long-term purposes should not be classified on a statement of financial position with assets that are available for current use. As noted in paragraph 3.09, NFPs are required to provide information about liquidity or maturity of assets and liabilities, including restriction on the use of particular items.
- 4.80** Some limitations may exist on an NFP's ability to withdraw or use cash and cash equivalents. These limitations may be imposed by (a) creditors and other outside parties (such as limitations on cash held by financial institutions to meet compensating balance requirements, cash and cash equivalents held as collateral on debt obligations, cash received as collateral on loaned securities, and cash held for students, clients, and others under agency agreements); (b) donors, who place restrictions on their cash contributions (such as restricting the contributions to investments in buildings or creation of endowments, as described in paragraph 4.03); or (c) governing boards, which may designate cash for investment purposes (traditionally known as "funds functioning as endowment" or "quasi endowment"). NFPs are permitted, but not required, to disaggregate assets into unrestricted and donor-restricted classes when there are donor restrictions on the use of specific donated assets. Paragraphs 3.09–.23 discuss reporting similar limitations on assets other than cash.
- 4.81** FASB ASC 958-210-45-7 requires that relevant information about the nature and amount of limitations on the use of cash and cash equivalents (such as cash held on deposit as a compensating balance) be included on the face of the financial statements or in the notes. Information about the nature and amount of donor-imposed restrictions should also be disclosed in the net asset section of the statement of financial position or in the notes to the financial statements. (Chapter 11, "Net Assets and Reclassifications of Net Assets," discusses accounting for net assets.) FASB ASC 958-210-50-2 requires disclosure in the notes to the financial statements if unusual circumstances (such as special borrowing arrangements, requirements imposed by resource providers that cash be held in separate accounts, and known significant liquidity problems) are present, or if the NFP has not maintained appropriate amounts of cash and cash equivalents to comply with donor-imposed restrictions. (Paragraphs 3.172–.174 discuss reporting requirements if an NFP is not in compliance with donor-imposed restrictions.)

- 4.82** TIS sections 2130.38–.40 (AICPA, *Technical Practice Aids*) discuss the balance sheet classification of certificates of deposit and whether certificates of deposit are debt securities that must be recognized at fair value. Certificates of deposit with original maturities of 90 days or less are commonly considered "cash and cash equivalents" under FASB ASC 305, *Cash and Cash Equivalents*. A certificate of deposit with an original maturity greater than 90 days would not be included in cash and cash equivalents. Certificates of deposit generally are not debt securities as defined in FASB ASC 958-320. However, some negotiable certificates of deposit may meet the definition of a security. Certificates of deposit that are not debt securities are "other investments," as discussed in paragraph 4.37 of this guide.

Investments

- 4.83** FASB ASC 958-320-45-3 states that gains and investment income that are limited to specific uses by donor-imposed restrictions may be reported as increases in unrestricted net assets if the restrictions are met in the same reporting period as the gains and income are recognized, provided that the NFP has a similar policy for reporting contributions received,^{fn 5} reports consistently from period to period, and discloses its accounting policy in the notes to the financial statements.
- 4.84** Realized and unrealized losses on investments may be netted against realized and unrealized gains on a statement of activities.
- 4.85** FASB ASC 958-320-45-9 explains that some NFPs, in managing their endowment funds, use a spending-rate or total return policy. Those policies consider total investment return—investment income (interest, dividends, rents, and so forth) plus net realized and unrealized gains (or minus net losses). Typically, spending-rate or total return policies emphasize the use of prudence and a rational and systematic formula to determine the portion of cumulative investment return that can be used to support operations of the current period and the protection of endowment gifts from a loss of purchasing power as a consideration in determining the formula to be used. Example 1 (FASB ASC 958-320-55-4) illustrates a statement of activities and example disclosures of an NFP that uses a spending rate policy to include only a portion of its investment return in its operating measure.
- 4.86** Even if an NFP uses a spending-rate formula to determine how much of that return will be used for current operations, all investment income and recognized gains and losses should be reported on the statement of activities and classified as unrestricted unless

^{fn 5} Chapter 5, "Contributions Received and Agency Transactions," discusses the accounting policy for reporting contributions received if the organization meets donor-imposed restrictions on all or a portion of the amount contributed in the same reporting period as the contribution is received.

restricted by the donor or applicable law. NFPs are permitted to provide information on the face of the statement of activities and the notes to the financial statements about the total return on investments by segregating the total return between operating and nonoperating components based on a spending-rate formula.

- 4.87** FASB ASC 958-320-45-6 explains that some NFPs—primarily health care entities—would like to compare their results to business entities in the same industry. An NFP with those comparability concerns may report in a manner similar to business entities by identifying securities as available-for-sale or held-to-maturity as described in paragraphs 1–6 of FASB ASC 320-10-25 and excluding the unrealized gains and losses on those securities from an operating measure within the statement of activities. Per FASB ASC 958-320-50-1, a reconciliation of investment return to amounts reported in the statement of activities is required to be presented if investment return is separated into operating and nonoperating amounts.
- 4.88** Example 1 (paragraphs 4–10 of FASB ASC 958-320-55) illustrates a statement of activities that reports a portion of investment return within a measure of operations. If investment return is separated into operating and nonoperating amounts, certain information, as discussed in paragraph 4.95, is required to be disclosed. Those disclosures are also illustrated in the example.

Disclosures

- 4.89** The majority of the disclosures for investments are located in the “Disclosure” subsections (sections 50) of FASB ASC 958-320, FASB ASC 958-325, and FASB ASC 825-10. The following paragraphs discuss the more common disclosures but are not a substitute for reading the “Disclosure” subsections of FASB ASC. Certain disclosures are illustrated in FASB ASC 958-320-55.
- 4.90** Paragraphs 20–22 of FASB ASC 825-10-50 require that an NFP disclose all significant concentrations of credit risk arising from all financial instruments, including significant concentrations of credit risk arising from derivative instruments, whether from an individual counterparty or groups of counterparties. Further, as explained in FASB ASC 825-10-55-1, the terms of certain loan products may increase a reporting entity's exposure to credit risk and thereby may result in a concentration of credit risk.
- 4.91** An individual concentration of risk could exist, for example, if an NFP invests a significant amount in the securities of a single corporation or government entity. A group concentration could exist, for example, if an NFP invests a significant amount in debt securities of a single industry or a single geographic region. Program loan investments that permit low payments in early years of the loan and higher payments later in the loan's life also may result in a concentration of credit risk.
- 4.92** Paragraphs 10–19 of FASB ASC 825-10-50 require various disclosures, including disclosures of fair value and carrying amounts for all financial instruments for which it is

practicable to estimate that value, the method(s) and significant assumptions used to estimate the fair value of financial instruments, and the changes in the those methods and significant assumptions, if any, during the period, and the level of the fair value hierarchy within which the fair value measurements are categorized in their entirety (levels 1, 2, or 3), unless those disclosures are optional because the three criteria of FASB ASC 825-10-50-3 are met. FASB ASC 825-10-50-3 states that disclosures required by the “General” subsection of FASB ASC 825-10-50 are optional if an entity meets all of the following 3 criteria: (a) the entity is a nonpublic entity, (b) the entity’s total assets are less than \$100 million on the date of the financial statements, and (c) the entity has no instrument that, in whole or in part, is accounted for as a derivative instrument. For purposes of (a), the FASB ASC glossary defines a *nonpublic entity* as

any entity that does not meet any of the following conditions: (a) its debt or equity securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally, (b) it is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets), (c) it files with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market, or (d) it is controlled by an entity covered by the preceding criteria.

- 4.93** FASB ASC 815-10-50 requires disclosures if an NFP has investments in derivative financial instruments. Additional disclosures are required by FASB ASC 815-15-50 for embedded derivatives, and FASB ASC 815-20-50, 815-25-50, 815-30-50, and 815-30-50 for derivatives designated as hedging exposures to risk.
- 4.94** FASB 860-30-50-1A(a) requires that NFPs that enter into repurchase agreements or securities lending transactions disclose their policies for requiring collateral or other security. FASB ASC 860-30-50-1A(c) requires that if an NFP accepts collateral that it is permitted by contract or custom to sell or repledge, it should disclose (1) the fair value as of the date of each statement of financial position presented of that collateral, (2) the fair value as of the date of each statement of financial position presented of the portion of that collateral that it has sold or repledged, and (3) information about the sources and uses of that collateral.
- 4.95** For each period for which a statement of activities is presented, an NFP should disclose
- a. pursuant to FASB ASC 958-320-50-1, the composition of investment return including, at a minimum, investment income, net realized gains or losses on investments reported at other than fair value, and net gains or losses on investments reported at fair value.
 - b. pursuant to FASB ASC 958-320-50-1, a reconciliation of investment return to amounts reported in the statement of activities if investment return is separated

into operating and nonoperating amounts, together with a description of the policy used to determine the amount that is included in the measure of operations and a discussion of circumstances leading to a change, if any, in that policy. The reconciliation need not be provided if an NFP includes all investment return in its measure of operations or excludes it from that measure entirely.

- c.* pursuant to FASB ASC 958-320-50-1, the amount of the expenses, if investment revenues are reported net of related expenses, such as custodial fees and internal and external investment advisory costs (if not provided on the face of the statement of activities.
 - d.* the information required by FASB ASC 825-10-50-30, as modified by FASB ASC 815-10-15-7.
 - e.* the information required by FASB ASC 825-10-50-32 if the NFP made an election pursuant to FASB 825-10-25-4(d) or 9(e) during the period.
- 4.96** Per FASB ASC 958-325-45-2, the statement of activities of an institution of higher education should set forth the total performance (that is, investment income and realized and unrealized gains and losses) of the other investment portfolio unless that information is disclosed in the notes.
- 4.97** For each period for which a statement of financial position is presented, an NFP should disclose
 - a.* pursuant to FASB ASC 958-320-50-2, the aggregate carrying amount of investments by major types, for example, equity securities, U.S. Treasury securities, corporate debt securities, mortgage-backed securities, oil and gas properties, and real estate.
 - b.* pursuant to FASB ASC 958-325-50-2(a), the basis for determining the carrying amount for investments within the scope of FASB ASC 958-325.
 - c.* pursuant to FASB ASC 958-325-50-2(b), the method(s) and significant assumptions used to estimate the fair values of investments other than financial instruments if those other investments are reported at fair value.
 - d.* pursuant to FASB ASC 958-205-50-2, the aggregate amount of the deficiencies for all donor-restricted endowment funds for which the fair value of the assets at the reporting date is less than the level required by donor stipulations or law.
 - e.* the information required by FASB ASC 320-10-50-6(a) if the NFP holds cost-method investments in an unrealized loss position for which impairment losses have not been recognized.

- f. the information required by FASB ASC 325-20-50-1 if the NFP has cost-method investments.
- g. the information required by paragraphs 1–3 of FASB ASC 820-10-50 for investments measured at fair value, if applicable.
- h. the information required by paragraphs 28–29 of FASB ASC 825-10-50, if the NFP has made an election as described in the “Fair Value Option” subsections of FASB ASC 825-10.

4.98 Paragraphs 1A–1B of FASB ASC 958-205-50 require disclosures about an NFP’s endowment fund. At a minimum, those disclosures must include the following information about the NFP’s donor-restricted endowment funds and its board designated endowment funds:

- a. A description of the governing board’s interpretation of the law(s) that underlies the NFP’s net asset classification of donor-restricted endowment funds. (The term *endowment fund* as defined in UPMIFA does not include assets that an institution designates as an endowment fund for its own use.)
- b. A description of the NFP’s policy(ies) for the appropriation of endowment assets for expenditure (its endowment spending policy[ies]).
- c. A description of the NFP’s endowment investment policies. The description should include the NFP’s return objectives and risk parameters; how those return objectives relate to the NFP’s endowment spending policy(ies); and the strategies employed for achieving those return objectives.
- d. The composition of the NFP’s endowment by net asset class at the end of the period, in total and by type of endowment fund, showing donor-restricted endowment funds separately from board-designated endowment funds.
- e. A reconciliation of the beginning and ending balance of the NFP’s endowment, in total and by net asset class, including, at a minimum, all of the following line items (as applicable): investment return, separated into investment income (for example, interest, dividends, rents) and net appreciation or depreciation of investments; contributions; amounts appropriated for expenditure; reclassifications; and other changes.

4.99 For the most recent period for which a statement of financial position is presented, an NFP should disclose

- a. pursuant to FASB ASC 958-320-50-3, the nature of and carrying amount for each individual investment or group of investments that represents a significant concentration of market risk, such as risks that result from the nature of the

investments or from a lack of diversity of industry, currency, or geographic location.

- b.* the information required by FASB ASC 320-10-50-6(b) if the NFP has cost-method investments in an unrealized loss position for which impairment losses have not been recognized.
- c.* the information required by FASB ASC 825-10-50-30, if the NFP has made an election as described in the “Fair Value Option” subsections of FASB ASC 825-10.

Additionally, paragraphs 1–2 of FASB ASC 825-10-45 require that, if an NFP elects the fair value option, it display on the face of its statement of financial position (either by separate line items or parenthetically) the assets and liabilities reported at fair value separately from the carrying amounts of similar assets and liabilities measured using another measurement attribute.

4.100 In circumstances in which an NFP transfers some or all of its investments to a pool that is managed by a third party, the NFP may be subject to additional financial statement disclosures. FASB ASC 958-605-50-6 requires the following disclosures for each period for which a statement of financial position is presented if an NFP transfers assets to a recipient entity and specifies itself or its affiliate as the beneficiary:

- a.* The identity of the recipient entity to which the transfer was made
- b.* Whether variance power was granted to the recipient entity and, if so, a description of the terms of the variance power
- c.* The terms under which amounts will be distributed to the resource provider or its affiliate
- d.* The aggregate amount recognized in the statement of financial position for those transfers and whether that amount is recorded as an interest in the net assets of the recipient entity or as another asset (for example, as a beneficial interest in assets held by others or a refundable advance)

4.101 If an interest in an investment pool managed by a third party is reported at net asset value per unit or share as a practical expedient for fair value, as discussed in paragraph 4.42, FASB ASC 820-10-35-54B provides guidance for making disclosures about the level within the fair value hierarchy in which the fair value measurement falls. The level depends upon whether and how soon the NFP can redeem its investment in the pool and whether that redemption would be at net asset value. If an NFP has the ability to redeem its investment in the pool at net asset value per share (or its equivalent) at the reporting date, the fair value measurement of the investment is categorized within level 2 of the fair value hierarchy. If an NFP will never have the ability to redeem its investment in the pool at net asset value per share (or its equivalent), the fair value measurement of the

investment shall be categorized within level 3 of the fair value hierarchy. If an NFP cannot redeem its investment with the investee at net asset value per share (or its equivalent) at the reporting date but the investment may be redeemable at a future date, the NFP should take into account the length of time until the investment will become redeemable in determining whether the fair value measurement of the interest in the investment pool should be categorized within level 2 or level 3 of the fair value hierarchy. For example, if the NFP does not know when it will have the ability to redeem the investment or it does not have the ability to redeem the investment in the near term at net asset value per share (or its equivalent), the fair value measurement of the investment should be categorized within level 3 of the fair value hierarchy.

- 4.102** In circumstances in which NFPs invest in hedge funds or similar investment vehicles that invest in other funds (sometimes referred to as fund-of-funds), FinREC recommends that the notes to the financial statements disclose the nature of amounts included in investment expenses so that it is clear to financial statement users that investment expenses do not reflect the proportionate share of expenses of the underlying investee funds.

4.103

Appendix A

A-1 The following Technical Questions and Answers (TIS sections 2220.18–.26 [AICPA, *Technical Practice Aids*]) are intended to assist reporting entities in applying the provisions of Financial Accounting Standards Board *Accounting Standards Codification* 820, *Fair Value Measurement*, to alternative investments.

.18 Applicability of Practical Expedient

Inquiry—Which investments are permitted, as a practical expedient, to be measured at fair value on the basis of the net asset value (NAV)?

Reply—FASB ASC 820-10-35-59 permits reporting entities, as a practical expedient, to estimate the fair value of their investments in certain entities that calculate NAV per share (or its equivalent) by using NAV. Such investments, which are often referred to as alternative investments, include interests in hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds, offshore fund vehicles, and funds of funds, as well as some bank common/collective trust funds and other similar funds. Companies in various industries, including investment companies, broker-dealers, banks, insurance companies, employee benefit plans, healthcare organizations, and not-for-profit organizations, often invest in alternative investments.

[Issue Date: December 2009]

.19 Unit of Account

Inquiry—According to the FASB ASC glossary, the *unit of account* is “[t]hat which is being measured by reference to the level at which an asset or liability is aggregated (or disaggregated).” How should the unit of account be identified for an interest in an alternative investment?

Reply—For interests in alternative investments, the appropriate unit of account is the interest in the investee fund itself, not the underlying investments within the investee fund; this is because the reporting entity owns an undivided interest in the whole of the investee fund portfolio and typically lacks the ability to dispose of individual assets and liabilities in the investee fund portfolio. However, as discussed in FASB ASC 820-10-35-61, if it is probable at the measurement date that a reporting entity will sell a portion of an investment at an amount different from NAV, and the criteria described in FASB ASC 820-10-35-62 are met, the portion that the reporting entity intends to sell is valued in accordance with other provisions of FASB ASC 820. The remaining portion of the interest that is not probable of being sold may be valued by using NAV as a practical expedient in accordance with FASB ASC 820-10-35-59.

[Issue Date: December 2009]

.20 Determining Whether NAV Is Calculated Consistent With FASB ASC 946, Financial Services—Investment Companies

Inquiry—FASB ASC 820-10-35-59 states:

A reporting entity is permitted, as a practical expedient, to estimate the fair value of an investment within the scope of paragraphs 820-10-15-4 through 15-5 using the net asset value per share (or its equivalent, such as member units or an ownership interest in partners’ capital to which a proportionate share of net assets is attributed) of the investment, if the net asset value per share of the investment (or its equivalent) is calculated in a manner consistent with the measurement principles of Topic 946 as of the reporting entity’s measurement date.

How does a reporting entity conclude that the NAV, as most recently reported by the manager of the alternative investment (reported NAV), has been calculated in a manner consistent with the measurement principles of FASB ASC 946, *Financial Services—Investment Companies*?

Reply—A reporting entity’s management is responsible for the valuation assertions in its financial statements. Determining that reported NAV is calculated consistently with FASB ASC 946, including measurement of all or substantially all of the underlying investments of the investee in accordance with FASB ASC 820, requires a reporting entity to independently evaluate the fair value measurement process utilized by the investee fund manager to calculate the NAV. Such an evaluation is a matter of

professional judgment and includes determining that the investee fund manager has an effective process and related internal controls in place to estimate the fair value of its investments that are included in the calculation of NAV. The reporting entity's controls used to evaluate the process of the investee fund manager may include the following:

- *Initial due diligence* (procedures performed before the initial investment)
- *Ongoing monitoring* (procedures performed after the initial investment)
- *Financial reporting controls* (procedures related to the accounting for, and reporting of, the investment) (Refer to Interpretation No. 1, "Auditing Investments in Securities Where a Readily Determinable Fair Value Does Not Exist," of AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* [AICPA, *Professional Standards*, AU sec. 9332 par. 02-.04] and the AICPA nonauthoritative practice aid *Alternative Investments—Audit Considerations* for examples of these controls. ^{fn 1})

Before concluding that the reported NAV is calculated in a manner consistent with the measurement principles of FASB ASC 946, the reporting entity might evaluate the evidence that is gathered via the initial due diligence and ongoing monitoring of the investee fund. Only after considering all relevant factors can the reporting entity reach a conclusion about whether the reported NAV is calculated in a manner consistent with the measurement principles of FASB ASC 946. For example, the reporting entity might consider the following key factors relating to the valuation received from the investee fund manager:

- The investee fund's fair value estimation processes and control environment, and any changes to those processes or the control environment ^{fn 2}
- The investee fund's policies and procedures for estimating fair value of underlying investments, and any changes to those policies or procedures ^{fn 3}
- The use of independent third party valuation experts to augment and validate the investee fund's procedures for estimating fair value
- The portion of the underlying securities held by the investee fund that are traded on active markets
- The professional reputation and standing of the investee fund's auditor (this is not intended to suggest that the auditor is an element of the investee fund's internal control system, but as a general risk factor in evaluating the integrity of the data obtained from the investee fund manager)
- Qualifications, if any, of the auditor's report on the investee fund's financial statements
- Whether there is a history of significant adjustments to the NAV reported by the investee fund manager as a result of the annual financial statement audit or otherwise

- Findings in the investee fund’s advisor or administrator’s Statements on Standards for Attestation Engagements No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801), ^{fn 4} report on management’s description of a service organization’s system and the suitability of the design of controls (a type 1 report) or on management’s description of a service organization’s system and the suitability of the design and operating effectiveness of controls (a type 2 report), if any
- Whether NAV has been appropriately adjusted for items such as carried interest and clawbacks (more fully described in section 6910.29, “Allocation of Unrealized Gain (Loss), Recognition of Carried Interest, and Clawback Obligations”)
- Comparison of historical realizations to last reported fair value

If the last reported NAV is not as of the reporting entity’s measurement date, refer to section 2220.22 for further considerations.

In cases when the reporting entity invests in a fund of funds (the investee fund invests in other funds that do not have readily determinable fair values), the reporting entity might conclude that the NAV reported by the fund of funds manager is calculated in a manner consistent with FASB ASC 946 by assessing whether the fund of funds manager has a process that considers the previously listed items in the calculation of the NAV reported by the fund of funds, and that the fund of funds manager has obtained or estimated NAV from underlying fund managers in a manner consistent with paragraphs 59–62 of FASB ASC 820-10-35 as of the measurement date. The reporting entity is not required to look through the fund of funds interest to underlying fund investments if the reporting entity has concluded that the fund of funds manager reports NAV consistent with FASB ASC 946 for the fund of funds interest.

[Issue Date: December 2009; Revised: June and August 2011, to reflect conforming changes necessary due to the issuance of SSAE No. 16.]

.21 Determining Whether an Adjustment to NAV Is Necessary

Inquiry—FASB ASC 820-10-35-60 allows the reporting entity, as a practical expedient, to estimate the fair value of an investment within the scope of paragraphs 4 and 5 of FASB ASC 820-10-15 using the NAV as reported by the investee when the reporting entity has satisfied itself that (a) the investee has calculated NAV consistent with FASB ASC 946 (see section 2220.20), and (b) the NAV has been calculated as of the reporting entity’s financial reporting (measurement) date.

FASB ASC 820-10-35-60 further states:

If the net asset value per share of the investment obtained from the investee is not as of the reporting entity’s measurement date or is not calculated in a manner

consistent with the measurement principles of Topic 946, the reporting entity shall consider whether an adjustment to the most recent net asset value per share is necessary. The objective of any adjustment is to estimate a net asset value per share for the investment that is calculated in a manner consistent with the measurement principles of Topic 946 as of the reporting entity's measurement date.

How does a reporting entity determine whether an adjustment to the last reported NAV is necessary?

Reply—Examples of when an adjustment to the last reported NAV may be necessary include, but are not limited to the following:

- NAV is not as of the reporting entity's measurement date
- NAV is not calculated in a manner consistent with the measurement principles of FASB ASC 946 (which requires, among other things, measurement of all or substantially all of the underlying investments of the investee in accordance with FASB ASC 820)
- Both

The existence of either of these factors may lead the reporting entity to conclude that an adjustment to the last reported NAV may be necessary. Practically, it is difficult to assess whether an adjustment is necessary unless an estimate of the adjustment is calculated.

[Issue Date: December 2009]

.22 Adjusting NAV When It Is Not as of the Reporting Entity's Measurement Date

Inquiry—If the reporting entity concludes that the reported NAV is calculated consistently with FASB ASC 946, but an adjustment is necessary because the NAV is not as of the reporting entity's measurement date, how should the reporting entity estimate the adjustment? (Refer to the inquiry in section 2220.21 for applicable FASB literature.)

Reply—FASB ASC 820-10-35-60 states that “The objective of any adjustment is to estimate a net asset value per share for the investment that is calculated in a manner consistent with the measurement principles of Topic 946 as of the reporting entity's measurement date.” If the last reported NAV is calculated consistently with FASB ASC 946 but is not as of the reporting entity's measurement date, the reporting entity may either request the investee fund manager to provide a supplemental NAV calculation consistent with the measurement principles of FASB ASC 946 as of the reporting entity's measurement date, or it may be necessary to adjust or roll forward (or roll back) ^{fn 5} the reported NAV for factors that might cause it to differ from the NAV at the measurement date. For example, the following factors might necessitate an adjustment to the reported NAV when it is not calculated as of the reporting entity's measurement date:

- The reporting entity has made an additional investment(s) (capital contributions) since the calculation date of the reported NAV and prior to the reporting entity's measurement date
- The reporting entity has received a distribution(s) or partial redemption since the calculation date of the reported NAV
- The reporting entity has become aware (through inquiry of the investment manager or communication by the investment manager to the reporting entity) of changes in the value of underlying investments since the calculation date of the reported NAV
- Market changes or other economic conditions have changed to affect (favorably or unfavorably) the value of the investee's portfolio after the calculation date of the reported NAV
- Changes have occurred in the composition of the underlying investment portfolio of the investee fund after the NAV calculation date

The roll forward NAV might be calculated as follows:

i. Last Reported NAV (calculated consistently with FASB ASC 946)	\$X,XXX
ii. Add capital contributions/subscriptions	C,CCC
iii. Subtract distributions/redemptions/withdrawals	(D,DDD)
iv. Adjust for changes in valuations ^(a)	<u>V,VVV</u>
Roll forward NAV (as of the reporting entity's measurement date)	<u><u>\$ R,RRR</u></u>

- (a) Market changes refer to market fluctuations between the date of the reported NAV and the reporting entity's measurement date. Examples of other economic conditions for which it may be necessary to adjust a reported NAV include, but are not limited to, a portfolio company being acquired, going public, or declaring bankruptcy between the date of the reported NAV and the reporting entity's measurement date, or changes in the value of underlying investments caused by company performance or market conditions, or both.

[Issue Date: December 2009]

.23 Adjusting NAV When It Is Not Calculated Consistent With FASB ASC 946

Inquiry—If the reporting entity concludes that an adjustment is necessary because a reported NAV is not calculated consistently with the measurement principles of FASB ASC 946, how does a reporting entity estimate the adjustment? (Refer to the inquiry in section 2220.21 for applicable FASB literature.)

Reply—Although it is not possible to state all the reasons why a reported NAV may not be consistent with the measurement principles of FASB ASC 946 (that is, it is not fair value based), the reporting entity would need to consider and understand the following:

- The reasons why NAV has not been based upon fair value. In some cases investees may appear to function similarly to investment companies, but do not meet the definition of an *investment company* provided in FASB ASC 946-10-15-2 and it is not industry practice for the investee to issue financial statements using the measurement principles in FASB ASC 946. (In those cases, the practical expedient is unavailable and the entity should be valued using the general measurement principles of FASB ASC 820.)
- Whether a fair value based NAV can be obtained from the investee manager.
- Whether the specific data needed to adjust the reported NAV can be obtained and properly utilized to estimate a fair value based NAV.

Examples of circumstances in which the reporting entity may be able to obtain data to estimate an adjustment include, but are not be limited to the following:

- Reported NAV is on a cash basis. The reporting entity could estimate the fair value of each underlying investment as of the measurement date by obtaining additional information from the investee manager.
- Reported NAV utilizes blockage discounts taken on securities valued using level 1 inputs, which is not consistent with FASB ASC 820. The reporting entity could estimate the adjustment to reported NAV required to remove the blockage discount based on additional information from the financial statements or from the investee manager.
- Reported NAV has not been adjusted for the impact of unrealized carried interest or incentive fees. The reporting entity could estimate the impact of carried interest or incentive fees and adjust reported NAV.

If the reporting entity finds that it is not practicable to calculate an adjusted NAV (for example, because sufficient information is not available or it is not in a position to reasonably evaluate the information available and estimate values consistent with FASB ASC 946), then the practical expedient is not available. The reporting entity may also elect not to utilize the practical expedient. In those instances, the reporting entity should apply the general measurement principles of FASB ASC 820 instead (see section 2220.27).

[Issue Date: December 2009]

.24 Disclosures—Ability to Redeem Versus Actual Redemption Request

Inquiry—FASB ASC 820-10-35-58(c) states:

If a reporting entity cannot redeem its investment with the investee at net asset value per share (or its equivalent) at the measurement date but the investment may be redeemable with the investee at a future date (for example, investments subject to a lockup or gate or investments whose redemption period does not coincide with the measurement date), the reporting entity shall consider the length of time until the investment will become redeemable in determining whether the fair value measurement of the investment shall be categorized as a Level 2 or a Level 3 fair value measurement. For example, if the reporting entity does not know when it will have the ability to redeem the investment or it does not have the ability to redeem the investment in the near term at net asset value per share (or its equivalent), the fair value measurement of the investment shall be categorized as a Level 3 fair value measurement.

In most cases, redemptions from alternative investment funds that redeem at NAV are only permitted with advance notice, ranging from 30 to 120 days. In order to classify the investment as level 2, must the investor have submitted a previous redemption request effective as of the measurement date or is it sufficient for an investor to have had the ability to redeem on the measurement date, even though it may not have exercised this ability?

Reply—Determining the appropriate level within the fair value hierarchy is a matter of professional judgment. Even though a redemption notice may not have been submitted effective on the measurement date, so long as the reporting entity has the ability to redeem at NAV in the near term (for example, it has the contractual and practical ability to redeem) at the measurement date, then consistent with 820-10-35-58(a), the investment may be classified as level 2.

[Issue Date: December 2009]

.25 Impact of “Near Term” on Classification Within Fair Value Hierarchy

Inquiry—What is considered “near term” for purposes of determining whether the investment would be classified as level 2 or level 3? (Refer to the inquiry in section 2220.24 for applicable FASB literature.)

Reply—What is viewed as near term is a matter of professional judgment and depends on the specific facts and circumstances. A redemption period of 90 days or less generally would be considered near term, because any potential discount relative to the time value of money to the next redemption date would be unlikely to be considered a significant unobservable input in accordance with FASB ASC 820. However, other factors (for example, likelihood or actual imposition of gates) may influence the determination of whether the investment will be redeemable in the near term.

[Issue Date: December 2009]

.26 Categorization of Investments for Disclosure Purposes

Inquiry—The sample disclosure provided in FASB ASC 820-10-55-64A appears to apply to an institutional investor with a diversified portfolio of hedge, private equity, and real estate funds. Certain entities, however, specialize in one particular investment category or have a significant investment in one such category, such as private equity or venture capital. Should these reporting entities use a different categorization than that appearing in the sample disclosure?

Reply—Yes. FASB ASC 820-10-55-64A indicates that “the major categories presented ... are provided as examples only and are not intended to be treated as a template. The major categories disclosed should be tailored to the nature and risks of the reporting entity’s investments.”

Accordingly, the disclosure should be tailored to address the concentrations of risk that are specifically attributable to the investments. For example, a private equity fund of funds should not simply categorize its investments as “private equity” as this categorization is not specific enough to address the nature and risks of the investee funds. In this example, more specific categorization, perhaps relating to industry, geography, vintage year, or the strategy of the investees (venture, buyout, mezzanine, and so on), may be more appropriate and more useful to the reader. Such categorization is a matter of judgment and should only be made after careful consideration of the specific risks and attributes of the portfolio investments has been made.

[Issue Date: December 2009]

.27 Determining Fair Value of Investments When the Practical Expedient Is Not Used or Is Not Available

Inquiry—For entities that do not elect to use NAV as a practical expedient to estimate fair value or are unable to adjust the most recently reported NAV to estimate a NAV that is calculated in a manner consistent with the measurement principles of FASB ASC 946 as of the reporting entity’s measurement date, what inputs or investment features should be considered in estimating fair value?

Reply—Section 2220 distinguishes between redeemable and nonredeemable types of alternative investments, which are defined as follows:

- **Investments with redeemable interests.** Typically consist of hedge funds (based both in the United States and offshore) and some bank common/collective trust funds. These investment funds permit holders periodic opportunities to subscribe for or redeem interests at frequencies that can run from daily to annually. Certain funds may impose lock-up periods after an initial investment, under which an investor agrees that it may not redeem its investment for a specified period of time

(in some cases, an early redemption may be permitted upon payment of an early redemption fee).

- **Investments with nonredeemable interests.** Typically consist of private equity, venture capital, and real estate funds. Generally, these investments have an initial subscription period, under which each investor makes a commitment to contribute a specified amount of capital as called for by the investment manager, typically as investments are identified and money is needed to acquire them. Due to the inherent illiquidity of the underlying investments, redemptions are not permitted during the fund's life; however, typically, as investments are sold or experience another liquidity event (for example, an initial public offering), the proceeds of the sale, less any incentives due to the fund sponsor, are often distributed back to the investors in the fund immediately following the sale or liquidity event.

Investment Inputs

A reporting entity might first consider the other market participants to whom it could sell the asset. In accordance with FASB ASC 820-10-35-9, "[t]he fair value of the asset ... shall be determined based on the assumptions that market participants would use in pricing the asset..." Based on guidance in FASB ASC 820-10-35-53, in the absence of relevant observable inputs, a reporting entity uses "unobservable inputs [that] shall reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk)." In accordance with FASB ASC 820-10-35-55, "[i]n developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. However, the reporting entity shall not ignore information about market participant assumptions that is reasonably available without undue cost and effort." When doing so, the reporting entity is reminded that the FASB ASC glossary defines *market participants* as "knowledgeable, having a reasonable understanding about the asset or liability and the transaction based on all available information, including information that might be obtained through due diligence efforts that are usual and customary." Thus, it can be presumed that a market participant would be aware of, and may be willing to accept, limitations on conversion to cash inherent to alternative investments. However, in some cases, those types of limitations may also affect the fair value measurement (see "Investment Features").^{fn 6} It also can be presumed that market participants may consider other factors such as the investment manager's track record and potentially limited access to desirable investment opportunities. Finally, it should be acknowledged that market participant assumptions normally result in a range of values. According to FASB ASC 820-10-35-24, "[a] fair value measurement is the point within that range that is most representative of fair value in the circumstances." See FASB ASC 820-10-35-9 for further guidance. The reporting entity should also consider the guidance in paragraphs 51A–51H of FASB ASC 820-10-35.

Alternative investments may lend themselves to valuation techniques consistent with the income or market approaches. If both of these approaches are used to measure fair

value, the results should be evaluated and weighted as discussed in FASB ASC 820-10-35-24. When NAV is not used as a practical expedient, examples of factors that might be used when estimating fair value (depending on the valuation technique(s) and facts and circumstances) are as follows:

- NAV (as one valuation factor)
- Transactions in principal-to-principal or brokered markets (external markets) and overall market conditions
- Features of the alternative investment
- Expected future cash flows appropriately discounted (detailed description is beyond the scope of this document; however, for many funds with nonredeemable interests, expected future cash flows from the interests might typically coincide with the expected future cash flows from the underlying investments)
- Factors used to determine whether there has been a significant decrease in the volume and level of activity for the asset when compared with normal market activity for the asset (FASB ASC 820-10-35-51A)

The preceding examples are not listed in any order of importance. Rather, the reporting entity might determine the relative weighting and importance of these inputs based on its view of what market participants might consider in estimating fair value.

Investment Features ^{fn 7}

A valuation technique used to measure the fair value of an asset or a liability should reflect assumptions a market participant might use to price the asset or liability, including assumptions about liquidity and risk, based on the best information available. The following discussion provides a detailed description of features of alternative investments that normally might be expected to be considered by market participants in the estimation of the fair value of an alternative investment. When considering the potential impact of the features of an alternative investment on its fair value, it is important that all relevant features be considered in the aggregate because that is how a market participant might be likely to evaluate them in determining how much it might be willing to pay for an alternative investment.

Other factors that may be considered include observed subscriptions and redemptions in redeemable interests; external market transactions in nonredeemable interests; expected future cash flows; and features of the alternative investment. Additionally, a market participant might normally be expected to compare the performance of the alternative investment to publicly available data (for example, benchmarks, indexes, expected returns, and returns of comparable vehicles), and the cash returns of the investment to NAVs reported by the alternative investment during the year. A conclusion may ultimately be reached that the reported NAV is equivalent to fair value, either because no conditions exist to suggest an adjustment is necessary or because factors

indicating a discount to the reported NAV may be offset by other factors that might justify a premium. In other cases, however, the investment may be valued at a discount or premium to the reported NAV because factors indicate that the fair value of the investment is less than, or more than, the reported NAV. Regardless of whether or not NAV is determined to be equivalent to fair value, the reporting entity needs to evaluate the relevant individual factors and their potential impact on fair value, and consider the level of documentation in its evaluation.

Among the factors that market participants might be expected to consider are the various terms and features of the alternative investment. Such features generally fall into one of two categories: initial due diligence features or ongoing monitoring features. The magnitude of any adjustment resulting from consideration of ongoing monitoring features is a matter of judgment and should be evaluated based on the facts and circumstances specific to each investee fund.

Initial Due Diligence Features. Generally, *initial due diligence features* are inherent characteristics that may have been considered by the reporting entity as part of its due diligence when making its initial investment in the particular investee fund. The following provides examples of initial due diligence features of an alternative investment. Not every feature may be relevant to every alternative investment, nor does this list necessarily include all assumptions that market participants may apply in any specific situation.

Lock-up periods and redemption fees. (Typically applies only to redeemable interests)

Lock-up period refers to the initial amount of time a reporting entity is contractually required to invest before having the ability to redeem. Typically, when the lock-up period expires, the reporting entity may redeem its interests on any scheduled liquidity date, subject to the other liquidity terms described in the investee fund's governing documents. The length of the lock-up period often depends on the quality and reputation of the fund manager as well as the expected liquidity of the underlying investment portfolio. In some instances, alternative investments may offer reduced fees if an investor agrees to a longer lock-up period. Also, some funds may permit investors to redeem during a lock-up period upon payment of a redemption fee. Such fees are typically imposed on the amount to be redeemed and generally range from 1 percent to 3 percent of the gross redemption amount.

Related to the concept of lock-up periods is the general frequency in which an investor is allowed to redeem or withdraw from a fund. In the absence of a lock-up period, investors with redeemable interests typically may only redeem at prescribed liquidity dates (generally monthly, quarterly, or annually).

Notice periods. (Typically applies only to redeemable interests)

Following the expiration of any applicable lock-up period, a reporting entity may, upon specified prior written notice (generally 45–120 days) to the general partner or manager (redemption notice), elect to redeem all or a portion of its interest as of the last day of a calendar month, quarter, or year (redemption date).

Holdbacks. (Typically applies only to redeemable interests)

When the general partner or investment manager receives a redemption notice, the fund will redeem the interests of an investor as specified in the redemption notice, at the redemption price (as discussed subsequently) as of the applicable redemption date. The fund will distribute all or a substantial portion (for example, 90 percent) of the redemption price with respect to the interests being redeemed within a specified number of business days (for example, 30 days) following the applicable redemption date. Any balance (for example, the remaining 10 percent) is distributed within a specific time frame, often following the release of the fund's audited financial statements for the year in which the redemption date falls. Holdback amounts protect the general partner or investment manager from adjustments reducing the NAV of the fund during an audit of the financial statements.

Suspension of redemptions ("gates"). (Typically applies only to redeemable interests)

Pursuant to the fund's governing documents, the general partner or investment manager can suspend or restrict the right of any investor to redeem his or her interests (whether in whole or in part). The general partner or investment manager can implement this restriction for certain reasons, including the aggregate amount of redemption requests, certain adverse regulatory or tax consequences, reduced liquidity of portfolio holdings, and other reasons that may render the manager unable to promptly and accurately calculate the fund's NAV. The most common example is the use of a "gate," whereby certain redemption requests are deferred, in whole or in part, because the aggregate amount of redemption requests as of a particular redemption date exceeds a specified level, generally ranging from 15 percent to 25 percent of the fund's net assets. The mere presence of a provision allowing the imposition of a gate might not normally be expected to have an effect on fair value, in the absence of any evidence suggesting that the provision actually may be exercised (see "Ongoing Monitoring Features," which follows).

Lack of redemption option. (Nonredeemable interests and instances where all or a portion of otherwise redeemable interests have been declared nonredeemable)

As discussed earlier, funds investing in private equity, venture capital, or real estate investments generally do not permit withdrawals or redemptions, primarily to match the liquidity provisions of the fund with the liquidity of the investment

portfolio. When the fund sells any of its portfolio holdings, it often distributes the proceeds received on the sale to the investors in the fund.

Fund sponsor approval to transfer. (Redeemable and nonredeemable interests)

As discussed earlier, in virtually all cases, transfers of interests in alternative investments are not permitted under the governing documents of the fund without the written consent of the fund sponsor or general partner, for regulatory or tax reasons or both, and thus, are inherent to the category of investments. Past experiences, as well as the current operating environment, are both considerations in assessing the likelihood of such approval being granted.

In some private equity, venture capital and real estate funds that require investors to make commitments to invest over time and periodically call on the commitments as needed, the fund sponsor or general partner may allow an investor to withdraw or redeem from the fund and, thus, be absolved of future commitments, but the investor may forfeit its existing interest if no other investors (including the fund sponsor or general partner) are willing to assume the withdrawn partner's interest, including future commitments. If forfeiture occurs (which, in practice, is rare), the investor's interest is generally reallocated to the remaining investors in the fund. (The balance of the withdrawing partner's commitment may also be reallocated to the other investors, or the total size of the fund may be reduced).

Use of "side pockets." (Typically applies only to redeemable interests)

As noted earlier, certain funds issuing redeemable interests may be allowed to invest a portion of their assets in illiquid securities. In such cases, a common mechanism used is a "side pocket," whereby, at the time of an investment in an illiquid security, a proportionate share of an investor's capital account, relative to the entire interest of the fund, is assigned to a separate memorandum capital account or designated account. Typically, the investor loses its redemption rights to the designated account, and even a full redemption request is fulfilled only with that capital ascribed to his or her basic capital account (that is, the nondesignated capital account), while the investor continues to hold its proportionate interest in the designated account. Only when the security is sold (or otherwise deemed liquid) by the fund is the amount moved back to each applicable investor's basic capital account (and otherwise withdrawn investors can redeem the designated account balance). This designated account generally does not pay a performance fee^{fn 8} (although one may be levied) until the illiquid investment is sold or otherwise deemed liquid. Designated accounts are often referred to as "side pocket accounts" or as "special investment accounts." Similar to "gates," the mere existence of contractual provisions permitting the use of side pockets typically does not have a material effect on estimating the fair value unless those provisions

are actually exercised and access to a portion of the investment is actually limited (see “Ongoing Monitoring Features,” which follows).

As previously noted, these examples of initial due diligence features are common characteristics of alternative investment funds and, as such, are generally considered and accepted by investors when making investment decisions in these investments. Accordingly, a market participant may or may not require an adjustment to the reported NAV in a transfer of an investment interest in an alternative investment solely due to the existence of these items. However, it is necessary to consider these features in conjunction with other inputs available to the reporting entity. For example, if the reporting entity is valuing redeemable interests and observes that other investors are subscribing for interests at the reported NAV under the same terms as the reporting entity’s agreement, that fact may provide evidence that no adjustment to the reported NAV is necessary. However, if other investors are subscribing to the fund at the reported NAV under terms that, in aggregate, are less favorable than those in the reporting entity’s agreement (for example, higher fees, greater restrictions on redemption), that fact may provide evidence that the reporting entity’s holdings may trade at a premium to the reported NAV. Similarly, if other investors are receiving more favorable terms in aggregate than those in the reporting entity’s agreement (for example, lower fees, fewer restrictions on redemption), that fact may provide evidence that the reporting entity’s holding may trade at a discount to the reported NAV. An investor may also typically consider whether the fund’s terms are more or less restrictive than those prevailing in the current market. For example, terms that are more restrictive may suggest a discount. Alternatively, the quality of the investment manager may command a premium.

In short, if market participants would be expected to place a discount or premium on the reported NAV because of features, risk, or other factors relating to the interest, then the fair value measurement of the interest would need to be adjusted for that risk or opportunity.^{fn 9} However, if market participants might accept the same features, risk, and other factors relating to the interest and might transact at the reported NAV without a premium or discount, that fact may suggest that no adjustment is needed for the factors discussed previously to estimate fair value.

Ongoing Monitoring Features. *Ongoing monitoring features* are characteristics related to activity in an investee fund subsequent to a reporting entity’s initial investment. Because ongoing monitoring features often include specific events relating to the investee fund, the fund sponsor, the industry or the asset class, they are more likely to result in consideration of a discount or premium to the reported NAV than initial due diligence features. The following provides some examples of ongoing monitoring features for an alternative investment.

As with initial due diligence features, not every feature may be relevant to a particular investment, nor does this list necessarily include all assumptions that market participants may apply in any specific situation. Also, changes in market conditions may affect the investor’s assumptions relating to the significance of any particular feature.

Imposition of a gate. (Typically applies only to redeemable interests)

Though an investee fund manager's mere ability to impose a gate on redemption requests is a common initial due diligence feature (as noted previously), the actual imposition of a gate by an investee fund manager may warrant further consideration of whether a discount should be applied to the reported NAV. The act of imposing the gate generally implies that the investee fund manager is experiencing liquidity concerns, either related to specific investments or its portfolio as a whole, which the reporting entity and a market participant normally would be expected to consider in estimating fair value of the interest in the investee fund. Further, the imposition of a gate increases the uncertainty of the ultimate timing of receipt of cash upon redemption, sometimes significantly, and, thus, may impose an additional risk premium on the investment.

Redemptions from an investee fund. (Typically applies only to redeemable interests)

Even in the absence of the actual imposition of a gate, when an investee fund experiences material redemption requests this may suggest comparable liquidity issues that could result in a discount from the reported NAV, particularly in situations when the investee fund is leveraged.

Notification of redemption triggers the assessment of redemption fee. (Typically applies only to redeemable interests)

Though, as noted previously, an investee fund manager may have the ability to charge redeeming investors a redemption fee, the mere existence of this feature is generally considered to be an initial due diligence feature which, in many instances, may not cause the reported NAV to exceed the fair value of the investment interest. However, if a reporting entity irrevocably agrees to redeem some or all of its interest, the redemption fee normally would be expected to cause the reported NAV to exceed the fair value of the investment interest.

Significant changes in key terms of the investee fund. (Redeemable and nonredeemable interests)

The initial due diligence features, as previously noted, represent standard or common characteristics of an alternative investment. They are generally known and accepted by the reporting entity at the time of making an initial investment at the reported NAV. As such, a market participant with full knowledge of these features may also likely transact at the reported NAV, so long as the terms remain within the range prevailing in the market.

If, however, the investee fund makes significant changes to the terms (for example, fees, lock-up periods, notification periods, gates) subsequent to the

initial investment, the reporting entity normally would be expected to consider these changes when evaluating whether the reported NAV should be adjusted to arrive at fair value. In some cases, changes may be deemed to have little impact on the investment decisions of a market participant, whereas in other cases, changes to key terms may create a distinct difference between the existing interest and other interests (either in the specific alternative investment or comparable investments), which may result in either a discount or premium to the reported NAV.

Closure of fund to new subscriptions. (Redeemable interests)

Some funds may cease accepting subscriptions from new investors because doing so might cause them to exceed the maximum number of investors they can accept without requiring public filings of financial information under securities laws. In other cases, funds may voluntarily suspend the acceptance of subscriptions from new investors, and even in some cases additional subscriptions from existing investors, because of the adviser's view that opportunities to make further investments under the fund's investment strategy may be limited given the size of the markets involved or that they might not bring acceptable returns, or both. Such an event may suggest that existing interests in the fund could trade at a premium because prospective investors may have no other means of investing in the fund. Further, a large number of investors or the intent not to "dilute" the fund's returns by accepting additional investment funds, or both, may provide evidence that the fund may trade at a premium to the reported NAV.

Ability of fund to identify and make acceptable investments. (Nonredeemable interests)

Venture capital, private equity, and real estate funds typically offer interests on the basis of committed capital, which is only called from investors as investments are identified. Investors agree to commit capital under implicit or explicit understandings that committed capital will be called during an initial investment period, often from one to five years. Depending on the market environment, managers may find that they are unable to identify sufficient investments to utilize committed capital on a timely basis. Such funds often are smaller and less diversified than expected at the time of inception of the fund, which may negatively influence fair value. Further, certain vintages (that is, years when funds were organized) may be identified over time as having represented exceptionally good or poor investment opportunities for the particular investment style, and interests in funds organized in those years may be more likely to incur premiums or discounts, respectively. The fund's potential inability to identify and make acceptable investments will often result in unfunded capital commitments, which may need to be considered when estimating the fair value of an investment interest in the fund.

Allegations of fraud against the investee fund manager. (Redeemable and nonredeemable interests)

If the reporting entity is aware of allegations of fraud, illegal acts, or other improprieties against the investee fund manager or its affiliates, the reporting entity should consider the potential impact of these allegations on the value of its interest in the investee fund. In many cases, such allegations may result in the unexpected inability to obtain any cash proceeds from the investee fund pending the resolution of the investigation or from a general lack of liquidity resulting from historical misrepresentation of the net assets of the fund. In other cases, the ongoing ability of the investee fund manager to manage the fund may be brought into question.

Change in financial strength or key personnel of investment manager. (Redeemable and nonredeemable interests)

In some cases, a key consideration for investment in certain funds is the reputation, and prior investment record, of the investment manager, or specific individuals expected to manage the investee fund's portfolio. In some situations, the desirability of the investment manager or individuals, or both, may influence the nature of the fee, lock-up, and similar terms investors are willing to accept in making an initial investment. If those key personnel no longer provide services to the alternative investment, investors may not be willing to continue to accept those terms. Further, if the advisory organization experiences financial deterioration, it may be less able to retain key personnel or, for certain private equity, venture capital, or real estate funds, to repay previously-received incentive fees to the fund under contractual clawback provisions (if the fund experiences subsequent losses). Those uncertainties may increase the risk of the investment.

[Issue Date: December 2009]

^{fn 1} The AICPA nonauthoritative practice aid *Alternative Investments—Audit Considerations* is available on the AICPA website at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestGuidance/Pages/alternative_investments.aspx.

^{fn 2} For further guidance, see AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*), and the AICPA nonauthoritative practice aid *Alternative Investments—Audit Considerations*.

^{fn 3} See footnote 2.

^{fn 4} Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801), establishes the requirements and application guidance for a service auditor reporting on controls at a service organization relevant to user entities' internal control over financial reporting. AU section 324, *Service Organizations* (AICPA, *Professional Standards*), contains the requirements and application guidance related to an auditor's use of a service auditor's report in an audit of the financial statements of an entity that uses a service organization.

[Footnote revised, August 2011, to reflect conforming changes necessary due to the issuance of SSAE No. 16.]

^{fn 5} When the reporting entity's measurement date is prior to the net asset value (NAV) calculation date, it may be more appropriate to use that NAV and perform a roll back rather than using a reported NAV calculated prior to the entity's measurement date.

^{fn 6} Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820-10-35-15 states that "the effect on a fair value measurement of a restriction on the sale or use of an asset by a reporting entity will differ depending on whether the restriction would be considered by market participants in pricing the asset."

^{fn 7} The "Investment Features" section contains important information related to features of alternative investments that a reporting entity may consider in determining fair value when the option to utilize the practical expedient is unavailable or not elected. The list of features highlighted in this section is intended to provide some examples to better explain the types of scenarios that could impact fair values. Because individual investments may have additional terms and features, the examples included in the "Investment Features" section should not be viewed as an all-inclusive "checklist." Professional judgment should be applied in evaluating the assumptions appropriate to any individual investment. The actual computation of fair value requires management's professional judgment and is beyond the scope of this Technical Questions and Answers section.

^{fn 8} Consistent with the definition in the AICPA Audit and Accounting Guide *Investment Companies*, a *performance fee* (also referred to as an *incentive fee*) is a fee paid to an investment adviser based upon the fund's performance for the period. It may be an absolute share of the fund's performance or a share of the performance in excess of a specified benchmark.

^{fn 9} This is consistent with FASB ASC 820-10-35-54, which states, "A measurement (for example, a mark-to-model measurement) that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one in pricing the related asset or liability."

Chapter 5

Contributions Received and Agency Transactions

Introduction

- 5.01** Some not-for-profit entities (NFPs) receive contributions of cash, other assets, and services from individuals, for-profit entities, other NFPs, and governments. Other assets include securities, land, buildings, use of facilities or utilities, material and supplies, intangible assets, and unconditional promises to give in the future.
- 5.02** The Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary, defines a *contribution* as
- an unconditional transfer of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner. Those characteristics distinguish contributions from exchange transactions, which are reciprocal transfers in which each party receives and sacrifices approximately equal value; from investments by owners and distributions to owners, which are nonreciprocal transfers between an entity and its owners; and from other nonreciprocal transfers, such as impositions of taxes or legal judgments, fines, and thefts, which are not voluntary transfers. In a contribution transaction, the value, if any, returned to the resource provider is incidental to potential public benefits. In an exchange transaction, the potential public benefits are secondary to the potential proprietary benefits to the resource provider. The term contribution revenue is used to apply to transactions that are part of the entity's ongoing major or central activities (revenues), or are peripheral or incidental to the entity (gains).
- 5.03** The “Contributions Received” subsections of FASB ASC 958-605 provide guidance for contributions of cash and other assets received, including promises to give. FASB ASC 958-605-15-6 states that the guidance in those subsections do not apply to the following transactions and activities:
- Transfers of assets that are in substance purchases of goods or services—exchange transactions, in which each party receives and sacrifices commensurate value. However, if an entity voluntarily transfers assets to another or performs services for another in exchange for assets of substantially lower value and no unstated rights or privileges are involved, the contribution received that is inherent in that transaction is within the scope of the “Contributions Received” subsections. (For additional information about transfers that include inherent contributions, see paragraph 5.42.)

- Transfers of assets in which the reporting entity is acting as an agent, trustee, or intermediary rather than as a donor or donee. (Those transactions are within the scope of the “Transfers of Assets to a Not-for Profit Entity or Charitable Trust that Raises or Holds Contributions for Others” subsections of FASB ASC 958-605.)
- Tax exemptions, tax incentives, and tax abatements.

5.04 This chapter provides guidance for distinguishing contributions from other kinds of transactions. It also discusses recognition, measurement, and disclosure principles for contribution revenues^{fn 1} and related receivables.^{fn 2} Chapter 12, “Revenue and Receivables From Exchange Transactions,” discusses accounting principles for revenues, gains, and receivables from providing services and from other exchange transactions. Chapter 13, “Expenses, Gains, and Losses,” discusses reporting contributions made by NFPs.

Distinguishing Contributions From Other Transactions^{fn 3}

- 5.05** A contribution by definition must be a voluntary transfer. Some resource providers may be required to transfer assets or provide services to NFPs involuntarily; for example, to settle legal disputes or to pay fines. Those transactions are not contributions. Accounting for contributions is different from accounting for other kinds of voluntary transfers, such as conditional transfers, agency transactions, and exchange transactions. Accounting for transfers with donor-imposed conditions is discussed in paragraphs 5.58–.73.
- 5.06** Flowchart 5-1 provides guidance for determining whether a transfer of assets includes a contribution. To determine the accounting for transactions in which an entity voluntarily transfers assets to an NFP, it is first necessary to assess the extent of discretion the NFP has over the use of the assets that are received. If it has little or no discretion, the

^{fn 1} For purposes of this chapter, the term *contribution revenue* is used to apply to transactions that are part of the not-for-profit entity’s (NFP’s) ongoing major or central activities (revenues), or are peripheral or incidental to the NFP (gains). Chapter 12, “Revenues and Receivables From Exchange Transactions,” discusses the distinction between ongoing major activities and peripheral or incidental transactions and events.

^{fn 2} Unconditional promises to give cash or other financial instruments, such as an ownership interest in an entity, are *financial instruments* as defined in the Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary, and thus requirements for recognition and disclosure of financial instruments apply.

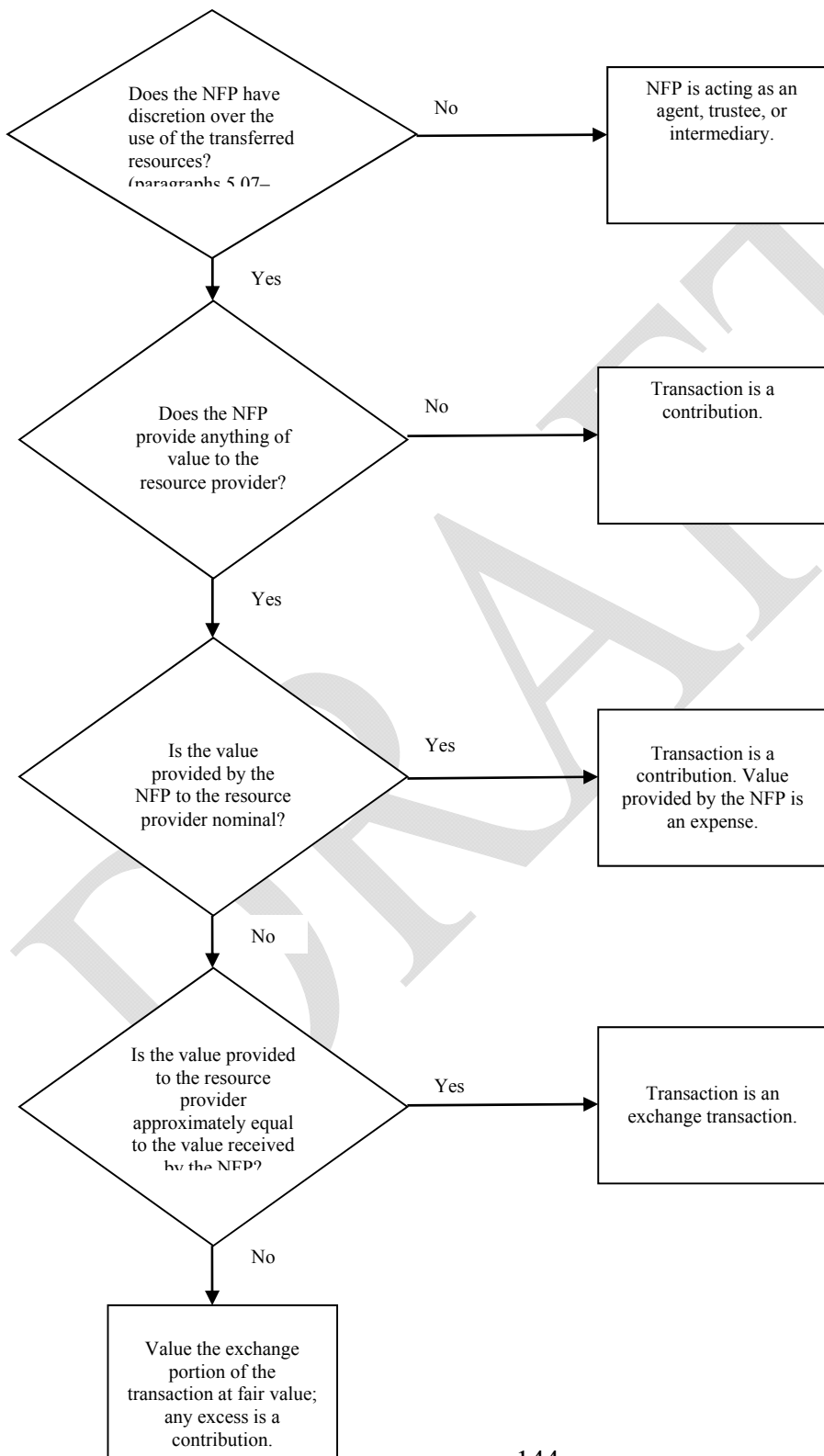
^{fn 3} Federal rules specify the classification of certain transactions for purposes other than reporting in conformity with generally accepted accounting principles (GAAP), such as contractual reporting requirements. For example, certain transactions should be classified as federal awards received and expended by NFPs. The guidance in this guide pertains to financial reporting in conformity with GAAP. Classifications in conformity with GAAP may differ from classifications in accordance with federal rules.

transaction is an agency transaction. If it has discretion over the assets' use, the transaction is a contribution, an exchange, or a combination of the two.

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Flowchart 5-1

Determining Whether a Transfer to a Not-For-Profit Entity Includes a Contribution



Agency Transactions

- 5.07** The FASB ASC glossary defines an *agency transaction* as “a type of exchange transaction in which the reporting organization acts as an agent, trustee, or intermediary for another party that may be a donor or donee.”
- 5.08** When NFPs act as agents, trustees, or intermediaries helping donors to make a contribution to another entity or individual, they do not receive a contribution when they receive the assets, nor do they make a contribution when they disburse the assets to the other entity or individual. Instead, they act as go-betweens, passing the assets from the donor through their organization to the specified entity or individual. Federated fund-raising entities, community foundations, and institutionally related entities are examples of NFPs that commonly serve as agents, trustees, or intermediaries, but any NFP can function in those capacities.
- 5.09** The “Transfers of Assets to a Not-for-Profit Entity or Charitable Trust That Raises or Holds Contributions for Others” subsections of FASB ASC 958-605 establish standards for transactions in which an entity—the donor—makes a contribution by transferring assets to an NFP or charitable trust—a recipient entity—that accepts the assets from the donor and agrees to use those assets on behalf of or transfers those assets, the return on investment of those assets, or both to an unaffiliated entity—the beneficiary—that is specified by the donor. Paragraphs 5.32–.37 discuss the standards for transactions that take place in a similar manner, but are not contributions because the transfers are revocable, repayable, or reciprocal. FASB ASC 958-605 does not set standards for recipient entities that are trustees.^{fin 4}
- 5.10** FASB ASC 958-605-55-76 states that a recipient entity has discretion sufficient to recognize a contribution received if it can choose the beneficiaries of the assets. Paragraphs 76–79 of FASB ASC 958-605 provide guidance to help determine whether a recipient entity has discretion to choose the beneficiary. FASB ASC 958-605-25-24 states that except as described in FASB ASC 958-605-25-25 [variance power] and FASB ASC 958-605-25-27 [financially interrelated entities], a recipient entity that accepts assets from a donor and agrees to use those assets on behalf of [a specified beneficiary] or transfer those assets, the return on investment of those assets, or both to a specified beneficiary is [an agent and] not a donee. (The exceptions for variance power are discussed in paragraphs 5.22–.26 and for financially interrelated entities in paragraphs 5.27–.31.) FASB ASC 958-605-55-78 states that a donor may specify the beneficiary (a) by name, (b) by stating that all entities that meet a set of donor-defined criteria are beneficiaries, or (c) by actions surrounding the transfer that made clear the identity of the

^{fin 4} Chapter 6, “Split-Interest Agreements and Beneficial Interests in Trusts,” discusses split-interest and similar agreements in which NFPs act as trustee for a resource provider and have a beneficial interest in the assets transferred.

beneficiary. (Paragraphs 80–115 of FASB ASC 958-605-55 provide examples of donor stipulations and discuss whether those stipulations specify a beneficiary.)

- 5.11** The following are three examples of circumstances in which donors specify a beneficiary and the recipient entity should not recognize a contribution (unless the exceptions for variance power or for financially interrelated entities apply). If a donor selects a beneficiary from among a list of potential beneficiaries that have been prequalified or otherwise identified by the recipient entity, the assets received are not contributions to that recipient entity. Similarly, if a grantor specifies eligibility criteria and states that the grant proceeds must be transferred to all who meet those criteria, the recipient entity has not received a contribution even though it may be responsible for determining whether individuals or entities meet those grantor-specified eligibility criteria. Likewise, if a donor responds to a campaign request from an NFP that indicates that the proceeds of the campaign will be distributed to a named beneficiary, then that recipient entity has not received a contribution.
- 5.12** In contrast, if neither the language used by the donor, the representations of the recipient entity, nor the actions surrounding the transfers cause the donor to believe that he or she is directing the gift to a specified beneficiary, then the NFP is a donee and should recognize a contribution received. For example, an NFP is a donee and should recognize a contribution if it asks the donor to select one or more fields of interest from among a list of community needs prepared by the NFP. Similarly, if a donor uses broad generalizations to describe the beneficiaries, such as homeless individuals, the NFP has received a contribution because the choice of the beneficiary is within its control. Likewise, if an NFP asks its donors to indicate an NFP for consideration by its allocation committee, the NFP is the donee if that request is conveyed in a manner that leads the donor to conclude that its role is merely to propose possible allocations.
- 5.13** The representations made to the donor during the solicitation of a gift are important in determining whether a transaction is an agency transaction. If an NFP creates a donor's reasonable expectation that a contribution will be transferred to a beneficiary specified by the donor, the NFP is an agent or intermediary. Unless the NFP has variance power or is financially interrelated to the specified beneficiary, it should not recognize a contribution received.
- 5.14** FASB ASC 958-605-55-75 states that discretion to determine the timing of the distribution to the specified beneficiary, by itself, does not give the recipient entity discretion sufficient to recognize a contribution. That limited discretion is not sufficient. The ability to choose a payment date does not relieve an entity from its obligation to pay.
- 5.15** Pursuant to FASB ASC 958-605-25-24, an agent should recognize its liability to the specified beneficiary concurrent with its recognition of cash or other financial assets received from the donor. As discussed in FASB ASC 958-605-30-13, both the asset and the liability should be measured at the fair value of the assets received from the donor. FASB ASC 958-605-25-24 states that except as described in [the paragraphs about

variance power and financially interrelated entities], a recipient entity that receives nonfinancial assets is permitted, but not required, to recognize its liability and those assets provided that the recipient entity reports consistently from period to period and discloses its accounting policy. An NFP should consider the need for disclosure of its accounting policy in the notes to the financial statements pursuant to FASB ASC 235-10-50-1.

- 5.16** Distributions of cash or other assets to the specified third-party beneficiaries should be reported as decreases in the assets and liabilities.
- 5.17** Technical Questions and Answers (TIS) section 6140.12, “Nondiscretionary Assistance Programs” (AICPA, *Technical Practice Aids*), provides the following example of a circumstance in which a donor specifies a beneficiary and the recipient entity should not recognize a contribution (unless the exceptions for variance power or financially interrelated entities apply). Some NFPs participate in activities wherein the resource provider (donor) determines the eligibility requirements for the ultimate beneficiaries and the NFP (recipient entity) must disburse to any who meet guidelines specified by the resource provider or return the assets. In some of those programs, the NFP receives assets, such as food, food vouchers, public transportation vouchers, and cash, and distributes the assets on behalf of the resource provider (donor) in exchange for a fee for performing that service. Receipts and disbursements of assets under such nondiscretionary programs (other than any fees for performing the service) are agency transactions, and are not contributions to the recipient NFP. A recipient entity that receives financial assets, such as cash or vouchers that can be exchanged for cash, should recognize its liability to the beneficiaries concurrent with its recognition of financial assets received from the donor. A recipient entity that receives nonfinancial assets, such as food vouchers or public transportation vouchers that are denominated in either dollar values or in nonfinancial terms, such as pounds of food or bus rides, but that will not be settled in cash, is permitted, but not required, to recognize its liability and those assets provided that the entity reports consistently from period to period and discloses its accounting policy.
- 5.18** FASB ASC 958-230-55-4 states that cash received and paid in agency transactions should be reported as cash flows from operating activities in a statement of cash flows. If the statement of cash flows is presented using the indirect method, cash received and paid in such transactions is permitted to be reported either gross or net. FASB ASC 958-605-50-5 states that additional information about transactions in which an NFP acts as an agent, trustee, or intermediary may be required to be disclosed under FASB ASC 850, *Related Party Disclosures*.
- 5.19** Paragraphs 28–30 of FASB ASC 958-605-25 provide guidance for recognition of an agency transaction by the specified beneficiary. A specified beneficiary should recognize its rights to the assets (financial or nonfinancial) held by a recipient entity as an asset unless the recipient entity is explicitly granted variance power. Those rights are any one of the following: (a) an interest in the net assets of the recipient entity (which is discussed

in paragraphs 5.27–.31), (b) a beneficial interest (which is an unconditional right to receive all or a portion of the specified cash flows from a charitable trust or other identifiable pool of assets), or (c) a receivable (which is discussed in the following paragraph). Chapter 6, “Split-Interest Agreements and Beneficial Interests in Trusts,” provides additional information about the beneficiaries’ rights to trust assets.

- 5.20** FASB ASC 958-605-25-30 states that if the beneficiary’s rights are neither an interest in the net assets of the recipient entity nor a beneficial interest, a beneficiary should recognize its rights to the assets held by a recipient entity as a receivable and contribution revenue in accordance with paragraphs 8–10 of FASB ASC 958-605-25 and FASB ASC 958-605-45-5 for unconditional promises to give. (Paragraphs 5.88–.110 and 5.178–.210 discuss recognition and measurement of promises to give.) In some cases, an agent will charge a fee for raising the contributions. As discussed in FASB ASC 958-605-55-86, if a federated fund-raising entity charges an administrative fee that will be deducted from all contributions that are to be transferred to a donor’s chosen entity, the beneficiaries should report the gross amount of the gifts as contribution revenue and the administrative fees withheld by the federated fund-raising entity as expenses. TIS section 6140.21, “Should an NPE Report Amounts Charged to the NPE by a Professional Fund-Raiser Gross, as Fund-Raising Expenses, or Net, as a Reduction of Contributions?,” and TIS section 6140.22, “In Circumstances in Which the Reporting NPE Undertakes a Transaction in Which Another NPE (Fund-Raising NPE) Raises Contributions on Behalf of the Reporting NPE, and the Reporting NPE Compensates the Fund-Raising NPE for Raising Those Contributions (Compensation Including, But Not Limited to, an Administrative Fee), Should the Reporting NPE Report the Fund-Raising NPE’s Compensation Gross, as Fund-Raising Expenses, or Net, as a Reduction of Contributions?” (AICPA, *Technical Practice Aids*), also discuss situations in which an NFP is charged a fee by a professional fund-raiser, a federated fund-raising entity, or another agent for soliciting contributions on the NFP’s behalf. The NFP should report the gross amount of contributions from the donors without reduction. The amount charged or retained as compensation by the professional fund-raiser, federated fund-raising entity, or other entity acting as an agent or intermediary is reported as fund-raising expenses. For example, an NFP enters into a transaction with a professional fund-raiser, whereby the fund-raiser solicits contributions on behalf of the NFP for a fee of 20 percent of the contributions raised. The fund-raiser raises \$100,000 from donors and remits \$80,000 to the NFP after retaining its fee of \$20,000. The NFP should report \$100,000 of contribution revenue and \$20,000 of fund-raising expense. TIS sections 6140.21 and 6140.22 are discussed further in chapter 13.
- 5.21** Present value techniques are one valuation technique for measuring the fair value of the contribution and the beneficial interest or receivable; other valuation techniques also are available, as described in FASB ASC 820, *Fair Value Measurement*.^{fn 5} If present value

^{fn 5} Paragraphs 3.73–.94 discuss FASB ASC 820, *Fair Value Measurement*, which defines *fair value*, establishes a framework for measuring fair value, and identifies required disclosures about fair value measurements. Paragraphs 4–20 of FASB ASC 820-10-55 provide standards for using present value techniques when the measurement objective is fair value.

techniques are used, the contribution revenue and the beneficial interest or receivable should be measured as the present value of the future cash inflows over the expected term of the agreement. The choice of accounting policies regarding recognition of nonfinancial assets, as discussed in paragraph 5.15, applies only to the agent or intermediary; beneficiaries should recognize their rights to nonfinancial assets held by the recipient entity.

Variance Power

5.22 The FASB ASC glossary defines *variance power* as

[t]he unilateral power to redirect the use of the transferred assets to another beneficiary. A donor explicitly grants variance power if the recipient entity's unilateral power to redirect the use of the assets is explicitly referred to in the instrument transferring the assets. Unilateral power means that the recipient entity can override the donor's instructions without approval from the donor, specified beneficiary, or any other interested party.

- 5.23** Paragraphs 25–26 of FASB ASC 958-605-25 discuss the effects of variance power on recognition of the transferred assets by the recipient entity. A recipient entity that is directed by a donor to distribute the transferred assets, the return on investment of those assets, or both to a specified unaffiliated beneficiary acts as a donee, rather than an agent, trustee, or intermediary, if the donor explicitly grants the recipient entity variance power. A recipient entity that is explicitly granted variance power has the ability to use assets it receives to further its own purpose from the date it accepts the assets. In that situation, the recipient entity should account for receipt of funds by recognizing an asset and corresponding contribution revenue unless the transfer is revocable, repayable, or reciprocal as described in FASB ASC 958-605-25-33 (paragraph 5.33).
- 5.24** Variance power provides the recipient entity with discretion sufficient to recognize a contribution received despite the specification of a beneficiary by the donor, subject to the exception in the following paragraph. If a donor explicitly grants a recipient entity variance power and names an unaffiliated beneficiary, the recipient entity is a donee and recognizes contribution revenue. Unaffiliated means that the beneficiary is other than the donor or the donor's affiliate as defined in the FASB ASC glossary.
- 5.25** A recipient entity that receives variance power should not report a contribution if the resource provider specifies itself or its affiliate(s) as the beneficiary of the transferred assets. Because of their reciprocal nature, those transfers are not contributions received by the recipient entity—even if the resource provider granted the recipient entity variance power at the time of the transfer. Paragraphs 5.32–.37 discuss transactions in which a resource provider names itself or its affiliate as beneficiary of a transfer of assets to a recipient entity.

- 5.26** As discussed in FASB ASC 958-605-25-31, if the donor explicitly grants a recipient entity variance power, the specified unaffiliated beneficiary should not recognize its potential for future distributions from the assets held by the recipient entity. Those future distributions, if they occur, should be recognized as contributions by the specified beneficiary when received or unconditionally promised.

Financially Interrelated Entities

- 5.27** The FASB ASC glossary defines *financially interrelated entities* stating that a recipient entity and a specified beneficiary are financially interrelated if the relationship between them has both of the following characteristics: (a) one of the entities has the ability to influence the operating and financial decisions of the other and (b) one of the entities has an ongoing economic interest in the net assets of the other.
- 5.28** FASB ASC 958-20-15-2 states that the ability to exercise that influence (of the operating and financial decisions of the other) may be demonstrated in several ways, including the following:
- a. The entities are affiliates as defined in the FASB ASC glossary.
 - b. One entity has considerable representation on the governing board of the other entity.
 - c. The charter or bylaws of one entity limit its activities to those that are beneficial to the other entity.
 - d. An agreement between the entities allows one entity to actively participate in the policy making processes of the other, such as setting organizational priorities, budgets, and management compensation.

The FASB ASC glossary defines an *ongoing economic interest in the net assets of another* as a residual right to another NFP's net assets that results from an ongoing relationship. The value of those rights increases or decreases as a result of the investment, fund-raising, operating, and other activities of the other entity.

- 5.29** FASB ASC 958-605-25-27 states that if a recipient entity and a specified beneficiary are financially interrelated entities and the recipient entity is not a trustee, the recipient entity should recognize a contribution received when it receives assets (financial or nonfinancial) from the donor that are specified for the beneficiary. FASB ASC 958-20-25 provides the following example. A foundation that exists to raise, hold, and invest assets for the specified beneficiary or for a group of affiliates of which the specified beneficiary is a member generally is financially interrelated with the NFP or NFPs it supports. The foundation should recognize contribution revenue when it receives assets from the donor. Pursuant to FASB ASC 958-20-25-2, the beneficiary should recognize its interest in the net assets of the recipient entity and adjust that interest for its share of the change in net assets of the recipient entity using a method similar to the equity method of accounting

for investments in common stock.^{fn 6} Examples 1–3 (paragraphs 3–17) of FASB ASC 958-20-55 illustrate this guidance. (Paragraphs 13.116–.118 of this guide provide guidance pertaining to distributions from financially interrelated fund-raising foundations to specified beneficiaries.) Appendix B of chapter 13 includes a series of nonauthoritative technical questions and answers (TIS sections 6140.13–.18 [AICPA, *Technical Practice Aids*]) that discuss the classification of a beneficiary’s interest in the net assets of a financially interrelated fund-raising foundation in the beneficiary’s financial statements.

- 5.30** FASB ASC 958-20-55-2A states that although most of the relationships described in the definition of *economic interest* used in FASB ASC 958-810 (see FASB ASC 958-810-55-6) are potentially ongoing economic interests in the net assets of the other, some do not meet the criterion in paragraph 958-20-15-2(b). (The examples of economic interest in FASB ASC 958-810-55-6 are included in paragraph 3.63 of this guide.) Only economic interests that are both ongoing and residual interests in the net assets are ongoing economic interests in the net assets of another.
- 5.31** Most of the relationships described in FASB ASC 958-810-55-6 are potentially ongoing economic interests in the net assets of a financially interrelated entity. However, some will not meet the definition because they are not ongoing interests; or they are not residual interests; or are neither ongoing nor residual. By specifying that an interest in the net assets of a financially interrelated entity be ongoing, the definition of *financially interrelated entities* includes economic interests in entities that provide ongoing support to the NFP and excludes economic interests that arise only upon the dissolution of the NFP. By specifying that the interest in the net assets be residual, the definition excludes economic interests that are a fixed dollar amount. For example, some NFPs receive equity infusions from another entity, and they are required to return the fixed amount of that equity infusion upon the occurrence of a triggering event, such as the cancellation of an affiliation agreement. Economic interests of that type are not residual rights whose value increases or decreases as a result of the investment, fund-raising, operating, and other activities of the other entity.

Similar Transactions That Are Revocable, Repayable, or Reciprocal

- 5.32** In addition to establishing standards for contributions transferred to beneficiaries via agents, trustees, and intermediaries, the “Transfers of Assets to a Not-for-Profit Entity or Charitable Trust that Raises or Holds Contributions for Others” subsections of FASB ASC 958-605 also set standards for transactions that take place in a similar manner (that is, there is a resource provider, a recipient entity, and a specified beneficiary), but that are not contributions because the terms of the transfer or the relationships between the parties make the transfer revocable, repayable, or reciprocal.

^{fn 6} FASB ASC 958-20-55-11 states that an interest in the net assets of an affiliate would be eliminated if that affiliate was included in consolidated financial statements of the interest holder.

5.33 FASB ASC 958-605-25-33 describes four types of transfers that are not contributions to either the recipient entity or the specified beneficiary. The first three types are the following:

- a. The transfer is subject to the resource provider's unilateral right to redirect the use of the transferred assets to another beneficiary.
- b. The transfer is accompanied by the resource provider's conditional promise to give or is otherwise revocable or repayable.
- c. The resource provider controls the recipient entity and specifies an unaffiliated beneficiary. Several definitions of control exist. The definition of control in FASB ASC 958-810 and FASB ASC 850 should be considered when determining whether one entity controls another.^{fn 7}

Those transfers should be reported as an asset of the resource provider and as a liability of the recipient entity.

5.34 Sometimes a resource provider specifies itself or its affiliate as beneficiary of a transfer of assets to a recipient entity. Those transfers are reciprocal and thus are not contributions. Examples of those types of transfers are (a) an NFP transfers assets to a community foundation to establish an endowment for the benefit of the NFP and (b) an NFP transfers assets to a foundation it creates to hold those assets.

5.35 Paragraphs 4–7 of FASB ASC 958-20-25 describe two types of reciprocal transactions, which are as follows:

- a. An equity transaction—A transfer of assets to a recipient entity that meets all of the following conditions:
 - i. The resource provider specifies itself or its affiliate as the beneficiary,
 - ii. The resource provider and the recipient entity are financially interrelated entities (paragraphs 5.27–.31 discuss financially interrelated entities), and
 - iii. Neither the resource provider nor its affiliate expects payment of the transferred assets, although payment of investment return on the transferred assets may be expected.

^{fn 7} FASB ASC 850, *Related Party Disclosures*, defines *control* as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an enterprise through ownership, by contract, or otherwise." FASB ASC 958-810 defines *control* as "the direct or indirect ability to determine the direction of management and policies through ownership, contract, or otherwise."

- b. The resource provider specifies itself or its affiliate as the beneficiary and any of the conditions (ii.) and (iii.) in paragraph (a) are not met (that is, the transfer is not an equity transaction).
- 5.36** Per FASB ASC 958-605-25-33, if the transfer in which the resource provider specifies itself or its affiliate as the beneficiary is not an equity transaction, the resource provider should report an asset and the recipient entity should report a liability. If the transaction is an equity transaction, the reporting depends upon whether the resource provider or its affiliate is the specified beneficiary. Per FASB ASC 958-20-25-5 and FASB ASC 958-20-45-1, if the resource provider specifies itself as the beneficiary, the resource provider should report an equity transaction as an interest in the net assets of the recipient entity (or an increase in a previously recognized interest), and the recipient entity should report an equity transaction as a separate line in its statement of activities. Per FASB ASC 958-605-25-6 and FASB ASC 958-20-45-1, if the resource provider specifies an affiliate as the beneficiary, the resource provider and the recipient entity should report an equity transaction as separate lines in their statements of activities, and the affiliate named as beneficiary should report an interest in the net assets of the recipient entity.
- 5.37** In accordance with FASB ASC 958-20-45-3, if the beneficiary (resource provider or its affiliate) and the recipient entity are included in consolidated financial statements, the beneficiary's interest in the net assets of the recipient entity (as recognized in the previous paragraph) should be eliminated.

Exchange Transactions^{fn 8}

- 5.38** The FASB ASC glossary defines *exchange transaction* as a reciprocal transfer between two entities that results in one of the entities acquiring assets or services or satisfying liabilities by surrendering other assets or services or incurring other obligations. The FASB ASC glossary definition of *contribution* states that contributions differ from exchange transactions, which are reciprocal transfers in which each party receives and sacrifices something of approximately equal value.
- 5.39** In some situations, exchange transactions can be easily distinguished from contributions. For example, sales in a museum bookstore or payments of employees' salaries clearly are exchange transactions: each party gives up and receives equivalent economic value. In contrast, an example of a contribution is a donation to an NFP's mass fund-raising appeal: donors are providing resources in support of the NFP's mission and expect to receive nothing of direct value in exchange.

^{fn 8} Certain reciprocal transactions that involve transfers to recipient entities are discussed in paragraphs 5.24 and 5.30–35.

- 5.40** In some cases, NFPs provide premiums to donors or to potential donors. Paragraphs 18–19 of FASB ASC 958-720-45 discuss the cost of premiums and whether premiums are given in exchange for resources provided. The guidance is included in this paragraph and the following paragraph. The cost of premiums (such as postcards, address labels, or calendars) given to potential donors as part of mass fund-raising appeals is a fund-raising expense, and the classification of the donations received from the appeal as contributions is unaffected by the fact that premiums were given to potential donors. The premiums are not provided to potential donors in exchange for the assets contributed; they can be kept by all those from whom funds are solicited, regardless of whether a contribution is made.
- 5.41** The cost of premiums (such as coffee mugs) that are given to resource providers to acknowledge receipt of a contribution also should be reported as fund-raising expenses if those costs are nominal in value compared with the value of the goods or services donated by the resource provider. For example, an NFP may provide a coffee mug to people making a contribution of \$50 or more; the mug costs the NFP \$1. The NFP should recognize contributions for the total amount contributed and fund-raising expense of \$1 for each coffee mug provided to donors. The cost of premiums that are greater than nominal in value should be reported as cost of sales. If premiums are greater than nominal in value, transactions shall be reported as part exchange transaction and part contribution.
- 5.42** Transactions that are in part a contribution and in part an exchange transaction (also referred to as bargain purchases) include an inherent contribution. The FASB ASC glossary defines an *inherent contribution* as a contribution that results if an entity voluntarily transfers assets (or net assets) or performs services for another entity in exchange for either no assets, or for assets of substantially lower value, and unstated rights or privileges of a commensurate value are not involved. For example, an individual has a home currently valued at \$150,000, which is subject to a mortgage of \$30,000. If the individual pays off the mortgage and sells the home to an NFP for \$50,000, a contribution of \$100,000 is inherent in the transaction. The Financial Reporting Executive Committee (FinREC) believes that in circumstances in which the transaction is in part a contribution and in part an exchange, NFPs should first determine the fair value of the exchange portion of the transaction, with the residual (excess of the resources received over the fair value of the exchange portion of the transaction) reported as contributions.
- 5.43** In other circumstances, however, classifying asset transfers as exchange transactions or as contributions may require the exercise of judgment concerning whether a reciprocal transaction has occurred, that is, whether a recipient NFP has given up assets, rights, or privileges approximately equal to the value of the assets, rights, or privileges received. Value should be assessed from both the recipient NFP's and the resource provider's points of view and can be affected by a wide variety of factors; for example, resource providers can retain the right to share in the use of or income from an asset provided to the NFP or obtain benefit in the marketplace, such as stimulating a positive entity image.

- 5.44** Table 5-1 contains the list of indicators from FASB ASC 958-605-55-8 that may be helpful in determining whether individual asset transfers are contributions, exchange transactions, or a combination of both. Depending on the facts and circumstances, some indicators may be more significant than others; however, no single indicator is determinative of the classification of a particular transaction. Indicators of a contribution tend to describe transactions in which the value, if any, returned to the resource provider is incidental to potential public benefits. Indicators of an exchange tend to describe transactions in which the potential public benefits are secondary to the potential proprietary benefits to the resource provider.

Table 5-1

**Indicators Useful in Distinguishing Contributions
From Exchange Transactions**

<i>Indicator</i>	<i>Contribution</i>	<i>Exchange Transaction</i>
Recipient not-for-profit entity's (NFP's) intent in soliciting the asset	Recipient NFP asserts that it is soliciting the asset as a contribution.	Recipient NFP asserts that it is seeking resources in exchange for specified benefits.
Resource provider's expressed intent about the purpose of the asset to be provided by recipient NFP	Resource provider asserts that it is making a donation to support the NFP's programs.	Resource provider asserts that it is transferring resources in exchange for specified benefits.
Method of delivery	The time or place of delivery of the asset to be provided by the recipient NFP to third-party recipients is at the discretion of the NFP.	The method of delivery of the asset to be provided by the recipient NFP to third-party recipients is specified by the resource provider.
Method of determining amount of payment	The resource provider determines the amount of the payment.	Payment by the resource provider equals the value of the assets to be provided by the recipient NFP, or the assets' cost plus markup; the total payment is based on the quantity of assets to be provided.
Penalties assessed if NFP fails to make timely delivery of assets	Penalties are limited to the delivery of assets already produced and the return of the unspent amount. (The NFP is not penalized for nonperformance.)	Provisions for economic penalties exist beyond the amount of payment. (The NFP is penalized for nonperformance.)
Delivery of assets to be provided by the recipient NFP	Assets are to be delivered to individuals or organizations	Assets are to be delivered to the resource provider or to

	other than the resource provider.	individuals or organizations closely connected to the resource provider.
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* This table refers to assets. Assets may include services. The terms *assets* and *services* are used interchangeably in this table.

5.45 The following voluntary asset transfers are discussed in more detail because they may be difficult to classify:

- Membership dues (paragraphs 5.46–.49)
- Grants, awards, and sponsorships (paragraphs 5.50–.51)
- Naming opportunities (paragraphs 5.52–.55)
- Donor status (paragraph 5.56)
- Gifts in kind (paragraphs 5.122–.128)

Membership Dues

5.46 Paragraphs 9–12 of FASB ASC 958-605-55 discuss NFPs that receive dues from their members. This paragraph and the following paragraph and table reproduce that guidance. The term “members” is used broadly by some NFPs to refer to their donors and by other NFPs to refer to individuals or other entities that pay dues in exchange for a defined set of benefits. These transfers often have elements of both a contribution and an exchange transaction because members receive tangible or intangible benefits from their membership in the NFP. Usually, the determination of whether membership dues are contributions rests on whether the value received by the member is commensurate with the dues paid. For example, if an NFP has annual dues of \$100 and the only benefit members receive is a monthly newsletter with a fair value of \$25, \$25 of the dues are received in an exchange transaction and should be recognized as revenue as the earnings process is completed and \$75 of the dues are a contribution.

5.47 Member benefits generally have value regardless of how often (or whether) the benefits are used. For example, most would agree that a health club membership is an exchange transaction, even if the member stops using the facilities before the completion of the membership period. It may be difficult, however, to measure the benefits members receive and to determine whether the value of those benefits is approximately equal to the dues paid by the members. Table 5-2 contains the list of indicators from FASB ASC 958-605-55-12 that may be helpful in determining whether membership dues are contributions, exchange transactions, or a combination of both. Depending on the facts and circumstances, some indicators may be more significant than others; however, no single indicator is determinative of the classification of a particular transaction.

- 5.48** FASB ASC 958-605-25-1 states that revenue derived from membership dues in exchange transactions should be recognized over the period to which the dues relate. Nonrefundable initiation and life membership fees received in exchange transactions should be recognized as revenues in the period in which the fees become receivable if future fees are expected to cover the costs of future services to be provided to members. If nonrefundable initiation and life membership fees, rather than future fees, are expected to cover those costs, nonrefundable initiation and life member fees received in exchange transactions should be recognized as revenue over the average duration of membership, the life expectancy of members, or other appropriate time periods.

Table 5-2

**Indicators Useful for Determining the
Contribution and Exchange Portions of Membership Dues**

<i>Indicator</i>	<i>Contribution</i>	<i>Exchange Transaction</i>
Recipient not-for-profit entity's (NFP's) expressed intent concerning purpose of dues payment	The request describes the dues as being used to provide benefits to the general public or to the NFP's service beneficiaries.	The request describes the dues as providing economic benefits to members or to other entities or individuals designated by or related to the members.
Extent of benefits to members	The benefits to members are negligible.	The substantive benefits to members (for example, publications, admissions, educational programs, and special events) may be available to nonmembers for a fee.
NFP's service efforts	The NFP provides service to members and nonmembers.	The NFP benefits are provided only to members.
Duration of benefits	The duration is not specified.	The benefits are provided for a defined period; additional payment of dues is required to extend benefits.
Expressed agreement concerning refundability of the payment	The payment is not refundable to the resource provider.	The payment is fully or partially refundable if the resource provider withdraws from membership.
Qualifications for membership	Membership is available to the general public.	Membership is available only to individuals who meet certain criteria (for example, requirements to pursue a specific career or to live in a certain area).

5.49 TIS section 6140.02, "Income Recognition of Membership Dues by Not-for-Profit Entity" (AICPA, *Technical Practice Aids*), provides the following example:

A local NFP collects membership dues and does not provide any services to its members in return for the dues. For an additional cost, the NFP provides services, such as seminars, group insurance, and so on, to its members. It records the dues as contributions and recognizes them as revenue in the period they are received. FASB ASC 958-605-25-2 requires that the dues be recognized as contributions revenue when received because the members receive no benefits from the dues. In accordance

with FASB ASC 958-605-25-1, if the member did receive benefits from those dues, dues revenue would be recognized over the period of membership.

Grants, Awards, and Sponsorships

- 5.50** Paragraphs 2–5 of FASB ASC 958-605-55 discuss transactions in which foundations, business entities, and other types of entities provide resources to NFPs under programs referred to as *grants*, *awards*, or *sponsorships*. A grant or sponsorship may be entirely a contribution, entirely an exchange transaction, or a combination of the two. In addition, those transactions may also have characteristics of agency transactions.^{fn 9} Those asset transfers are contributions if the resource providers receive no value in exchange for the assets transferred or if the value received by the resource providers is incidental to the potential public benefit from using the assets transferred. A grant made by a resource provider to an NFP would likely be a contribution if the activity specified by the grant is to be planned and carried out by the NFP and the NFP has the right to the benefits of carrying out the activity. If, however, the grant is made by a resource provider that provides materials to be tested in the activity and that retains the right to any patents or other results of the activity, the grant would likely be an exchange transaction.
- 5.51** Some transfers of assets between NFPs and governments (such as the sale of goods and services) are clearly exchange transactions. Other transfers of assets between NFPs and governments (such as unrestricted support given by state and local governments) are clearly contributions. Other kinds of government transfers (sometimes referred to as *grants*, *awards*, or *appropriations*) have characteristics that require judgment determine whether they are contributions or exchange transactions. The indicators described in table 5-1 provide guidance on how to classify such transfers. Depending on the facts and circumstances, some indicators may be more significant than others; however, no single indicator is determinative of the classification of a particular transaction.

Naming Opportunities

- 5.52** NFPs may publicly recognize resource providers (individuals, foundations, corporate entities, and others) through what are commonly referred to as naming opportunities. *Naming opportunities*, which may be accompanied by additional rights and privileges, may be either an acknowledgement of a gift or what is effectively advertising (or other benefits) provided by the NFP in exchange for the resources provided, or a combination of both. For example, naming opportunities might include the following:
- An NFP gives resource providers the opportunity to name or sponsor a building or a portion thereof, based on receiving certain dollar amounts. Such naming

^{fn 9} Paragraphs 5.07–.35 discuss agency transactions.

opportunities may result in the sponsorship being publicized through name and logo placement at the building, in addition to other benefits that may be provided.

- A college or university gives resource providers the opportunity to name a faculty position or to provide scholarships bearing the resource provider's name, based on receiving certain dollar amounts. As part of the transaction, the resource provider may receive certain recruiting privileges.
- An NFP gives resource providers the opportunity to sponsor a particular event, with that sponsorship being publicized through logo placement at the event and in any publications or advertisements connected with the event.
- An NFP conducts a multiyear capital campaign (or similar fund-raiser), with different levels of commitment resulting in an escalating variety of sponsorship or advertising benefits to the resource provider. The benefits include future naming options (either temporary or permanent), as well as other items of significant value being delivered to the resource provider.

5.53 NFPs should consider whether naming opportunities are contributions, exchange transactions, or some combination of both. FinREC believes that if public recognition and accompanying rights and privileges result in only nominal value to the resource provider, the NFP has received a contribution. However, an NFP should consider the specific facts and circumstances of the naming opportunity and accompanying rights and privileges, such as the type of resource provider (individual or corporation), the length of time that the naming benefit is provided, control over name and logo use, and other contract stipulations. For example, the right to name an endowed research fund "The Jane Doe Cancer Research Fund," is by itself considered of nominal value to Jane Doe. In contrast, the right to name the sports arena of a local college has value to a local corporation if that corporation includes terms similar to the following in its agreement with the college: the number of years the arena will carry its name, the location of the sign in relation to the nearby highway, the font used for the sign, and the right to rename the arena if the corporation's name changes during the agreement's term.

5.54 Table 5-3 contains a list of indicators that may be helpful in determining whether naming opportunities are contributions, exchange transactions, or a combination of both. Depending on the facts and circumstances, some indicators may be more significant than others; however, no single indicator is determinative of the classification of a particular transaction.

5.55 In determining the value of a naming opportunity and accompanying rights and privileges, if any, FinREC believes that the exchange portion of the transaction, if any, should be valued first at fair value, and any residual would be recognized as a contribution. FinREC believes that the NFP should consider stipulations placed on the use of the resources provided, if any, in determining the nature of the contribution portion received (for example, unrestricted or restricted). If multiple deliverables spanning a

period of years are part of the exchange transaction, it is possible that the contribution element would be reflected in current year's revenues but some or all portions of the exchange transaction components could be deferred. Chapter 12 provides guidance on the recognition of exchange transactions.

Table 5-3

**Naming Opportunities
Indicators Useful in Distinguishing Contributions From Exchange Transactions**

<i>Indicator</i>	<i>Contribution</i>	<i>Exchange Transaction</i>
Value of public recognition	Resource provider receives nominal value related to the public recognition and there are no direct benefits provided to the resource provider.	Resource provider receives significant value related to the public recognition or there are direct benefits provided to the resource provider.
Length of time that the naming benefit is provided	Naming benefit is provided for a relatively short time, or the not-for-profit entity (NFP) has the right to change the name at its discretion.	Naming benefit is provided for relatively long time, and the name cannot be changed solely at the NFP's discretion.
Control over name and logo use	Party receiving the naming opportunity cannot change the name.	Party receiving the naming opportunity can change the name, such as if a corporate donor changes its name and requires a corresponding name change at the NFP.
Other rights and privileges	The named party receives no other rights or privileges in connection with the naming opportunity transaction.	The named party receives other rights and privileges in connection with the naming opportunity transaction, such as an exclusive right to sell, exclusive recruitment opportunities, and so forth.

Donor Status

- 5.56** In some circumstances, NFPs use status or recognition levels such as platinum, gold, silver, and bronze to acknowledge the generosity of their donors. Often those levels include benefits provided by the NFP beyond the mere listing of names under the appropriate heading in a roll of donors. Analogous to the naming opportunity transactions and guidance discussed in paragraphs 5.52–.55, NFPs should consider whether such transactions are contributions, exchange transactions, or a combination of both. Typically, the benefits have some fair value, and the NFP should consider whether amounts received are in excess of the fair value returned to the donor. Some NFPs offer

increasing levels of benefits for increasing levels of recognition. For example, an aquarium may offer multiple levels of membership with each level providing different benefits for the members. The basic membership level provides only year-round entry to the aquarium whereas the more advanced levels provide exclusive access to special events and discounts at the gift shop. When benefits provided by the NFP correspond to differing levels of support the NFP receives, the comparison of fair value returned to fair value received needs to be assessed at each level. If the NFP receives assets at a given status or recognition level in exchange for benefits of substantially lower value and no unstated rights or privileges of a commensurate value are involved, the excess should be reported as a contribution.

Core Recognition and Measurement Principles for Contributions

5.57 The core principles for recognition and measurement of contributions are discussed in paragraphs 5.58–.87. That discussion is followed by special accounting considerations related to the following types of contributions:

- Promises to give (paragraphs 5.88–.110)
- Contributed services (paragraphs 5.111–.116)
- Special events (paragraphs 5.117–.121)
- Gifts in kind (paragraphs 5.122–.148)
- Contributed items to be sold at fund-raising events (paragraphs 5.149–.150)
- Contributed fund-raising material, informational material, or advertising, including media time or space (paragraphs 5.151–.161)
- Contributed utilities and use of long-lived assets (paragraphs 5.162–.164)
- Guarantees (paragraphs 5.165–.169)
- Below-market interest rate loans (paragraphs 5.170–.172)
- Contributed collection items (paragraph 5.173)
- Split-interest agreements (paragraph 5.174 and chapter 6)
- Administrative costs of restricted contributions (paragraphs 5.175–.177)

Recognition Principles

5.58 The recognition principles for contributions are discussed in the “Contributions Received” subsections of FASB ASC 958-605. Accounting for contributions depends on

whether the transfer of assets, including promises to give, is received by the NFP with donor-imposed conditions, donor-imposed restrictions, or both. Donor-imposed conditions create a barrier that must be overcome before a contribution can be recognized; by definition, a contribution is unconditional. Donor-imposed restrictions do not affect the timing of recognition; instead, they affect the classification of the contribution revenue.

- 5.59** The FASB ASC glossary defines a *donor-imposed condition* as a donor-imposed stipulation that specifies a future and uncertain event whose occurrence or failure to occur gives the donor the right of return of the assets or releases the donor from the obligation to transfer assets in the future.
- 5.60** Some promises to give are in part conditional and in part unconditional. For example, an NFP may guarantee the debt of an unaffiliated entity without receiving commensurate consideration in return. That guarantee is in part conditional—the promise to make payments in future periods upon default—and in part unconditional—the gift of the guarantor’s credit support, which enables the entity to obtain a lower interest rate on its borrowing. In circumstances in which an NFP provides a guarantee to another without receiving commensurate consideration, the NFP has made a contribution. Likewise, in circumstances in which an NFP receives a guarantee without providing commensurate consideration, the NFP has received a contribution. (Paragraphs 5.165–169 provide additional information about a recipient’s accounting for a guarantee. Paragraphs 10.94–.95 provide additional information about a guarantor’s accounting for guarantees.)
- 5.61** The FASB ASC glossary defines a *donor-imposed restriction* as
- [a] stipulation that specifies a use for a contributed asset that is more specific than the broad limits resulting from the following: (a) the nature of the NFP, (b) the environment in which it operates, and (c) the purposes specified in its articles of incorporation or bylaws or comparable documents for an unincorporated association. A donor-imposed restriction on an NFP’s use of the asset contributed may be temporary or permanent. Some donor-imposed restrictions impose limits that are permanent, for example, stipulating that resources be invested in perpetuity (not used up). Others are temporary, for example, stipulating that resources may be used only after a specified date, for particular programs or services, or to acquire buildings and equipment.
- 5.62** Paragraphs 15–17 of FASB ASC 958-605-55 provide guidance for distinguishing between a condition stipulated by a donor and a restriction on the use of a contribution imposed by a donor. Those paragraphs are summarized in this paragraph and the next. Making that distinction may require the exercise of judgment. Conditional transfers are not contributions yet; they may become contributions upon the occurrence of one or more future and uncertain events. Because of the uncertainty about whether they will be met, conditions imposed by resource providers may cast doubt on whether the resource provider’s intent was to make a contribution, to make a conditional contribution, or to

make no contribution. As a result of this uncertainty, donor-imposed conditions should be substantially met by the entity before the receipt of assets is recognized as a contribution or a contribution receivable. In contrast to donor-imposed conditions, donor-imposed restrictions limit the use of the contribution, but they do not change the transaction's fundamental nature from that of a contribution.

- 5.63** If donor stipulations do not state clearly whether the right to receive payment or take delivery depends on meeting those stipulations, or if those stipulations are ambiguous, distinguishing a conditional promise to give from an unconditional promise to give may be difficult. First, review the facts and circumstances surrounding the gift and communicate with the donor. If the ambiguity cannot be resolved as a result of those efforts, presume a promise containing stipulations that are not clearly unconditional is a conditional promise to give. However, if the possibility that the condition will not be met is remote,^{fn 10} a conditional promise to give is considered unconditional. For example, a stipulation that an annual report must be provided by the donee to receive subsequent annual payments on a multiyear promise is not a condition if the possibility of not meeting that administrative requirement is remote. A challenge (or matching) grant is a common form of conditional promise to give.
- 5.64** FASB ASC 958-605-25-2 states that except as provided (for contributed services and collections), contributions received shall be recognized as revenues or gains in the period received and as assets, decreases of liabilities, or expenses depending on the form of the benefits received.^{fn 11} The classification of contributions received as revenues or gains depends on whether the transactions are part of the NFP's ongoing major or central activities (revenues), or are peripheral or incidental to the NFP (gains).
- 5.65** Depending on the kind of benefit received, in addition to recognizing contribution revenue, the NFP should also recognize (a) an increase in assets (for example, cash, securities, contributions receivable, collections [if capitalized, see chapter 7, "Other Assets"], and property and equipment); (b) a decrease in liabilities (for example, accounts payable or notes payable); or (c) an expense (for example, donated legal services).

Measurement Principles

- 5.66** The "Contributions Received" subsections of FASB ASC 958-605-30 discuss the initial measurement of contributions received. Specifically, FASB ASC 958-605-30-2 states that a contribution received should be measured at its fair value, although FASB ASC 958-605-30-6 states that unconditional promises to give that are expected to be collected

^{fn 10} The FASB ASC glossary defines *remote* as "the chance of the future event or events occurring is slight."

^{fn 11} Unconditional contributions of services and collection items are subject to different recognition criteria. Paragraphs 5.90–.93 and chapter 7, "Other Assets," discuss those transactions.

in less than one year may be measured at net realizable value because that amount results in a reasonable estimate of fair value. FASB ASC 820 establishes a framework for measuring fair value. FASB ASC 820-10-35-9 states that a reporting entity should measure the fair value of an asset using the assumptions that market participants would use in pricing the asset, assuming that market participants act in their economic best interest. FASB ASC 820-10-35-2B states that when measuring fair value, a reporting entity should take into account the characteristics of the asset, including restrictions on the sale or use of the asset, if market participants would take those characteristics into account when pricing the asset. Example 6 (paragraphs 51–55 of FASB ASC 820-10-55) illustrates that restrictions that are a characteristic of an asset, and therefore would transfer to a market participant, are the only restrictions reflected in fair value. Donor restrictions that are specific to the donee are reflected in the classification of net assets, not in the measurement of fair value.

- 5.67** Contribution revenue should be measured at the fair value of the assets or services received or promised or the fair value of the liabilities satisfied. However, FASB ASC 958-605-25-4 states that a major uncertainty about the existence of value may indicate that an item received or given should not be recognized. For example, a gift of clothing or furniture has no value unless it can be utilized in either of the following ways: (a) used internally by the NFP or for program purposes, or (b) sold by the NFP. Chapter 7 provides additional information about gifts of clothing or furniture.
- 5.68** FASB ASC 958-605-25-4 also states that if an item is accepted solely to be saved for its potential future use in scientific or educational research, it may have uncertain value, or perhaps no value, and should not be recognized. For example, contributions of flora, fauna, photographs, and objects identified with historic persons, places, or events often have no value or have highly restricted alternative uses.
- 5.69** Some items that NFPs receive as contributions are more difficult to measure than others, but difficulty in measuring fair value is not, in and of itself, a reason for not recognizing a contribution. As noted in FASB ASC 958-605-25-5, certain forms of contributed resources may be more difficult to measure reliably than others, but the form of the contributed resources alone should not change conclusions about whether to recognize the underlying event.

Recognition if a Donor Imposes a Condition

- 5.70** Per FASB ASC 958-605-25-13, a transfer of assets with a conditional promise to contribute them should be accounted for as a refundable advance until the conditions have been substantially met or explicitly waived by the donor. A change in the original conditions of the agreement between the promisor and the promisee should not be implied without an explicit waiver.
- 5.71** Transfers of assets, including promises to give, on which resource providers have imposed conditions should be recognized as contributions if the likelihood of not meeting

the conditions is remote (because the transfer is considered unconditional as discussed in paragraphs 5.62–.63). Consistent with paragraph 62 of the basis for conclusions of superseded FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, FinREC believes that conditions as described in FASB ASC 958-605 are similar to those described in federal income tax laws and regulations. Those regulations provide, in part, that "if a transfer for charitable purposes is dependent upon the performance of some act or the happening of a preceding event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible."

- 5.72** FASB ASC 958-605-55-21 discusses promises that become unconditional in stages because they are dependent on several or a series of conditions—milestones—rather than on a single future and uncertain event. Those promises are recognized in increments as each of the conditions is met. Similarly, other promises are conditioned on promisees' incurring certain qualifying expenses (or costs). Those promises become unconditional and are recognized to the extent that the expenses are incurred. A portion of those contributions should be recognized as revenue as each of those stages is met.
- 5.73** FASB ASC 958-605-55-17 provides the following example. A resource provider promises to contribute \$1 for each \$1 of contributions received by an NFP, up to \$100,000, over the next 6 months. As contributions are received from other resource providers, the conditions would be met and the promise would become unconditional. For example, if \$10,000 is received in the first month from donors, \$10,000 of the conditional promise would become unconditional and should be recognized as contribution revenue.

Recognition if a Donor Imposes a Restriction

- 5.74** Contributions may be received with donor-imposed restrictions. Donor's restrictions impose special responsibilities on management of an NFP to ensure that it uses donated assets as stipulated. They also place limits on the use of resources. Some restrictions permanently limit the NFP's use of contributed assets. Other restrictions are temporary in nature, limiting the NFP's use of contributed assets to (a) later periods or after specific dates (time restrictions), (b) specific purposes (purpose restrictions), or (c) both. The responsibilities of management to use restricted resources in accordance with the donors' stipulations are discussed more fully in paragraphs 11.03–.08.
- 5.75** FASB ASC 958-605-45-3 notes that a restriction on an NFP's use of the assets contributed results either from a donor's explicit stipulation or from circumstances surrounding the receipt of the contribution that make clear the donor's implicit restriction on use.
- 5.76** For example, restrictions may (a) be stipulated explicitly by the donor in a written or oral communication accompanying the contribution—an explicit restriction or (b) result implicitly from the circumstances surrounding receipt of the contributed asset—an implicit restriction. For example, restrictions can result from the following:

- Contributions accompanied by a letter (or oral statement) from the donor, stating that the contribution should be used for Program Z (explicit)
- Contributions to a capital campaign whose stated objective is to raise funds for a new building (implicit)
- Contributions to a fund-raising appeal in which the stated objective is to raise funds for Program A (implicit)

5.77 FASB ASC 958-225-45-13(d) notes that a donor can impose restrictions on otherwise unrestricted net assets. For example, a donor may make a restricted contribution that is conditioned on the NFP restricting a stated amount of its unrestricted net assets. Such restrictions that are not reversible without donors' consent result in a reclassification of unrestricted net assets to restricted net assets.

5.78 Paragraphs 3–7 of FASB ASC 958-605-45 provide guidance on classification of contributions received. Contributions without donor-imposed restrictions should be reported as unrestricted support that increases unrestricted net assets. Contributions with donor-imposed restrictions should be reported as restricted support, which increases permanently restricted or temporarily restricted net assets, depending on the nature of the restriction.

5.79 The permanently restricted classification should be used if the limits imposed on the use of the contributed assets are permanent (for example, contributions of cash or securities that must be invested in perpetuity to provide a permanent source of income for the NFP or contributions of permanently restricted collection items (if capitalized) or of cash that must be used to purchase permanently restricted collection items). The temporarily restricted classification should be used for contributions if the limitations are temporary (for example, a restriction that contributed assets may be used only after some future date, or for some specific program, or to acquire a specific asset).

5.80 In most cases, whether a restriction is permanent or temporary is clear. Paragraphs 120 and 124 of FASB Concept No. 6, *Elements of Financial Statements—a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2)*, may be helpful in resolving cases that might be unclear. Those paragraphs state, in part, that:

Receipt of a contribution increases permanently restricted net assets if the donor stipulates that the resources received must be maintained permanently and those resources are capable of providing future economic benefit indefinitely. Only assets that are not by their nature used up in carrying out the organization's activities are capable of providing economic benefits indefinitely. Gifts of cash,

securities, or nonexhaustible property, such as land and art objects,^{fn12} to be added to an organization's endowment or collections are common examples of those types of assets.

In contrast to permanent restrictions, . . . temporary restrictions pertain to assets that by their nature are spent or used up in carrying out the receiving organization's activities or, if capable of providing economic benefits indefinitely, need not be retained after a stipulated time.

5.81 For example, a donor may stipulate that an NFP is a beneficiary of a charitable trust held by a third-party trustee. The trust document states the following:

- The trustee should invest the trust assets as a prudent investor would, using a portfolio approach in making investments and considering the risk and return objectives of the trust.
- The trustee may distribute some or all of the net income and principal of the trust at any time or times in equal shares to the beneficiary.
- In each calendar year the trustee shall distribute such amounts of income and principal in equal shares to the beneficiary as shall be necessary to avoid the tax on failure to distribute income imposed by Section 4942 of the IRS code (that is, tax on nonexempt charitable trusts and private foundations).
- The trust document states that the "trust created under this agreement shall be perpetual in duration..."

The trustee has indicated that it will maintain the trust in perpetuity and only distribute the minimum annual amount required by IRS regulations.

5.82 FinREC believes that in implementing the guidance in FASB ASC 958-605-45, donor intent is the overriding factor in determining net asset classifications. All other facts and circumstances are information to help determine donor intent. In the fact pattern described in the previous paragraph, FinREC believes that the net asset classification should be permanently restricted. Although losses on trust investments and distributions from the trust that are in excess of the trust income could reduce the trust assets for a time, the trust assets (investments) are capable of providing economic benefits indefinitely and the donor has instructed that the trust should be perpetual in duration.

Accounting Policies That Affect the Classification of Contributions

5.83 FASB ASC 958-605-45 allows an NFP's policy decisions to affect classification of net assets in only two situations, which are described in paragraphs 5.84–.87.

^{fn 12} The recognition of contributions of collection items depends on the collections-capitalization policy adopted by the NFP. Accounting for collections is discussed in chapter 7.

- 5.84** In some situations, an NFP may meet donor-imposed restrictions on all or a portion of the amount contributed in the same reporting period in which the contribution is received. In those cases, pursuant to FASB ASC 958-605-45-4, the contribution (to the extent that the restrictions have been met) may be reported as unrestricted support provided that the NFP has a similar policy for reporting investment gains and income (see FASB ASC 958-320-45-3),^{fn 13} reports consistently from period to period, and discloses its accounting policy in notes to financial statements.
- 5.85** NFPs may receive contributions of long-lived assets (such as property and equipment) or of cash and other assets restricted to the purchase of long-lived assets, for which donors have not expressly stipulated how or how long the long-lived asset must be used by the NFP or how to use any proceeds resulting from the asset's disposal. FASB ASC 958-605-45-6 states that gifts of long-lived assets received without stipulations about how long the donated asset must be used should be reported as restricted support if it is an NFP's policy to imply a time restriction that expires over the useful life of the donated assets. NFPs that adopt a policy of implying time restrictions also shall imply a time restriction on long-lived assets acquired with gifts of cash or other assets restricted for those acquisitions.
- 5.86** If an NFP adopts such a policy, the contributions of long-lived assets or of cash and other assets restricted to the purchase of long-lived assets it receives should be reported as restricted support that increases temporarily restricted net assets. Expiration of the restrictions is discussed in paragraphs 11.45–.48.
- 5.87** Alternatively, an NFP may adopt a policy of not implying time restrictions on contributions of long-lived assets (or of other assets restricted to the purchase of long-lived assets) received without donor stipulations about how long the contributed assets must be used. If an NFP adopts such a policy, contributions of long-lived assets with no donor-imposed time restrictions should be reported as unrestricted support, and contributions of long-lived assets with donor-imposed time restrictions should be reported as temporarily restricted support.^{fn 14} Contributions of cash and other assets restricted to the acquisition of long-lived assets should be reported as restricted support that increases temporarily restricted net assets.

^{fn 13} FASB ASC 958-320-45-3 (see paragraph 8.32) discusses the accounting policy for reporting investment gains and income if the NFP meets donor-imposed restrictions on all or a portion of such gains and income in the same reporting period as the gains and income are recognized.

^{fn 14} In most cases, long-lived assets are not capable of providing future economic benefit indefinitely, as discussed in paragraph 5.80. However, if a donor requires that the proceeds of a sale of the contributed long-lived asset be used to create a permanent endowment fund, the contribution of the long-lived asset would be reported as an increase in permanently restricted net assets.

Additional Accounting Considerations for Certain Contributions

Promises to Give

- 5.88** The FASB ASC glossary defines *promise to give*, *unconditional promise to give*, and *conditional promise to give* as follows:

A promise to give is a written or oral agreement to contribute cash or other assets to another entity. A promise carries rights and obligations—the recipient of a promise to give has a right to expect that the promised assets will be transferred in the future, and the maker has a social and moral obligation, and generally a legal obligation, to make the promised transfer. A promise to give may be either conditional or unconditional.

An unconditional promise to give is a promise to give that depends only on passage of time or demand by the promisee for performance.

A conditional promise to give is a promise to give that depends on the occurrence of a specified future and uncertain event to bind the promisor.

- 5.89** NFPs may enter into written or oral agreements with donors involving future nonreciprocal transfers of cash, other assets, and services.^{fn 15} These items are sometimes referred to as pledges, a term that FASB ASC 958, *Not-for-Profit Entities*, and this guide avoid because it may be misinterpreted because that term is used by some to include intentions to give as well as promises. Such agreements between NFPs and potential donors should be reported as contribution revenue and receivables if such agreements are, in substance, unconditional promises to give, even if the promises are not legally enforceable.

Recognition of Unconditional Promises to Give

- 5.90** Paragraphs 8–10 of FASB ASC 958-605-25 provide recognition guidance for unconditional promises to give. An unconditional promise to give shall be recognized when it is received. However, to be recognized there must be sufficient evidence in the form of verifiable documentation that a promise was made and received. A communication that does not indicate clearly whether it is a promise is considered an unconditional promise to give if it indicates an unconditional intention to give that is

^{fn 15} FASB ASC 958-605-55-20 notes that "promises to give services generally involve personal services that, if not explicitly conditional, are often implicitly conditioned upon the future and uncertain availability of specific individuals whose services have been promised." It is assumed in the remainder of this chapter that promises to give services are conditional and, hence, not recognized until the services are performed.

legally enforceable. Legal enforceability refers to the availability of legal remedies, not the intent to use them.

- 5.91** Promises to give that do not discuss the specific time or place for the contribution but that are otherwise clearly unconditional in nature should be considered unconditional promises to give.
- 5.92** Per FASB ASC 958-605-55-19, the requirement (that there be sufficient evidence that a promise was received and made) does not preclude recognition of verifiable oral promises, such as those documented by tape recordings, written registers, or other means that permit subsequent verification.
- 5.93** Other forms of sufficient verifiable evidence documenting that a promise was made by the donor and received by the NFP include (a) written agreements, (b) pledge cards, (c) oral promises documented by contemporaneous written logs, and (d) oral promises documented by follow-up written confirmations.
- 5.94** Per FASB 958-605-45-5, contributions of unconditional promises to give with payments due in future periods should be reported as restricted support unless explicit donor stipulations or circumstances surrounding the receipt of a promise make clear that the donor intended it to be used to support activities of the current period. It is reasonable to assume that by specifying future payment dates donors indicate that their gift is to support activities in each period in which a payment is scheduled. For example, receipts of unconditional promises to give cash in future years generally increase temporarily restricted net assets.
- 5.95** Use of the *permanently restricted* classification is appropriate if donor-imposed restrictions stipulate that the resources must be maintained permanently (for example, donors' promises to give cash or securities that must be invested in perpetuity). Use of the unrestricted classification is appropriate if the donor explicitly stipulates that the promise to give is to support current-period activities or if other circumstances surrounding the promise make it clear that the donor's intention is to support current-period activities. The classification of contribution revenue is discussed further in paragraphs 5.74–.87.
- 5.96** FinREC believes that in implementing the guidance in FASB 958-605-45-5, an NFP implies time restrictions that expire in the periods that the payments of the unconditional promise to give are due. For example, absent explicit donor stipulations to the contrary, if a donor promises to give \$5,000 a year for 5 years to be used to fund scholarships for students that are accounting majors, it is reasonable to assume that the donor wanted a \$5,000 scholarship to be granted in each of the 5 years. The promise to give would increase temporarily restricted net assets because there is both a purpose restriction (for scholarships) and 5 time restrictions—one for \$5,000 expiring when the first payment is due, another for \$5,000 expiring when the second payment is due, and so forth.

5.97 However, FinREC believes that an NFP would not imply time restrictions that expire in the periods that the payments of the unconditional promise to give are due if another time period is inherent in the donor's purpose restriction. For example, a donor may give to sponsor the Tenth Annual Fundraising Walk, which takes place in the current fiscal year, but specifies a payment date for the unconditional promise in the next fiscal year. Because the donor's explicit stipulation specified an event of the current year, no time restriction is implied by the donee, and because the purpose restriction is met by holding the fund-raising walk in the current year, the net assets are unrestricted at the end of the year. The contribution revenue relating to the promise would be reported as an increase in unrestricted net assets if the NFP adopted the policy discussed in FASB ASC 958-605-45-4 (see paragraph 5.84); otherwise, it would be reported as an increase in temporarily restricted net assets (to reflect the purpose restriction) along with a release of that restriction in the current year. Similarly, a donor may give to support a traveling exhibit the museum will host in year 2, but specify that the payments on that unconditional promise are due in installments in each of years 1, 2, and 3. The contribution revenue relating to the promise would be reported in year 1 as an increase in temporarily restricted net assets to reflect the purpose restriction, but a time restriction would not be implied because a time period is inherent in the donor's restriction for an event that will occur only in year 2.

Measurement of Unconditional Promises to Give

5.98 Initial and subsequent measurement of unconditional promises to give is discussed in paragraphs 5.178–.210.

Recognition of Conditional Promises to Give

5.99 Paragraphs 11–13 of FASB ASC 958-605-25 provide recognition guidance for conditional promises to give. Conditional promises to give cash or other assets (such as securities or property and equipment) should be recognized as contribution revenue and receivables when the conditions on which they depend are substantially met or explicitly waived by the donor, that is, when the conditional promise becomes unconditional.

5.100 Pursuant to FASB ASC 958-605-30-7, if a promise to give has not previously been recognized as contribution revenue because it was conditional, fair value should be measured when the conditions are met.

5.101 Recognition and measurement of conditional promises to give should be based on facts and circumstances existing at the reporting date. When information about whether the conditions placed by the donor have been substantially met comes to light after the reporting date (but before financial statements are issued or are available to be issued), the nature of the information determines whether the promise to give is recognized at the reporting date in the statement of financial position. In accordance with FASB ASC 855-10-25-3, if information comes to light that provides evidence that the donor-imposed conditions were substantially met after the reporting date, the conditional promise to give

would not be recognized (because the promise became unconditional after the reporting date). In contrast, if the information provides evidence that the donor-imposed conditions had been met prior to the reporting date, then, pursuant to FASB ASC 855-10-25-1, the conditional promise to give is recognized at the reporting date (because the promise became unconditional before the reporting date).

- 5.102** For example, assume that in March 20X1, an individual makes a conditional promise to give an NFP \$1 million if NFP raises \$1 million or more in matching contributions by December 31, 20X1. At the end of the fiscal year on June 30, the NFP has raised \$800,000. The NFP raises an additional \$200,000 by July 15, prior to issuance of the NFP's June 30, 20X1, financial statements. This type of subsequent event provides evidence about facts and circumstances that did not exist at the date of the financial statements. At June 30, 20X1, the condition was not met and the fact that it was met subsequent to June 30, 20X1, should not result in an adjustment to the June 30, 20X1, financial statements. The \$1,000,000 contribution from the individual would be recognized on July 15, 20X1, in the fiscal year ended June 30, 20X2.
- 5.103** As a separate example, assume a company promises to donate \$100,000 to an NFP if the NFP raises at least \$100,000 at a special fund-raising event to be held on December 31, 20X2. The NFP fiscal year-end is December 31, and when the promise is made, the possibility that the NFP will raise \$100,000 at the event is uncertain, therefore the promise is conditional. The NFP holds the special event on December 31, 20X2, but does not complete its recordkeeping and determine the amount raised at the event until January 15, 20X3. On January 15, 20X3, prior to the issuance of its financial statements, the NFP determines that it raised \$115,000 at the event. This type of subsequent event provides additional evidence about facts and circumstances that existed at the date of the financial statements (that is, the special event raised \$115,000 as of December 31, 20X2). At December 31, 20X2, the condition was met, and the \$100,000 contribution would be recognized in the December 31, 20X2, financial statements.

Intentions to Give

- 5.104** NFPs may receive communications that are intentions to give, rather than promises to give. For example, communications from individuals indicating that the NFP has been included in the individual's will as a beneficiary are intentions to give. Such communications are not unconditional promises to give, because individuals retain the ability to modify their wills during their lifetimes. (When the probate court declares the will valid, the NFP should recognize contribution revenue and a receivable at the fair value of its interest in the estate, unless the promise is conditioned upon future or uncertain events, in which case a contribution should not be recognized until the conditions are substantially met.) Paragraphs 49–51 of FASB ASC 958-605-55 provide an example of an individual naming an NFP as a beneficiary in her will. NFPs should disclose information about conditional promises in valid wills in conformity with FASB ASC 958-310-50-4. In cases in which the testator has not placed a purpose restriction on the gift, the classification of a bequest receivable as unrestricted contribution revenue or

temporarily restricted contribution revenue differs in practice among NFPs. Some have concluded that because the contribution is in receivable form and will be paid at a future date, it is inherently time-restricted and therefore should be recognized as temporarily restricted revenue. Others have concluded that because restrictions can only be placed by donors and the receivable is due and payable on the date the will cleared probate, the contribution revenue is unrestricted. The latter say that although there may be time delays between clearing probate and payment because of administrative dealings of the courts and attorneys, those delays are not the actions of donors, and the timeline is not a function of a time restriction placed by a donor. NFPs should consider the facts and circumstances in determining the classification of the contribution revenue.

- 5.105** Per FASB ASC 958-605-25-10, solicitations for donations that clearly include wording such as "information to be used for budget purposes only" or that clearly and explicitly allow resource providers to rescind their indications that they will give are intentions to give rather than promises to give and should not be reported as contributions.
- 5.106** In some cases, it may be unclear whether a donor communication is an intention to give or a promise to give. FASB ASC 958-605-25-9 states that a communication that does not indicate clearly whether it is a promise is considered an unconditional promise to give if it indicates an unconditional intention to give that is legally enforceable. Legal enforceability refers to the availability of legal remedies, not the intent to use them.
- 5.107** For example, a donor may tell an NFP that he or she promises to give an amount that will be paid upon the donor's death. The donor may also inform the NFP of the manner in which the promise will be funded such as by (a) the donor's estate, (b) an irrevocable trust, or (c) a revocable trust that becomes irrevocable upon the donor's death. Depending on the communication from the donor, it may be unclear whether the communication is a promise to give, as discussed in paragraphs 5.88–.103, or an indication that the NFP has been included in the individual's will, as discussed in paragraph 5.104.
- 5.108** If the communication is a donor's notification that the NFP has been included in the donor's will, FinREC believes that the donor has communicated an intention to give. If the communication is a donor's notification that the NFP is named as a beneficiary of a trust, the guidance in chapter 6 is used to determine if the beneficial interest in the trust is recognized and, if so, how it is measured. If the communication is a donor's promise to contribute a defined amount of cash or specific assets and the date of death is used as a payment date for the promise, FinREC believes that the donor has communicated a promise to give.
- 5.109** Using the date of death to define the due date of the payment is not a donor-imposed condition because although the date itself may be unpredictable, its eventuality is not. Thus, the promise is not conditioned on the death of the donor. Unless the communication from the donor specifies a future and uncertain event on which the contribution depends, as discussed in paragraphs 5.58–.65, a donor that makes an irrevocable promise to give that is payable upon his or her death has made an

unconditional promise to give. Although the possibility that a donor will deplete the assets of an estate or a trust affects the measurement of the contribution, that ability does not constitute a donor-imposed condition, as defined in the FASB ASC glossary (paragraph 5.59). FinREC believes information about the assets promised (that is, a defined amount of cash or specific assets) and the manner in which the promise will be funded, such as by (a) the donor's estate, (b) an irrevocable trust, or (c) a revocable trust that becomes irrevocable upon the donor's death, would be considered when measuring the fair value of the contribution.

5.110 In measuring the fair value of an unconditional promise to give that is payable upon the donor's death, NFPs should apply the guidance in FASB ASC 820. As noted in the AICPA White Paper *Measurement of Fair Value for Certain Transactions of Not-for-Profit Entities* (fair value white paper), FinREC believes that the income approach (that is, present value techniques) typically would be the appropriate valuation technique. FinREC believes that if present value techniques are used to measure the fair value of the contribution in accordance with FASB ASC 820, the NFP should consider the terms of the contribution and other inputs, such as

- whether sufficient assets will exist to fulfill the promise,
- anticipated date of distribution of assets to the NFP, including donor mortality, and
- whether the NFP has been designated as the beneficiary of a trust and whether that designation could change, in the case in which the promise is funded by a trust.

FinREC believes that consideration and assessment of the inputs requires judgment and may lead to a low estimate of fair value (including zero), depending in particular on the funding for the promise and expected date of death. In general, the greater the uncertainty associated with the promise to give, the lower the fair value because market participants generally seek compensation (that is, a risk premium) for bearing uncertainty. For example, a promise of \$100,000 received from a healthy 29-year-old individual of modest means would have a lower fair value than a promise of the same amount from a wealthy 89-year-old individual that is not in good health.

Contributed Services

5.111 FASB ASC 958-605-25-16 requires that contributions of services be recognized if the services received meet any of the following criteria:

- a. They create or enhance a nonfinancial asset. The FASB ASC glossary defines a *nonfinancial asset* as an asset that is not a financial asset. Nonfinancial assets include land, buildings, use of facilities or utilities, materials and supplies, intangible assets, or services.

- b.* They require specialized skills, are provided by individuals possessing those skills and would typically need to be purchased if not provided by donation. Services requiring specialized skills are provided by accountants, architects, carpenters, doctors, electricians, lawyers, nurses, plumbers, teachers, and other professionals and craftsmen.
- 5.112** Recognized contributed services should be reported as contribution revenue and as assets or expenses. Whether such contributions should be recognized is unaffected by whether the NFP could afford to purchase the services at their fair value.
- 5.113** FASB ASC 958-605-25-16 states that contributed services and promises to give services that do not meet the criteria (in paragraph 5.111) should not be recognized. Examples 7–10 (paragraphs 52–68 of FASB ASC 958-605-55) illustrate the recognition of contributed services. Per FASB ASC 958-605-30-2, if such contributions are recognized, they should be measured at fair value.
- 5.114** Per FASB ASC 958-605-30-10, the fair value of contributed services that create or enhance nonfinancial assets may be measured by referring to either the fair value of the services received or the fair value of the asset or of the asset enhancement resulting from the services. Fair value should be used for the measure regardless of whether the NFP could afford to purchase the services at their fair value.
- 5.115** When measuring the fair value of contributed services that create or enhance nonfinancial assets, the prevalent practice is to measure the contributed services at fair value, with an upper limit on the amount recognized (a cap) at the fair value of the asset enhancement or resulting nonfinancial assets. In determining the fair value of the resulting nonfinancial assets, an NFP could take a before and after approach to isolate the portion of the change in the fair value of the nonfinancial asset attributed to the contributed services from the portion attributed to other factors, such as market conditions. Generally, an NFP would use the fair value measure that is more readily determinable to measure contributed services.
- 5.116** Per FASB ASC 958-605-25-17, contributed services (and the related assets and expenses) should be recognized if employees of separately governed affiliated entities regularly perform services (in other than an advisory capacity) for and under the direction of the donee and the recognition criteria for contributed services are met.

Special Events

- 5.117** Some NFPs have special events that are in part fund-raising activities and in part exchange transactions, such as fund-raising dinners. In such circumstances, the ticket revenue from such events is divided between contributions and revenue from exchange transactions for financial reporting purposes. The exchange transaction is measured at fair value of the direct donor benefits, and the excess of the ticket price over the fair value of the direct donor benefits is the contribution portion.

- 5.118** In some circumstances, the event is scheduled to take place after the financial statement date and the revenue from the exchange transaction portion is deferred until the event takes place and the goods or services are transferred to the ticketholder. FinREC's guidance for reporting the revenue of a special event that will be held after year-end, for which amounts are received before year-end, is summarized in flowchart 5-2. FinREC believes that if a special event is scheduled to take place after the financial statement date, the contribution portion of the amount received for ticket sales prior to the end of the reporting period is presumed to be conditioned on the event taking place. Accordingly, the contribution portion that is received before the financial statement date should be accounted for in conformity with paragraphs 12–13 of FASB ASC 958-605-25. The contribution portion would be accounted for as a refundable advance until the event has taken place or the donor explicitly waives the condition of the event taking place. If a donor promises to purchase tickets, that promise is also presumed to be conditioned on the event taking place.
- 5.119** Assessing the likelihood that the event will take place requires judgment. As discussed in paragraph 5.71, FinREC believes that conditions described in FASB ASC 958-605 are similar to those described in federal income tax laws and regulations; that is, a condition will be disregarded if it is so remote that it is negligible. FinREC believes, in a manner similar to that guidance, concluding that a future special event will take place and that the contribution portion should be recognized at the time of the ticket sale requires overcoming a high hurdle. Unless the ticket purchase is determined to be unconditional, the contribution portion should be recognized as a refundable advance until the condition is substantially met (that is, the event takes place). The exchange transaction portion also should be recognized when the event takes place, in conformity with the same principles that govern recognition of revenue from other kinds of exchange transactions. A receivable for a promise to purchase tickets would not be recognized until the event takes place because, prior to that time, the condition on which the contribution depends has not been substantially met and the revenue from the exchange portion has not yet been earned. (Accounting for exchange transaction is discussed in chapter 12.)
- 5.120** For example, assume that in November 20X0, an NFP with a December 31 year-end begins selling tickets at \$100 each to a February 14, 20X1, fund-raising event. The event includes dinner (the exchange portion) that has a fair value of \$30. The NFP will hold the event only if it sells 100 tickets by January 31, 20X1. FinREC believes the \$70 contribution revenue is conditioned on the event taking place, and the \$30 for the dinner is not earned until the event takes place. For tickets sold before the event takes place, FinREC believes \$70 should be reported as a refundable advance unless the possibility that the event will not take place is so remote that it is negligible or the donor explicitly waives the condition that the event takes place. Only if the possibility that the event will not take place is so remote that it is negligible (for example, the dinner has been held every year for many years, well over 100 tickets have always been sold to the event by January 31, and all other available evidence indicates the possibility that the event will not take place is remote) would the contribution be considered unconditional, and the \$70 contribution revenue recognized when the ticket is sold. The \$30 portion of the ticket

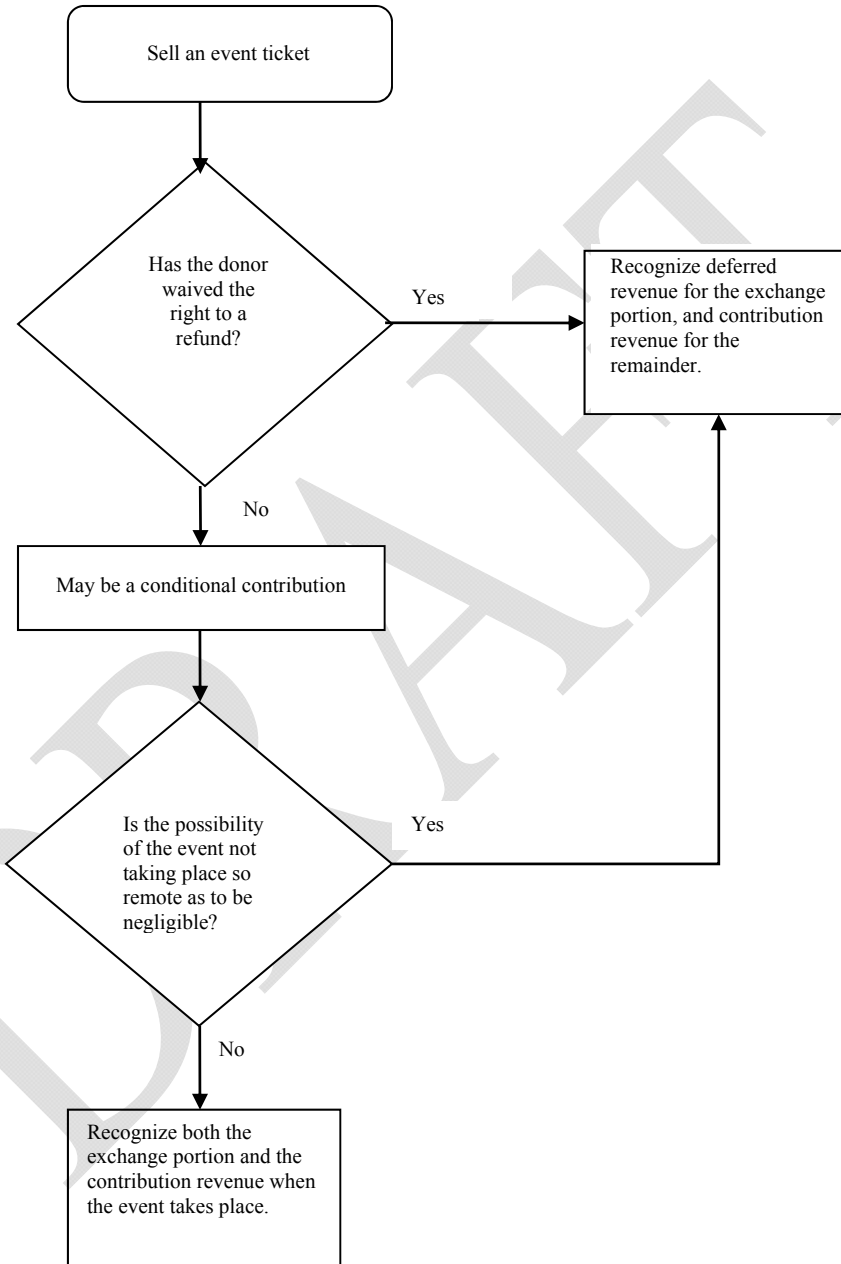
price allocated for the value of the dinner (that is, the fair value of the exchange transaction) should be accounted for as deferred revenue when received and should be recognized as revenue when the event takes place.

- 5.121** Presentation of special events in the statement of activities is discussed in paragraphs 13.40–.44.

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Flowchart 5-2

FinREC's Guidance for Reporting the Revenue of a Special Event That Will Be Held After Year-End for Which Amounts Are Received Before Year-End



Gifts in Kind

5.122 The term *gifts in kind* is used broadly to refer to all noncash gifts. Paragraphs 5.123–.148 discuss gifts of tangible personal property, such as furniture, equipment, clothing, pharmaceuticals, and supplies. Other types of gifts in kind are discussed in the following paragraphs:

- Contributed items to be sold at fund-raising events (paragraphs 5.149–.150)
- Contributed fund-raising material, informational material, or advertising, including media time or space (paragraphs 5.151–.161)
- Contributed utilities and use of long-lived assets (paragraphs 5.162–.164)
- Contributed collection items (paragraph 5.173)

5.123 Certain types of NFPs, such as thrift stores and international relief organizations, typically receive significant amounts of gifts in kind—such as furniture, equipment, clothing, pharmaceuticals, and supplies—from resource providers. In many cases, the donor contributes the gifts in kind directly to an NFP that sells them as inventory or consumes them as the end user, without involving any other parties in the transaction. In those cases, the NFP has received a contribution.

5.124 In other cases, the donor transfers the gifts in kind to an NFP recipient, and that recipient then transfers the gifts in kind to another NFP that sells them or consumes them as the end user (referred to as the NFP beneficiary). Whether these transfers are reported as agency transactions or as contributions depends on the extent of discretion that the NFP recipient has over the use or subsequent disposition of the assets. Determining whether an NFP recipient receives assets as an agent is discussed in the “Transfers of Assets to a Not-for-Profit Entity or Charitable Trust That Raises or Holds Contributions for Others” subsections of FASB ASC 958-605 and in paragraphs 5.07–.14. Paragraphs 5.15–.17 describe the accounting and disclosure requirements of an agent that receives nonfinancial assets.

5.125 FinREC believes that in implementing that guidance in FASB ASC 958-605, an NFP recipient should recognize gifts in kind as contributions if both of the following conditions are met:

- The NFP recipient has discretion in using or distributing the gifts in kind. FASB ASC 958-605-55-76 states that a recipient entity has discretion sufficient to recognize a contribution received if it can choose the beneficiaries of the assets transferred. The “Transfers of Assets to a Not-for-Profit Entity or Charitable Trust That Raises or Holds Contributions for Others” subsections of FASB ASC 958-605-55 provide examples of donor stipulations and discuss whether an NFP has discretion to choose the beneficiary. If a resource provider specifies a beneficiary

to whom the gifts in kind should be transferred, the NFP would meet this condition in circumstances in which it has variance power or is a financially interrelated entity. Variance power is discussed in paragraphs 5.22–.26. Financially interrelated entities are discussed in paragraphs 5.27–31.

- The NFP has risks and rewards of ownership over the gifts in kind, such as the risk of loss if they are lost, damaged, or destroyed and the ability to obtain the benefits of and control others' access to the gifts in kind. This typically, though not necessarily, occurs in circumstances in which the NFP takes physical possession of the gifts in kind. It also occurs in circumstances in which the NFP takes constructive possession; that is, the NFP owns the gifts in kind and can direct their use, but it does not have physical possession of the gifts in kind because they are stored in a third-party facility.

5.126 In circumstances in which the NFP receives gifts in kind, but does not meet both of the conditions in the previous paragraph for recognizing contribution revenue, the NFP is acting as an agent or intermediary pursuant to the “Transfers of Assets to a Not-for Profit Entity or Charitable Trust that Raises or Holds Contributions for Others” subsections of FASB ASC 958-605. An NFP that is acting as an agent or intermediary should not recognize contribution revenue in connection with that gift in kind. Likewise, an NFP that partners or cooperates with other entities in facilitating a gift in kind transaction should not report contribution revenue in connection with that transaction unless it meets both of the conditions in the previous paragraph. An NFP recipient that is an agent or intermediary should follow the accounting policy it adopted for nonfinancial gifts received as an agent or intermediary. In accordance with FASB ASC 958-605-25-24, the agent or intermediary is permitted, but not required, to recognize the nonfinancial assets it receives, along with the liability to distribute the assets to the beneficiary (paragraph 5.15), provided that it reports consistently from period to period and discloses its accounting policy.

5.127 If solicitation materials, contracts, pledge forms, governing board minutes, or other documentation indicates that the NFP recipient is acting as an agent or intermediary rather than a donee, gifts in kind are recognized if it is the NFP recipient's policy to recognize nonfinancial assets that it holds as an agent. In other situations, if the NFP recipient's role is not clear, the following factors may indicate that the NFP is acting as an agent or intermediary. None of these factors is determinative by itself; all applicable facts and circumstances should be considered in the particular situation:

- The NFP recipient does not take physical possession of the gifts in kind.
- The NFP recipient takes possession of gifts in kind for storage or transportation, but
 - does not receive them from the original donor, or

— does not sell them as inventory or consume them as the end user.

- The NFP recipient receives the gifts in kind from an entity that is its affiliate, that has overlapping board members or management, or both, or that shares physical facilities; and then the NFP recipient distributes the gifts in kind to another entity that is its affiliate, that has overlapping board members or management, or both, or that shares physical facilities.
- The donor would be readily able to make a contribution to the beneficiary, without involving the NFP recipient.
- Several NFP recipients participate in transferring the gifts in kind from the donor to the beneficiary.
- The NFP recipient was created shortly before receiving the gifts in kind from the donor, and appears to have been created specifically to serve as a pass-through between the donor and the beneficiary.
- The nature of the gifts in kind is not consistent (or is only marginally consistent) with the NFP recipient's mission.
- The NFP recipient did not solicit the gifts in kind.
- The NFP recipient receives all or most of its gifts in kind from the same donor or relatively small group of donors. (This is an indicator because the NFP recipient may be an entity created only to help those donors get the best tax advantages from their gifts, and the NFP recipient is merely carrying out the donors' directives.)
- A pattern exists whereby gifts in kind consistently pass from the same donor, to the same NFP recipient, to the same beneficiary.
- The NFP recipient and either or both the donor and the beneficiary have relatively minimal program activities beyond receipt or distribution of gifts in kind.

5.128 An NFP that is the specified by the donor as the beneficiary of an agency transaction should recognize its rights to gifts in kind held by the NFP recipient unless the NFP recipient is granted variance power. If the donor explicitly grants the NFP recipient variance power, a specified unaffiliated beneficiary should not recognize its potential for future distributions from the gifts in kind held by the NFP recipient. Those future distributions, if they occur, should be recognized as contributions by the specified beneficiary when received or unconditionally promised. (Paragraphs 5.19–.20 describe more fully the specified beneficiary's accounting.) However, FASB ASC 958-605-25-4 states that a major uncertainty about the existence of value may indicate that an item received or given should not be recognized. For example, a gift of clothing or furniture

has no value unless it can be utilized in either of the following ways: (a) used internally by the NFP or for program purposes, or (b) sold by the NFP.

Fair Value Measurement of Gifts in Kind

- 5.129** Per FASB ASC 958-605-30-11, gifts in kind that can be used or sold should be measured at fair value. FASB ASC 820, which is discussed in paragraphs 3.137–.167, defines *fair value* and establishes a framework for measuring fair value. NFPs may encounter unique measurement challenges for gifts in kind because items contributed to an NFP (a) often do not have active markets and some contributed items, such as preservation easements, generally are not bought or sold; (b) sometimes are items that the NFP would not otherwise purchase or sell and therefore the NFP is not familiar with markets for the items; and (c) sometimes are not used at their highest and best use by the NFP. However, as explained in FASB ASC 958-605-25-5, contributed tangible property worth accepting generally possesses the common characteristic of all assets—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. Certain forms of contributed resources may be more difficult to measure reliably than others, but the form of the contributed resources alone should not change conclusions about whether to recognize the underlying event.
- 5.130** The highest level (level 1 measure) of the fair value hierarchy is a quoted price in an active market; that price provides the most reliable evidence of fair value. However, an *active market* (that is, 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) does not exist for many of the nonfinancial assets an NFP receives. In some cases, there may be publicly available information about transactions for the identical items or similar items in inactive markets (such as auction websites), which provide level 2 measures. In other cases, 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. In those cases, the NFP must determine fair value by making assumptions that a market participant would use in pricing the asset in a hypothetical transaction occurring at the measurement date (a level 3 measure). In developing those assumptions, an NFP would consider factors specific to the nonfinancial asset, the principal market for the asset or liability (or in the absence of a principal market, the most advantageous market), and market participants with whom the NFP would enter into a transaction in that market, assuming that market participants generally act in their economic best interest. An NFP need not undertake exhaustive efforts to obtain information about market participant assumptions. However, it should take into account all information about market participant assumptions that is reasonably available.
- 5.131** FASB ASC 820-10-35-5 states that a fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place either in the principal market for the

asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. If an NFP does not regularly purchase or sell the donated nonfinancial asset, it may not know which market is the principal market. The FASB ASC glossary defines the *principal market* as the market with the greatest volume and level of activity for the asset or liability. An NFP need not undertake an exhaustive search of all possible markets to identify the principal market or, in the absence of a principal market, the most advantageous market, but it should take into account all information that is reasonably available. As noted in FASB ASC 820-10-35-6A, the NFP must have access to the principal (or most advantageous) market at the measurement date. The principal (or most advantageous) market (and thus, market participants) should be considered from the perspective of the reporting entity, thereby allowing for differences between and among entities with different activities. For example, an NFP that receives pharmaceuticals would not look to retail pharmacy sales prices for valuing those gifts in kind unless it was able to sell in that market; most NFPs do not have the proper licenses, controlled substances registrations, and facilities needed to access that market, and it would not be financially feasible to obtain them. In the absence of evidence to the contrary, the market in which the NFP normally would enter into a transaction to sell the asset or to transfer the liability is presumed to be the principal market or, in the absence of a principal market, the most advantageous market.

- 5.132** In implementing that guidance, 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. In selling or distributing donated nonfinancial assets, the NFP may be more interested in fulfillment of its mission than it is in maximizing the sales price. Thus, beneficiaries receiving gifts in kind from NFPs are not necessarily the group to whom the NFP should look when identifying the assumptions that market participants would use. For example, beneficiaries receiving gifts in kind from NFPs may be economically disadvantaged and, if the gifts in kind are sold to them, the prices accepted by the NFPs may be significantly less than they could get in another market. Further, certain nonfinancial assets, such as certain medicines, may be unavailable in markets in certain geographic areas, other than through free distribution by NFPs. Although the supply of such gifts in kind distributions may affect the demand, and therefore pricing, in geographically nearby markets, the fact that the NFP will be distributing the gifts in kind to economically disadvantaged beneficiaries has no effect on the principal market in which the goods would normally be sold, which is the market that should be used for valuing the goods.
- 5.133** For example, pharmaceutical companies have agreed to provide AIDS medicines to NFPs at a price substantially lower than the fair value that such drugs are sold to market participants in the United States and in other countries. Although the NFP may be charged a purchase price or handling charge for the medicines, if that charge is substantially below fair value for the medicines, there is a contribution inherent in the transaction (paragraph 5.42). If a specific AIDS drug has a fair value of \$100 per dose in the United States, but is provided to an NFP for use in its programs in the United States at a cost of only \$20, the fact that the NFP sells the medicines to its patient beneficiaries for

a nominal charge (or provides them for free) does not affect the determination of fair value of the medicine and the amount of the contribution. In this example, the NFP would recognize contribution revenue of \$80 and a disbursement of \$20 to obtain inventory with a value of \$100 to be utilized in its programs.

- 5.134** FinREC believes transactions at prices substantially less than those observed in the principal market should not be used as inputs in determining the fair value of gifts in kind unless they are adjusted. Additionally, FinREC observes that in some circumstances a market may not exist sufficient to provide level 1 or level 2 inputs, and therefore the NFP should determine fair value using level 3 inputs, as discussed in FASB ASC 820-10-35 (see paragraphs 3.154–.157).
- 5.135** As noted in paragraph 5.132, an NFP may not always use gifts in kind for its highest and best use. A fair value measurement of a nonfinancial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use, which would maximize the value of the gifts in kind. In addition to programmatic reasons for not pursuing highest and best use, in some cases tax law or donor-imposed restrictions limit the use of the nonfinancial asset to a use other than its highest and best use. As explained in FASB ASC 820-10-35-10B, the highest and best use of a nonfinancial asset takes into account the use of the asset that is physically possible, legally permissible, and financially feasible.
- 5.136** For example, in some circumstances, NFPs obtain gifts in kind that the donor requires be used subject to limitations imposed by Internal Revenue Code (IRC) Section 170(e)(3). In order to get an enhanced deduction under that section, the donee cannot transfer the gifts in kind in exchange for money, property, or services. In other cases, donors may restrict gifts in kind distributions to certain geographic locations, sometimes due to regulatory or market protection concerns. In still other cases, a donor may permanently restrict the NFP's ability to sell an asset for its highest and best use, such as when a donor places a conservation easement on a piece of land. FASB ASC 820-10-35-6B states that although a reporting entity must be able to access the market, the reporting entity does not need to be able to sell the particular asset or transfer the particular liability on the measurement date to be able to measure fair value on the basis of the price in that market. The fact that the NFP cannot sell the asset because of a donor-imposed restriction does not affect its need to measure fair value on the basis of the price in the principal (or most advantageous) market considering the asset's highest and best use.
- 5.137** As discussed in paragraph 3.164, FASB ASC 820-10-35-2B and FASB ASC 820-10-55-51 state that when measuring fair value, an NFP should take into account the characteristics of an asset (such as certain legal restrictions on sale or use) if market participants would take those characteristics into account when pricing the asset or liability at the measurement date. The effect on the measurement arising from a particular characteristic will differ depending on whether that restriction will transfer to market participants. Thus, a conservation easement, which is recorded like a deed and is binding

upon future owners of the property, would be considered in pricing the asset if a donor places that restriction on use of the property.

- 5.138** In comparison, restrictions that are specific to the donee should be reflected in the classification of net assets, not in the measurement of fair value. FinREC believes that in implementing that guidance, limitations imposed by IRC Section 170(e)(3), prohibiting NFPs from selling the gifts in kind, as well as donor restrictions limiting the geographic locations area in which the gifts in kind may be distributed, are restrictions specific to the entity. Because those restrictions are not a characteristic of the asset, they would not transfer to market participants, and therefore should not be considered in pricing the asset.
- 5.139** Some NFPs receive commodities with restrictions requiring that the commodities be sold (monetized) upon receipt. Commodities transferred for monetization usually have specific restrictions on their sale, limiting the sale to a specific country and only after performing a study to ensure that such a sale will not disrupt the marketplace in that country. Those contracts are discussed in chapter 7.
- 5.140** FASB ASC 958-605-30-11 states that in determining fair value of gifts in kind, entities should consider the quality and quantity of the gifts, as well as any applicable discounts that would have been received by the entity, including discounts based on that quantity if the assets had been acquired in exchange transactions.
- 5.141** For example, if the gift in kind is received in wholesale quantity but only retail values are readily available to use as inputs to fair value, a wholesale discount generally would be applied. Similarly, if the gifts in kind that are received have a product expiration date that is sooner than products typically sold in the marketplace or if technological advances have made the gifts in kind less desirable than similar items in the marketplace, a discount should be applied. Whenever a gift in kind differs from the item observed in the marketplace transaction, the NFP should consider whether an adjustment is needed to determine fair value.
- 5.142** FASB ASC 820-10-35-38A states that if an observable input requires an adjustment using an unobservable input and that adjustment results in a significantly higher or lower fair value measurement, the resulting measurement would be categorized within level 3 of the fair value hierarchy.
- 5.143** An NFP has a responsibility to determine the fair value of gifts in kind in accordance with the standards in FASB ASC 820. Therefore, if a donor provides a valuation or an appraisal, the NFP should independently and without bias ascertain whether that value is determined in accordance with FASB ASC 820. Likewise, published sources exist that purport to provide the value of various assets that may be received as gifts in kind, such as pharmaceuticals or motor vehicles. FinREC believes that in measuring fair value in conformity with FASB ASC 820, NFPs 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.

- 5.144** FASB ASC 958-605-30-11 states that fair value would generally not increase when a gift in kind is passed from one entity to another. However, fair value could increase if an entity adds value to the gift, such as by cleaning and packaging the gift. Any increases should be evaluated to determine whether the entity did, in fact, add to the fair value of the assets.
- 5.145** Additional examples of activities that might increase the fair value of gifts in kind before they are passed to another entity include repairing and refurbishing used goods or repackaging items that were contributed in bulk quantities so that they can be sold individually.

Gross or Net Presentation of Gifts in Kind

- 5.146** According to FASB ASC 958-225-45-14, sales of contributed inventory or other gifts in kind should be reported gross if the sales are part of an entity's ongoing major or central operations and activities; that is, the sales are reported separately from (and therefore in addition to) the initial recording of the contribution of that inventory or other gifts in kind, with a corresponding cost of sales (subject to the exception in paragraphs 5.149–.150 that pertains to certain fund-raising events). For sales of contributed inventory or other gifts in kind that result from incidental or peripheral transactions, either gross reporting, as discussed in FASB ASC 958-225-45-14, or net reporting, as discussed in FASB ASC 958-225-45-15, is permitted, subject to the exception in paragraphs 5.149–.150. FinREC believes best practice is to report sales of contributed inventory or other gifts in kind that result from incidental or peripheral transactions net as a gain or loss on sale. As discussed in paragraph 13.34, FASB ASC 958-225-45-16 includes guidance to help distinguish events that are ongoing major or central, from peripheral or incidental.
- 5.147** Examples of transactions that typically result in reporting the sale of contributed assets as sales and costs of sales (gross reporting) include the following:
- Items contributed to an NFP that are used to produce inventory or that are further processed in vocational training workshops that are part of the NFP's mission
 - Items contributed to an NFP and subsequently sold in its thrift shops that are part of the NFP's mission
 - Sports equipment contributed to an NFP that is an athletic organization and subsequently sold to participants in the NFP's programs that provide opportunities to participate in the sport in which that equipment is used
- 5.148** Examples of transactions that typically result in reporting the sale of contributed assets net include the following:

- Charity auctions or other fund-raising events in which contributed gifts in kind can be linked to asset transfers from the original resource providers to the ultimate resource providers (recipients) because they are, in substance, part of the same transaction, as discussed in FASB ASC 958-605-25-20 (paragraph 5.149)
- Excess food, medicine, clothing, and other items received by the NFP as a contribution but that are beyond its current needs, assuming the sales transaction is peripheral or incidental
- Fixed assets, such as office equipment or real estate, received by the NFP as a contribution but that are beyond its current needs, assuming the sales transaction is peripheral or incidental

Contributed Items to Be Sold at Fund-raising Events

5.149 As discussed in FASB ASC 958-605-25-20, NFPs may also receive items, such as tickets, gift certificates, works of art, and merchandise, that are to be used for fund-raising purposes by transferring them to other resource providers (the ultimate resource provider or recipient) during fund-raising events. Those gifts in kind can be linked to asset transfers from the original resource providers to the ultimate resource providers (recipients) because they are, in substance, part of the same transaction; those gifts in kind should be reported as contributions and measured at fair value when originally received by an NFP. The difference between the amount received for those items from the ultimate resource providers (recipients) and the fair value of the gifts in kind when originally contributed to the NFP should be recognized as adjustments to the original contributions when the items are transferred to the ultimate resource providers (recipients).

5.150 For example, a public radio station receives a ticket with a fair value of \$75 from the local community theater (the original resource provider), which is to be auctioned to the highest bidder; a listener (the ultimate resource provider or recipient) subsequently acquires the ticket at auction for \$100. The initial transfer of the ticket to the NFP should be reported as a \$75 contribution and the ticket should be reported as an asset; an additional \$25 contribution should be reported when the ticket is transferred to the listener at auction, and no cost for the ticket should be reported on the statement of activities. In that example, the ultimate resource provider or recipient acquires the ticket in a transaction that is in part an exchange transaction and in part a contribution.^{fn 16} If instead a listener acquires the ticket for \$45, rather than \$100, a reduction of \$30 in contributions should be reported when the ticket is transferred to the listener at auction, because the transfer at auction is part of the transaction that was initiated when the NFP received the ticket. Holding the ticket from the time of initial receipt to the time of

^{fn 16} Paragraphs 13.26–.31 discuss reporting special events associated with an NFP's fund-raising efforts.

ultimate transfer at auction does not create a transaction separate from the initial contribution.

Contributed Fund-raising Material, Informational Material, or Advertising, Including Media Time or Space

5.151 In some cases, entities other than an NFP use for an NFP's benefit (or provide at no charge to an NFP) certain nonfinancial assets that encourage the public to contribute to the NFP or help the NFP communicate its message or mission. Examples of these include fund-raising material, informational material, or advertising, including media time or space for public service announcements or other purposes. TIS section 6140.24, "Contributions of Certain Nonfinancial Assets, Such as Fundraising Material, Informational Material, or Advertising, Including Media Time or Space for Public Service Announcements or Other Purposes" (AICPA, *Technical Practice Aids*), states that when such nonfinancial assets are used for the NFP's benefit (or provided to the NFP at no charge) and they encourage the public to contribute to an NFP or help the NFP communicate its message or mission, NFPs should consider whether they have received a contribution. If they have received a contribution, the nonfinancial asset received should be measured at fair value, pursuant to FASB ASC 958-605-30-2; and the related expense, at the time the expense is recognized, should be reported by function, based on the nature of the contributed item.

5.152 Examples of such activities include the following:

- An advertising agency, television station, or newspaper provides design services or professional talent services.
- A radio or television station gives an NFP (or uses for the NFP's benefit) commercial air time at no charge.
- A radio or television station airs a public service announcement provided to it by the NFP. (Some stations air the announcement and report information about the airings to the NFP.)
- A magazine, newspaper, or other print media gives an NFP (or uses for the NFP's benefit) advertising space at no charge.
- An Internet site gives an NFP (or uses for the NFP's benefit) advertising space at no charge.

5.153 FinREC believes that in the case of fund-raising material, informational material, advertising, and media time or space, the NFP has received an asset (future economic benefit) and can control others' access to the benefit, and therefore has received 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 (a) cash inflows, such as contributions arising from fund-raising activities or revenues

arising from exchange transactions, or (b) service potential in conducting program or management and general activities.

- 5.154** FinREC believes that the NFP's involvement in determining and managing the content need not be absolute in order to conclude that a transfer of assets has occurred and therefore a contribution has been received. For example, the NFP may receive assistance from a television station, publication, or website in the production of a public service announcement. FinREC believes that receiving such assistance would not lead to the conclusion that the NFP does not determine the content. As another example, if a radio or television station gives an NFP commercial air time at no charge, the NFP need not determine the timeslot in which the message will air in order to conclude that a transfer of assets occurred and therefore a contribution has been received.
- 5.155** Determining whether a transfer occurred based on the extent of the NFP's involvement may be a subjective determination. FinREC believes that in making such a determination, NFPs should consider all relevant facts and circumstances. The greater the NFP's involvement in determining and managing the message and the use of the materials, the greater the evidence that the NFP has received a contribution.
- 5.156** The following facts and circumstances are indicators that the NFP has received a contribution:
- The NFP approves the advertisement before it is placed in the newspaper (or other media).
 - The NFP provides or actively grants its permission to include its logo (or other materials or information) in an advertisement before the advertisement is placed in the newspaper (or other media). For purposes of applying this indicator, the NFP's silence or failure to defend the use of its logo (or other materials or information) is not considered implicit approval of such usage.
 - The NFP provides input to the person or entity producing and placing the advertisement (or materials produced and disseminated), and has significant influence, but not absolute approval power, in determining the content of the advertisement (or materials produced and disseminated). For example, an NFP that reviews an advertisement demonstrates significant influence but not absolute approval power.
 - The NFP provides artwork or other materials to the person or entity producing and placing the advertisement (or materials produced and disseminated).
 - Representatives of the NFP appear in an audio or video advertisement (or materials produced and disseminated).
- 5.157** The following facts and circumstances are evidence that the NFP has not received a contribution:

- Another entity designs a newspaper advertisement encouraging the public to contribute to an NFP and places that advertisement in the newspaper without seeking or receiving input from the NFP.
- The NFP is aware that the advertisement will be placed (or materials produced and disseminated), but is unable to provide significant input or objection.
- The NFP provides minimal input to the person or entity producing and placing the advertisement (or materials produced and disseminated), and does not have significant influence in determining the content of the advertisement (or materials produced and disseminated).

5.158 In circumstances in which fund-raising material, informational material, advertising, and media time or space are used for the NFP's benefit (or provided to the NFP at no charge) and encourage the public to contribute to an NFP, NFPs should consider whether the fund-raising activity is combined with program, management and general, membership development or other activities (that is, the activity is a joint activity). For example, an NFP receives as a contribution the production of a public service announcement, as well as media time to show that public service announcement. Further, assume the public service announcement is a joint activity because the message is part fund-raising and part program. FinREC believes that in such circumstances, expenses associated with reporting that activity should be reported pursuant to the "Accounting for Costs of Activities that Include Fundraising" subsections of FASB ASC 958-720. Those subsections are discussed in paragraphs 13.74–.113.

5.159 FinREC concluded that whether fund-raising materials, informational materials, or advertising, including media time or space for public service announcements or other purposes, are recognized as contributions received is unaffected by (a) whether the NFP could afford to purchase them or (b) whether they would typically need to be purchased by the NFP if they had not been provided by contribution. In reaching that conclusion, FinREC analogized to FASB ASC 958-605-55-23, which states that whether contributions of utilities and use of long-lived assets should be reported is unaffected by whether the NFP could afford to purchase the utilities or facilities at their fair value. As noted in FASB ASC 958-605-55-23, the use of property, utilities, or advertising time are considered to be forms of contributed assets, rather than contributed services. Therefore, the criteria for recognition of contributed services in FASB ASC 958-605-25-16, as discussed in paragraph 5.111, are not applicable.

5.160 However, those criteria do apply to graphic design services, professional talent services, and similar contributed services associated with the contribution of the nonfinancial assets. FinREC believes that those services create or enhance a nonfinancial asset and they should be recognized as a contribution in accordance with FASB ASC 958-605-25-16, as discussed in paragraph 5.111. For example, assume an NFP receives a solicitation from an advertising agency to create a multimedia advertising campaign promoting the NFP's new program and soliciting contributions to help fund the program. The NFP is

involved in the design and content of the advertising campaign at the outset and has approval rights before the advertisements are produced in final form. All services associated with the production of the advertising and the professional talent used to produce the television and radio advertisements are donated. The advertisements are placed on television, radio, and in print. In this example, the NFP would recognize a contribution for the contributed services because the NFP has the ability to approve design and content and the contributed services enhance a nonfinancial asset (the multimedia advertising campaign).

5.161 In determining fair value of contributions of fund-raising materials, informational materials, advertising, and media time or space, FinREC believes the following facts and circumstances may be relevant:

- The donor's own historical experience of receiving payment in the form of cash, marketable securities, or other consideration that is readily convertible to a known amount of cash for similar advertising from buyers unrelated to the NFP.
- Placement of the ad, such as the time of day or position within a website or publication.
- Number of viewers or readers.
- Demographics of the viewers or readers, such as income, age, gender, and other relevant factors, and whether those demographics correlate with the targeted audience for the NFP's message.
- Standard discounts given for similarly placed commercial messages or programs, such as discounts on unsold commercial time or space.
- Type of space, such as color or black and white. For Internet ads, consider whether the advertisement is a banner ad, the length of time displayed, the type of display (for example, flashing versus still), and the number of clicks required to get to the ad.
- Whether the NFP shares the message, advertising, or materials with others or is the only entity receiving the benefit of the message, advertising, or materials.

Contributed Utilities and Use of Long-Lived Assets

5.162 NFPs may receive unconditional contributions of the use of electric, telephone, and other utilities and of long-lived assets (such as a building or the use of facilities) in which the donor retains legal title to the long-lived asset. Pursuant to FASB ASC 958-605-55-23 and FASB ASC 958-605-25-2, an NFP should recognize the fair value of the use of

property or utilities as contribution revenue in the period in which the contribution^{fn 17} is received and expenses in the period the utilities or long-lived assets are used.^{fn 18} If the transaction is an unconditional promise to give (as described in paragraphs 5.88–.110) for a specified number of periods, the promise should be reported as contributions receivable and as restricted support that increases temporarily restricted net assets.^{fn 19}

5.163 FASB ASC 958-605-55-24 discusses unconditional promises to give the use of long-lived assets (such as a building or other facilities) for a specified number of periods in which the donor retains legal title to the long-lived asset. Those promises may be received in connection with leases or may be similar to leases but have no lease payments. For example, an NFP may use facilities under lease agreements that call for lease payments at amounts below the fair rental value of the property. In circumstances in which an NFP receives an unconditional promise to give for a specified number of periods, the promise should be reported as revenue and as a contribution receivable for the difference between the fair rental value of the property and the stated amount of the lease payments.^{fn 20} Amounts reported as contributions should not exceed the fair value of the long-lived asset at the time the NFP receives the unconditional promise to give. The contribution receivable may be described in the financial statements based on the item whose use is being contributed, such as a building, rather than as contributions receivable. The contribution of the use of the property could be subject to donor-imposed restrictions or conditions.

5.164 FinREC believes that in implementing the guidance in the previous paragraph, NFPs should consider whether a promise to give the use of property or equipment is similar to a capital lease, even though the lease payments are contributed and there is no lease obligation. FinREC also believes that when considering the limitation on the amount recognized as contribution revenue, the comparison is between the amount recognized *at the date the unconditional promise to give is received* and the fair value of the underlying long-lived asset at that same date. That is, the limitation on the amount recognized does not include additional contributions that the NFP may receive in the form of (a) promises to pay executory costs (that is, maintenance, insurance, and taxes), make renovations, or address environmental remediation obligations on the NFP's behalf, or (b) forgiveness of payments that would have been due under the gift agreement, such as to reimburse the

^{fn 17} As discussed in FASB ASC 958-605-55-26, contributions are received in several different forms, which include both the use of facilities and utilities, as well as unconditional promises to give those items in the future.

^{fn 18} FASB ASC 958-605-55-23 states that whether those contributions should be reported is unaffected by whether the NFP could afford to purchase the utilities or facilities at their fair value.

^{fn 19} Paragraph 5.57 discusses measurement principles for initial recognition of contributions received.

^{fn 20} See footnote 19.

^{fn 21} FASB ASC 460-10-25-1 states that the guidance in the “General” subsections of FASB ASC 460-10-25 and FASB ASC 460-10-30 does not apply to the following circumstances, among others:

donor (lessor) for expenses or to pay the donor (lessor) an amount computed based on the NFP's (lessee's) sales at the leased property or another metric. For example, a donor may promise the free use of equipment for 5 years, which is more than 75 percent of the equipment's useful life. The donor also agrees to pay the costs of the installation of the equipment and the costs of shipping the equipment to the NFP. If the equipment has a fair value of \$10,000, and installation and shipping costs are \$2,000, the limitation on the amount recognized for the equipment is \$10,000, but the NFP would also recognize a contribution of \$2,000 for the installation and shipping. The \$2,000 would also be capitalized as part of the cost of the equipment.

Guarantees

- 5.165** As discussed in paragraph 5.60, an NFP may receive a guarantee of its debt from an unaffiliated entity without providing commensurate consideration in return. FinREC believes that in circumstances in which an NFP receives a guarantee without providing commensurate consideration, the NFP has received a contribution that should be initially measured at fair value. That guarantee is in part a conditional contribution—the promise to make payments in future periods upon default—and in part an unconditional contribution—the gift of the guarantor's credit support, which enables the NFP to obtain a lower interest rate on its borrowing. (Paragraphs 10.94–.95 provide additional information about a guarantor's accounting for guarantees.)
- 5.166** FASB ASC 460, *Guarantees*, provides guidance pertaining to guarantees.^{fn21} Among other transactions, FASB ASC 460 applies to contracts that contingently require a guarantor to make payments to a guaranteed party based on another entity's failure to perform under an obligating agreement (performance guarantees).
- 5.167** FASB ASC 460-10-30-2 states that if a guarantee is issued in a standalone arm's-length transaction with an unrelated party, the liability recognized at the inception of the guarantee should be the premium received or receivable by the guarantor as a practical expedient. In implementing the guidance discussed in paragraphs 5.165–.166, the prevalent practice for determining the fair value of a guarantee of indebtedness is to use an estimate of the premium that would be required by the guarantor to issue the same guarantee in a stand-alone arm's-length transaction with an unrelated party. In the absence of observable market inputs for a premium amount, FinREC believes that the fair value of the guarantee might be estimated by using present value techniques, such as the present value of the interest savings (that is, the difference between the debt payments

^{fn21} FASB ASC 460-10-25-1 states that the guidance in the "General" subsections of FASB ASC 460-10-25 and FASB ASC 460-10-30 does not apply to the following circumstances, among others:

- A guarantee issued either between parents and their subsidiaries or between corporations under common control.
- A parent's guarantee of its subsidiary's debt to a third party (whether the parent is a corporation or an individual).
- A subsidiary's guarantee of the debt owed to a third party by either its parent or another subsidiary of that parent.

using the stated interest rate and the debt payments using a market interest rate, which is determined as the rate that the NFP would otherwise pay had the guarantor not provided the guarantee).

- 5.168** In subsequent periods, FinREC believes that the recipient of a guarantee should amortize the amount of the guarantee over the life of the debt using the effective interest method, or if immaterially different, the straight-line method. That accounting is computationally similar to a below-market interest rate loan, as discussed in paragraphs 5.170–.172. If the NFP defaults on its debt (or another event triggers the payment of funds to the lender by the guarantor), the NFP should recognize contribution revenue if the amount that the guarantor pays on its behalf is not repayable to the guarantor, or the NFP should recognize its liability to the guarantor if the guarantee agreement requires the NFP to repay the guarantor.
- 5.169** As an alternative to the accounting in the previous paragraph, the NFP might irrevocably elect to use fair value as the initial and subsequent measurement of the guarantee, in accordance with the Fair Value Option subsections of FASB ASC 825-10.

Below-Market Interest Rate Loans

- 5.170** Some NFPs receive loans of cash that are interest free or that have below-market interest rates. Interest expense and contribution revenue should be reported in connection with loans of cash to NFPs that are interest free or that have below-market interest rates (regardless of whether the loan is between related parties). Those contributions should be measured at fair value. FinREC believes that the difference between the fair value of the loan at a market interest rate and the fair value of the loan at its stated rate is one method of determining the fair value of the contribution. Donor accounting for below-market interest rate loans is further discussed in chapter 8, “Programmatic Investments.”
- 5.171** For example, on January 1, 20X8, an NFP with a December year-end receives an interest-free loan of \$200,000, payable on December 31, 20Y0. The purpose of the loan is to pay operating expenses and the appropriate imputed market rate of interest is 6 percent. The journal entries over the life of the loan would be as follows.

1/1/X8

Cash	200,000	
Loan payable		167,924
Contribution revenue—temporarily restricted		32,076

(Receipt of cash; liability reported at the fair value of the loan using the present value of \$200,000 due in 3 years, discounted at 6 percent.)

12/31/X8

Interest expense	10,075	
Loan payable		10,075
(Accretion of loan using the effective interest method.)		
Reclass: Temporarily restricted net assets	10,075	
Reclass: Unrestricted net assets		10,075
(Reclassification due to lapse of restriction.)		
12/31/X9		
Interest expense	10,680	
Loan payable		10,680
(Accretion of loan using the effective interest method.)		
Reclass: Temporarily restricted net assets	10,680	
Reclass: Unrestricted net assets		10,680
(Reclassification due to lapse of restriction.)		
12/31/Y0		
Interest expense	11,321	
Loan payable		11,321
(Accretion of loan using the effective interest method.)		
Reclass: Temporarily restricted net assets	11,321	
Reclass: Unrestricted net assets		11,321
(Reclassification due to lapse of restriction.)		
Loan payable	200,000	
Cash		200,000
(Payment of the loan.)		

5.172 As another example, on January 1, 19X8, an NFP with a December year-end receives an interest-free loan of \$200,000. The purpose of the loan is to pay operating expenses and the appropriate imputed rate of interest is 6 percent. Unlike the example in paragraph 5.171, the loan is payable on demand. The loan is repaid on December 31, 20Y0.

1/1/X8

Cash	200,000	
Loan payable		200,000

(Receipt of cash.)

12/31/X8

Interest expense	12,000	
Contribution revenue—Unrestricted		12,000

(Contribution revenue for below-market rate of interest on loan [loan balance \times interest rate: $\$200,000 \times .06$].)

12/31/X9

Interest expense	12,000	
Contribution revenue—Unrestricted		12,000

(Contribution revenue for below-market rate of interest on loan.)

12/31/Y0

Interest expense	12,000	
Contribution revenue—Unrestricted		12,000

(Contribution revenue for below-market rate of interest on loan.)

Loan payable	200,000	
Cash		200,000

(Payment of the loan.)

Contributed Collection Items

5.173 NFPs may receive contributions of works of art, historical treasures, and similar items that meet the definition of collections in the FASB ASC glossary. The recognition and measurement principles for contributions of collection items depend on the collections-capitalization policy adopted by the NFP. Accounting for collections is discussed in chapter 7.

Split-Interest Agreements

5.174 A *split-interest agreement* is a form of contribution in which an NFP receives benefits that are shared with other beneficiaries designated by the donor. Common kinds of such agreements include charitable lead and remainder trusts, charitable gift annuities, and pooled (life) income funds. Because of the specialized nature of these arrangements, they are discussed separately in chapter 6.

Administrative Costs of Restricted Contributions

5.175 Some NFPs have a policy of designating a certain percentage of restricted gifts to offset the costs of raising and administering those gifts. In applying the guidance in paragraphs 5.74–.82, NFPs may be required to determine whether an implicit restriction exists if an NFP has a policy that allocates a percentage of certain contributions to supporting services. In order to conclude that the policy to allocate a portion of the contribution to supporting services is an implicit donor restriction, FinREC believes that policy needs to be effectively communicated to or from the donor prior to receipt of the contribution.

5.176 For example, assume a donor contributes \$100 restricted for Program A to an NFP that has a policy of allocating 5 percent of all purpose-restricted contributions to supporting services. In determining whether that policy has been effectively communicated to or from the donor prior to receipt of the contribution, FinREC believes that

- in circumstances in which the NFP discloses the policy to donors when soliciting the contribution, an implicit restriction exists, and 95 percent of the gift is donor-restricted for Program A and 5 percent of the gift is restricted for supporting services,
- in circumstances in which the donor is unaware of that policy, no implicit restriction exists and 100 percent of the gift is donor restricted for Program A, and
- in circumstances in which the NFP discloses that policy in the notes to its financial statements, but does not otherwise disclose that policy directly to the donor, no implicit restriction exists and 100 percent of the gift is donor restricted for Program A. Disclosure of that policy in the financial statements, in and of

itself, would not be considered sufficient evidence that the donor intends a portion of the contribution to be restricted for supporting services because (1) the donor may not read the financial statements and (2) that type of communication might come after the contribution was already received.

- 5.177** If the NFP has not communicated to the donor its policy for cost allocations, charges, assessments, or assignments as it pertains to meeting donor restrictions, the NFP may be in noncompliance with donor restrictions. Paragraphs 3.172–.174 discuss noncompliance with donor-imposed restrictions, including illegal acts. Paragraphs 11.03–.08 discuss an NFP’s fiduciary responsibilities to meet donor’s restrictions.

Measurement Principles for Contributions Receivable

- 5.178** In accordance with FASB ASC 958-605-30-1, contributions receivable (unconditional promises to give) are initially measured at fair value. NFPs also have the option of electing to subsequently measure a contribution receivable at fair value in conformity with the “Fair Value Option” subsections of FASB ASC 825-10. *Fair value* is the price that would be received to sell an unconditional promise to give (an asset) in an orderly transaction between market participants at the measurement date.
- 5.179** FASB ASC 958-605-55-22 states that the present value of the future cash flows is one valuation technique for measuring the fair value of contributions arising from unconditional promises to give cash; other valuation techniques also are available, as described in FASB ASC 820.^{fn 22} The fair value white paper states that FinREC believes that a present value technique (an application of the income approach) will be the most prevalent valuation technique used to measure fair value of an unconditional promise to give that is expected to be collected in one year or more. In reaching that conclusion, FinREC observes that the market approach typically would not be operational for measuring the fair value of unconditional promises to give cash because no market exists, and the cost approach is not used for valuing financial assets such as promises to give. Because no market exists for unconditional promises to give, assumptions regarding what a hypothetical acquirer would pay for these assets (the right to receive from the donor the cash flow inherent in the promise), determined under current market conditions, are necessary in determining fair value. (The portions of the fair value white paper that discuss unconditional promises to give cash and other financial assets are included in appendix A of this chapter.)
- 5.180** Most NFPs do not elect to subsequently measure contributions receivable at fair value. Instead, they report contributions receivable using updated present value assumptions of cash flows, discounted at the rate used when the receivable was initially recognized.

^{fn 22} See footnote 5.

Those NFPs compute and disclose an allowance for uncollectible receivables and an allowance for the unamortized discount.

Present Value Techniques

- 5.181** FASB ASC 820-10-55 and the fair value white paper discuss two present value techniques, the (a) traditional or discount rate adjustment technique and (b) expected present value technique, which may be applied using one of two methods. Conceptually, the three present value methods should give the same results. FinREC observes that in practice, however, certain techniques may be easier, more practical, or more appropriate to apply to certain facts and circumstances.
- 5.182** Key pricing inputs used in a fair value measurement should reflect the factors that market participants would consider in setting a price for the promise to give. The fair value hierarchy in FASB ASC 820-10-35 prioritizes market observable inputs, but also allows for the use of unobservable (internally derived) inputs when relevant market observable inputs are unavailable. When using a present value technique, two key pricing inputs are the cash flows and the discount rate. The factors considered in determining the cash flows and the discount rate used should be documented.
- 5.183** Paragraphs 19–32 of the fair value white paper (appendix A) provide information about determining the discount rate for promises to give cash. FASB ASC 958-605-30-5 states that if present value techniques are used to measure fair value, the present value of unconditional promises to give should be measured using a discount rate that is consistent with the general principles for present value measurement discussed in paragraphs 5–9 of FASB ASC 820-10-55. FASB ASC 820-10-55-6 discusses general principles for determining the discount rate when applying present value techniques. As noted in FASB ASC 820-10-55-6(c), to avoid double counting or omitting the effects of risk factors, discount rates should reflect assumptions that are consistent with those inherent in the cash flows. For example, a discount rate that reflects the uncertainty in expectations about future defaults is appropriate if using promised cash flows of an unconditional promise to give. That same rate should not be used if using most likely cash flows or expected (that is, probability-weighted) cash flows because those cash flows already reflect assumptions about the uncertainty of future defaults.
- 5.184** The use of the word *expected* in the phrase *expected to be received* or the phrase *expected to be collected*, when used to describe the receipt of cash or other assets from an unconditional promise to give, is not intended to limit the NFP's choice of present value techniques to an expected present value technique as described in paragraphs 13–20 of FASB ASC 820-10-55.

Organization of the Measurement Guidance

- 5.185** The guidance for measurement of contributions receivable is organized as follows:

Contribution Receivable	Initial Measurement		Subsequent Measurement	
	FASB ASC	This Guide	FASB ASC	This Guide
Due in less than one year	958-605-30-6	Paragraphs 5.186–.187		Paragraph 5.196
Due in more than one year				
Promise to give cash	Paragraphs 4-5 of 958-605-30	Paragraphs 5.188–.190	Paragraphs 6–10 of 958-310-35	Paragraphs 5.197–.203
Promise to give equity securities with readily determinable fair value or debt securities	958-605-30-8	Paragraphs 5.191–.194	958-310-35-11	Paragraphs 5.197–.205
Promise to give other assets	958-605-30-8	Paragraphs 5.191–.194	Paragraphs 12–13 of 958-310-35	Paragraphs 5.202–.203; paragraphs 5.206–.209

Initial Measurement

Contributions Receivable in Less Than One Year

- 5.186** FASB ASC 958-605-30-6 states that unconditional promises to give that are expected to be collected in less than one year may be measured at net realizable value because that amount results in a reasonable estimate of fair value. FASB Concept No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, states that net realizable value is “the nondiscounted amount of cash, or its equivalent, into which an asset is expected to be converted in due course of business, less direct costs, if any, necessary to make that conversion.” That means, for contributions receivable, an NFP assesses whether the contribution is reasonably assured of collection, and only recognizes the amount that it estimates will be collected, less direct costs of collection, if any.
- 5.187** For contributions receivable that result from mass fund-raising appeals, an NFP may estimate the collectible portion by using the experience it gained from similar appeals. Paragraph 114 of the basis for conclusions of FASB Statement No. 116 explains:

Annual campaigns, mail solicitations, telethons, or phonathons generally result in many promises of small donor amounts that are due in less than one year and are unconditional. To measure individually the present value of estimated cash flows for promises to give resulting from those campaigns generally is impracticable.

Measurement difficulties are compounded because the solicitation process may result in some spurious promises.

Contributions Receivable in One Year or More

5.188 FASB ASC 958-605-30-4 discusses initial measurement of unconditional promises to give using present value techniques to measure the fair value of unconditional promises to give. An NFP should determine the amount and timing of the future cash flows of unconditional promises to give cash (or, for promises to give noncash assets, the quantity and nature of assets expected to be received). In making that determination, the NFP should consider all the elements in FASB ASC 820-10-55-5, including the following: when the receivable is expected to be collected, the creditworthiness of the other parties, the NFP's past collection experience, the NFP's policies concerning the enforcement of promises to give, expectations about possible variations in the amount or timing of the cash flows (that is, the uncertainty inherent in the cash flows), and other factors concerning the receivable's collectibility.

Unconditional Promises to Give Cash

5.189 Table 5-4 reproduces the table in FASB ASC 958-605-55-22, which illustrates the use of present value techniques for initial recognition and measurement of unconditional promises to give cash that are expected to be collected one year or more after the financial statement date.

Table 5-4

Initial Recognition of Unconditional Promises to Give Cash

Facts

Assume that a not-for-profit entity receives a promise (or promises from a group of homogeneous donors) to give \$100 in 5 years, that the anticipated future cash flows from the promise(s) are \$70, and that the present value of the future cash flows is \$50.

Solution

dr.	Contributions Receivable	\$70
cr.	Contribution Revenue—Temporarily Restricted	\$50
cr.	Discount on Contributions Receivable	\$20

(To report contributions receivable and revenue using a present value technique to measure fair value.)

[*Note:* Some entities may use a subsidiary ledger to retain information concerning the \$100 face amount of contributions promised in order to monitor collections of contributions promised.]

- 5.190** In conformity with FASB ASC 835-30-25-11, the discount rate should be determined at the time the unconditional promise to give is initially recognized and should not be revised subsequently unless the NFP has elected to measure the promise to give at fair value in conformity with the “Fair Value Option” subsections of FASB ASC 825-10, as discussed further in paragraphs 5.197–.198.

Unconditional Promises to Give Noncash Assets

- 5.191** FASB ASC 958-605-30-8 discusses initial measurement of unconditional promises to give noncash assets. It states that a present value technique is one valuation technique for measuring the fair value of an unconditional promise to give noncash assets; other valuation techniques also are available, as described in FASB ASC 820.^{fn 23} If present value techniques are used, the fair value of contributions arising from unconditional promises to give noncash assets might be determined based on the present value of the projected fair value of the underlying noncash assets at the date that those assets are expected to be received (that projected fair value is referred to in this section as the *future fair value*) and in the quantities that those assets are expected to be received, if the date is one year or more after the financial statement date.
- 5.192** In determining the future amount to be discounted, FASB ASC 958-605-30-8 requires that the NFP consider both the likelihood of the promise being fulfilled and the future fair value of those underlying assets, such as the future fair value per share of a promised equity security. The quantity, nature, and timing of assets expected to be received, such as the number of shares of a promised equity security, the entity in which those shares represent an equity interest, and when those shares will be received should be considered in determining the likelihood of the promise being fulfilled.
- 5.193** Similar to paragraphs 49 and 91 in the fair value white paper (appendix A), FinREC believes that if the NFP determines the fair value of unconditional promises to give noncash assets based on the present value of the future fair value of the underlying noncash assets in the quantities that those assets are expected to be received, the appropriate discount rate would equal or exceed the expected growth rate (rate of return) on the noncash assets. If, for example, the NFP expects, a promised equity security’s value to grow at a rate of 5 percent, then as the recipient of a promise of those securities, the NFP also bears at least that same risk. Thus, FinREC believes that best practice is for the discount rate to also reflect that risk, and the discount rate in this example would be, at a minimum, 5 percent.
- 5.194** FASB ASC 958-605-30-8 also states that, in cases in which the future fair value of the underlying asset is difficult to determine, the fair value of an unconditional promise to give noncash assets may be based on the fair value of the underlying asset at the date of

^{fn 23} See footnote 5.

initial recognition. No discount for the time value of money should be reported if an asset's fair value at the date of initial recognition is used to measure the fair value of the contribution. FinREC believes that the future fair value of the underlying asset typically is difficult or impossible to determine, and that best practice typically is to use the fair value of the underlying asset as the measure at the date of initial recognition for a promise to give a noncash asset.

Subsequent Measurement

- 5.195** FASB ASC 958-310-35 discusses the subsequent measurement of receivables. It states that after recognition, the value of a contribution arising from an unconditional promise to give cash or noncash assets (contribution receivable) may change because of any of the following reasons: (a) accrual of the interest element for a promise to give measured using present value techniques, (b) changes in the quantity or nature of assets expected to be received (such as changes in the amounts of future cash flows), (c) changes in the projected fair value of the underlying noncash assets at the date that those assets are expected to be received (referred to as the *future fair value* of underlying noncash assets), (d) changes in the timing of assets expected to be received, and (e) changes in the time value of money.

Contributions Receivable in Less Than One Year

- 5.196** Often, contributions receivable that are due in less than one year are outstanding at the end of the fiscal year. If they are outstanding, net realizable value is updated at the date of the statement of financial position. Net realizable value is the nondiscounted amount of cash, or its equivalent, into which the receivables are expected to be converted in due course of operations, less direct costs, if any, necessary to make that conversion.

Contributions Receivable in One Year or More

Election to Subsequently Measure Contributions Receivable at Fair Value

- 5.197** The “Fair Value Option” subsections of FASB ASC 825-10 create a fair value option under which an NFP may irrevocably elect fair value as the initial and subsequent measure for most contributions receivable. Unconditional promises to give cash and unconditional promises to give financial instruments (such as equity and debt securities) are financial assets, and an NFP may choose, when it first recognizes the receivable, to measure it at fair value (the fair value option) on an ongoing basis. The decision about whether to elect the fair value option should be (a) applied instrument by instrument, except as discussed in FASB ASC 825-10-25-7, (b) irrevocable (unless a new election date occurs, as discussed in FASB ASC 825-10-25-4), and (c) applied only to an entire instrument and not to only specified risks, specific cash flows, or portions of that instrument. An NFP may decide whether to elect the fair value option for each eligible

item on its election date; alternatively, it may elect the fair value option according to a preexisting policy for contributions receivable. Most NFPs do not elect the fair value option for their contributions receivable.

- 5.198** FASB ASC 958-310-35-1 states that if an NFP elects to measure a receivable at fair value and uses a present value technique to measure fair value, the discount rate assumptions, and all other elements discussed in FASB ASC 820-10-55-5, should be revised at each measurement date to reflect current market conditions.

If the Election to Subsequently Measure Contributions Receivable at Fair Value is Not Made

- 5.199** If an NFP does not elect to subsequently measure its contributions receivable at fair value, accounting for contributions receivable in one year or more is similar to trade receivables due in one year or more. Paragraphs 5–11 of FASB ASC 310-10-35 provide general principles for measurement impairment of receivables. An allowance for uncollectible amounts is established when both (a) it is probable that the NFP will be unable to collect all amounts promised according to the terms of the contribution receivable and (b) the amount of the loss can be reasonably estimated. TIS section 6140.09, “Reporting Bad Debt Losses” (AICPA, *Technical Practice Aids*), states that bad debt losses on unconditional promises to give cash or noncash assets are prohibited from being netted against contribution revenue under FASB ASC 958-225-45-15.
- 5.200** As noted in TIS section 6140.25, “Multiyear Unconditional Promises to Give—Measurement Objective and the Effect of Changes in Interest Rates” (AICPA, *Technical Practice Aids*), if an NFP has not elected the fair value option (as discussed in paragraphs 5.197–.198), and market interest rates change in periods subsequent to initial recognition of the contribution receivable, in conformity with FASB ASC 835-30-25-11, the discount rate used in a present value technique should not be revised to reflect those changes in market rates.
- 5.201** Discounts on contributions receivable should be amortized between the date the promise to give is initially recognized and the date the cash or other contributed assets are received. In conformity with FASB ASC 835-30-35, the interest method should be used to amortize the discount. Other methods of amortization may be used if the results are not materially different. FASB ASC 958-310-35-6 and FASB ASC 958-310-45-2 require that the subsequent accruals of the interest element be accounted for by donees as contribution revenue that increases either temporarily or permanently restricted net assets if the underlying promise to give is donor restricted.

Changes in the Quantity or Nature of Assets Expected to Be Received

- 5.202** This paragraph and the next discuss the guidance in paragraphs 7–10 of FASB ASC 958-310-35 for subsequent measurement of unconditional promises to give if there are changes in the quantity or nature of the promised assets. If the fair value of a contribution receivable decreases because of changes in the quantity or nature of assets expected to be

received, the decrease should be recognized in the period(s) in which the expectation changes. As discussed in FASB ASC 958-310-45-3, that decrease should be reported as an expense or loss (bad debt) in the net asset class in which the net assets are represented. Because all expenses are reported as decreases in the unrestricted net asset class, those decreases should be reported as losses if they are decreases in temporarily restricted net assets or permanently restricted net assets.

- 5.203** No increase in net assets should be recognized if the fair value of a contribution receivable increases because of a change in the quantity or nature of assets expected to be received between the date the unconditional promise to give is recognized and the date it is collected, unless the promise was previously written down because of expenses or losses from bad debts. If the fair value of a contribution receivable increases because of changes in the quantity or nature of assets expected to be received, and previous decreases in the value of that unconditional promise to give resulted in expenses or losses from bad debts, the increase should be reported as a recovery of those expenses or losses to the extent that those expenses or losses were previously recognized. The recovery should be reported in the net asset classes in which the net assets are represented. Amounts collected, other than a recovery of bad debt expenses or losses, in excess of the carrying amount of contributions receivable should be reported as contribution revenue in the appropriate net asset class.

Changes in the Fair Value of Underlying Noncash Assets—Gifts of Certain Securities

- 5.204** As discussed in FASB ASC 958-310-35-11, the fair value of a contribution receivable arising from an unconditional promise to give equity securities with readily determinable fair values or debt securities may change between the date the unconditional promise to give is recognized and the date the asset promised is received because of changes in the future fair value of the underlying securities. For purposes of subsequent measurement, the method of determining the future fair value of the underlying securities shall be the same as the method used for determining that amount for purposes of initial measurement. Thus, if a promise to give securities is measured based on the fair value of the underlying securities at the date of gift, as described in FASB ASC 958-605-30-8 (paragraph 5.194), an observed change in the current fair value of the underlying securities shall be recognized. The change should be reported as an increase or decrease in contribution revenue in the period(s) in which the change occurs. The change should be recognized in the net asset class in which the contribution was originally reported or in the net asset class in which the net assets are represented.
- 5.205** Assumed relationships, such as the relationship between the market price of the security at the time the initial measurement is made and its projected market price at the date the asset is expected to be received, should be presumed to continue in determining whether the future fair value of the underlying noncash asset has changed.

Changes in the Fair Value of Underlying Noncash Assets—Gifts of Other Assets

- 5.206** As discussed in paragraph 5.195 and FASB ASC 958-310-35-12, the fair value of a contribution receivable arising from an unconditional promise to give noncash assets other than equity securities with readily determinable fair values or debt securities may change between the date the unconditional promise to give is recognized and the date the asset promised is received because of changes in the future fair value of the underlying noncash assets. If, in a period subsequent to initial measurement, an observed change in the current fair value of the asset to be contributed occurs, that change in fair value may or may not result in changes in the future fair value of the underlying noncash asset, depending on the method and assumptions used for determining the future fair value of the underlying noncash asset.
- 5.207** As discussed in FASB ASC 958-310-35-12, for purposes of subsequent measurement, the method for determining the future fair value of the underlying noncash asset should be the same as the method used for determining that amount for purposes of initial measurement. (Paragraphs 5.191–.194 discuss the measurement principles for initial recognition of unconditional promises to give noncash assets, including consideration of the future fair value of the underlying asset.) Accordingly, assumed relationships, such as the relationship between the market price of the noncash asset at the time the initial measurement is made and its projected market price at the date the asset is expected to be received, should be presumed to continue in determining whether the future fair value of the underlying noncash asset has changed.
- 5.208** As discussed in paragraph 5.194, the fair value of an unconditional promise to give noncash assets may be based on the fair value of the underlying noncash asset at the date of initial recognition. If that method is used at initial measurement, for subsequent measurement, observed changes in the current fair value of the asset to be contributed should be treated as if they were changes in the fair value of contributions arising from unconditional promises to give noncash assets because of changes in the future fair value of the underlying asset. If that method is not used at initial measurement, for subsequent measurement, observed changes in the current fair value of the asset to be contributed may or may not result in changes in the future fair value of the underlying asset, and, therefore, may or may not result in changes in the fair value of contributions arising from unconditional promises to give noncash assets because of changes in the future fair value of the underlying asset.
- 5.209** As discussed in FASB ASC 958-310-35-13, if the future fair value of the underlying noncash asset (that is, other than equity securities with readily determinable fair values or debt securities) decreases, that decrease should be reported as a decrease in contribution revenue in the period(s) in which the decrease occurs. The decrease should be reported in the net asset class in which the contribution was originally reported or in the net asset class in which the net assets are represented. Thus, if a promise to give noncash assets is measured based on the fair value of those underlying noncash assets at the date of gift, as described in FASB ASC 958-605-30-8 (paragraph 5.194), an observed decrease in the current fair value of the underlying noncash asset shall be recognized. If the future fair value of the underlying noncash asset increases between the date the unconditional

promise to give is recognized and the date the asset promised is received, no additional revenue should be recognized.

Illustration

5.210 Table 5-5 reproduces the table in FASB ASC 958-310-55-1, which illustrates the accounting for changes in the fair value of unconditional promises to give subsequent to initial recognition, but before collection if those promises to give are not measured subsequently at fair value.

Table 5-5

**Accounting for Unconditional Promises to Give That Are Not Measured Subsequently at Fair Value
(Subsequent to Initial Recognition But Before Collection)**

<i>Underlying Asset</i>	<i>Reason for the Change in Value</i>			
	<i>Change in Collectibility of the Receivable</i>		<i>Change in the Fair Value of the Underlying Asset</i>	
	<i>Increase in Fair Value</i>	<i>Decrease in Fair Value</i>	<i>Increase in Future Fair Value</i>	<i>Decrease in Future Fair Value</i>
Cash	No adjustment ^a	Recognize expense or loss (bad debt)	Not applicable	Not applicable
Securities ^b	No adjustment ^a	Recognize expense or loss (bad debt)	Recognize additional contribution revenue	Recognize a decrease in contribution revenue
Other assets	No adjustment ^a	Recognize expense or loss (bad debt)	No adjustment	Recognize a decrease in contribution revenue

^a Recoveries of previously recognized decreases in fair value resulting from changes in estimates of collectibility (up to the amount of decreases previously recognized), however, should be recognized as reductions of bad debt expense or loss.

^b For purposes of this table, *securities* are defined as equity securities with readily determinable fair values and all debt securities, consistent with the use of the terms in Financial Accounting Standards Board *Accounting Standards Codification* 958-320.

Financial Statement Presentation

- 5.211** FASB ASC 958-605-45-1 states that resources received in exchange transactions should be classified as unrestricted revenues and net assets, even in circumstances in which resource providers place limitations on the use of the resources. For example, resources received from governments in exchange transactions in which those governments have placed limitations on the use of the resources should be reported as unrestricted revenues and net assets, because those limitations are not donor-imposed restrictions on contributions. (Classification of net assets is discussed further in paragraphs 5.74–.87; in chapter 3, "Financial Statements, the Reporting Entity, and General Financial Reporting Matters;" and in chapter 11, "Net Assets and Reclassifications of Net Assets.") Similar guidance applies to resources received from entities other than governments. For example, resources received from a manufacturer in an exchange transaction to test a potential product should be reported as unrestricted revenues and net assets, even if the manufacturer placed limitations on the use of the resources. Those limitations are not donor-imposed restrictions on contributions.
- 5.212** Contribution revenue may be reported as a separate line item on a statement of activities. However, this does not preclude reporting separate line items for government contracts, membership dues,^{fn 24} special events, or similar revenue sources in other revenue categories or in the notes to the financial statements.
- 5.213** As discussed in FASB ASC 958-310-45-1, contributions receivable should be reported net of the discount that arises if measuring a promise to give at present value. The discount should be separately disclosed by reporting it as a deduction from contributions receivable either on the face of a statement of financial position or in the notes to the financial statements. In accordance with FASB ASC 310-10-45-4, the valuation allowances for uncollectible contributions receivable should be deducted from the receivables account to which it relates. FASB ASC 958-605-50-1 states that the allowance for uncollectible promises to give does not include amounts determined to be uncollectible when the contributions receivable were initially measured. Thus, for the example in table 5-4, the notes to financial statements should disclose unconditional promises to give of \$70 and unamortized discount of \$20.

Disclosures

- 5.214** The majority of the disclosures for contributions received and agency transactions are located in the "Disclosure" sections (sections 50) of FASB ASC 958-310 and FASB ASC

^{fn 24} Accounting for the portion of membership dues that is an exchange transaction is different than accounting for the portion that is a contribution. Paragraphs 5.44–.46 discuss revenue recognition principles for membership dues.

958-605. The following paragraphs discuss the more common of those disclosures, but are not a substitute for the “Disclosure” sections of FASB ASC.

5.215 The notes to financial statements should include information about the accounting policies adopted by the NFP, including the following:

- Whether the NFP implies time restrictions on the use of contributed long-lived assets (and contributions of cash and other assets restricted to purchasing them) received without donor stipulations about how long the contributed assets must be used. (Paragraphs 5.85–.87 provide guidance concerning the application of this policy.)
- Whether the NFP classifies donor-restricted contributions as unrestricted or restricted support if restrictions are satisfied in the same reporting period in which the contributions are received. (Paragraph 5.84 provides guidance concerning the application of this policy.)
- Whether the NFP recognizes contributions of collection items. (Chapter 7 provides guidance concerning the application of this policy.)
- Disclosure of how the NFP computes its fund-raising ratio if it includes that ratio in its financial statements, as described in FASB ASC 958-205-50-3.

5.216 The notes to financial statements should include the following information about contributions receivable:

- Contributions receivable pledged as collateral or otherwise limited with regard to use.
- A schedule of contributions receivable (showing the total amount separated into amounts receivable in less than one year, in one to five years, and in more than five years) and the related allowance for uncollectible contributions receivable arising from subsequent decreases due to changes in the quantity or nature of assets expected to be received (see paragraphs 5.202–.203), and the unamortized discount.
- The amount of conditional promises to give—in total and, with descriptions, the amount of each group of similar promises (for example, those conditioned upon the development of new programs, upon the purchase or construction of new property and equipment, and upon the raising of matching funds within a specified time period).
- Disclosures required by paragraphs 10–19 of FASB ASC 825-10-50, including disclosures of fair value and carrying amounts for contributions receivable and all other financial instruments for which it is practicable to estimate fair value, the

method(s) and significant assumptions used to estimate the fair value of financial instruments, and the changes in the those methods and significant assumptions, if any, during the period, and the level of the fair value hierarchy within which the fair value measurements are categorized in their entirety (level 1, 2, or 3), unless those disclosures are optional because the three criteria of FASB ASC 825-10-50-3 are met.

- Disclosures required by paragraphs 20–21 of FASB ASC 825-10-50 if an individual donor or groups of donors constitutes a significant concentration of credit risk arising from contributions receivable, unless those disclosures are optional because the three criteria of FASB ASC 825-10-50-3 are met.
- Disclosures required by paragraphs 1–3 of FASB ASC 820-10-50 in the format described in FASB ASC 820-10-50-8, if contributions receivable are subsequently measured at fair value.
- Disclosures required by FASB ASC 820-10-50-2E if unconditional promises to give and not measured at fair value in the statement of financial position but for which the fair value is disclosed (public entities only).
- Disclosures required by paragraphs 28–31 of FASB ASC 825-10-50, if contributions receivable are subsequently measured at fair value.
- Disclosures required by FASB ASC 825-10-50-32, if an election to report contributions receivable at fair value is made after initial recognition pursuant to FASB ASC 825-10-25-4(e).
- Disclosures required by FASB ASC 835-30-45 for imputation of interest.

5.217 The notes to financial statements should include the following disclosures concerning contributions of services received during the period:

- The nature and extent of contributed services received by the NFP
- A description of the programs or activities for which the services were used
- The amount of contributed services recognized during the period

NFPs are encouraged to report in the notes to the financial statements, if practical, the fair value of contributed services received but not recognized.

5.218 If an NFP transfers assets to a recipient entity and specifies itself or its affiliate as beneficiary, the NFP should disclose the following information for each period for which a statement of financial position is presented:

- a. The identity of the recipient entity to which the transfer was made
 - b. Whether variance power was granted to the recipient entity and, if so, a description of the terms of the variance power
 - c. The terms under which amounts will be distributed to the resource provider or its affiliate
 - d. The aggregate amount recognized in the statement of financial position for those transfers and whether that amount is recorded as an interest in the net assets of the recipient entity or as another asset (for example, as a beneficial interest in assets held by others or a refundable advance)
- 5.219** Information about gifts-in-kind transactions may be required to be disclosed under FASB ASC 850. FinREC recommends that, in addition, NFPs with significant gift-in-kind activities disclose in the notes to the financial statements their accounting policies for gifts in kind; general sources of gifts in kind (such as governments, other NFPs, and private donors); as well as the gift-in-kind activity during the year, including the amount utilized by the NFP in its own programs and the amount donated to other NFPs. FinREC recommends that those disclosures include information about gifts in kind received from agency transactions, as well as gifts in kind received from contributions.

Illustrative Disclosures

- 5.220** The following section provides examples of notes to financial statements that illustrate some of the disclosures discussed in this chapter.

Example 1—Donor-Imposed Restrictions

Note X: Summary of Significant Accounting Policies

All contributions are considered to be available for unrestricted use unless specifically restricted by the donor. Amounts received that are designated for future periods or restricted by the donor for specific purposes are reported as temporarily restricted or permanently restricted support that increases those net asset classes. However, if a restriction is fulfilled in the same time period in which the contribution is received, the NFP reports the support as unrestricted.

Example 2—Promises to Give

Note X: Summary of Significant Accounting Policies

Unconditional promises to give that are expected to be collected within one year are recorded at net realizable value. Unconditional promises to give that are expected to be collected in future years are recorded at fair value, which is measured as the present value of their future cash flows. The discounts on those amounts are computed using risk-

adjusted interest rates applicable to the years in which the promises are received. Amortization of the discounts is included in contribution revenue. Conditional promises to give are not included as support until the conditions are substantially met.

Note Y: Promises to Give

Included in "Contributions Receivable" are the following unconditional promises to give:

	<u>20X1</u>	<u>20X0</u>
Capital campaign	\$1,220	
Restricted to future periods	795	\$530
Unconditional promises to give before unamortized discount and allowance for uncollectibles	2,015	530
Less: Unamortized discount	(180)	(24)
Subtotal	1,835	506
Less: Allowance for uncollectibles	(150)	(30)
Net unconditional promises to give	<u>\$1,685</u>	<u>\$476</u>
Amounts due in:		
Less than one year	\$1,220	
One to five years	725	
More than five years	70	
Total	<u>\$2,015</u>	

Discount rates ranged from 4 percent to 4.5 percent and from 3.5 percent to 4 percent for 20X1 and 20X0, respectively.

In 20X0, the NFP received \$650 for a capital campaign which must be returned if the NFP does not receive \$1,300 in donations to the capital campaign. The \$650 received was recorded on the 20X0 statement of financial position as a refundable advance. In 20X1, the NFP received \$500 in cash donations and \$865 in unconditional promises to give to this campaign. As a result, the \$650 was recognized as temporarily restricted contributions in 20X1.

In addition, the NFP received the following conditional promises to give that are not recognized as assets in the statements of financial position:

	<u>20X1</u>	<u>20X0</u>
Conditional promise to give upon the establishment of a library program	\$100	\$100
Conditional promise to give upon obtaining \$2,500 in unconditional promises to give to the capital campaign	5,000	

[The following disclosure is encouraged but not required.]

The NFP received an indication of an intention to give from an individual long-time donor. The anticipated gift is an extensive collection of pre-Columbian textiles with great historical and artistic significance. The value of this intended gift has not been established, nor has the gift been recognized as an asset or contribution revenue.

Example 3—Accounting Policy for Contributed Property and Equipment

Note X: Summary of Significant Accounting Policies

Contributed property and equipment is recorded at fair value at the date of donation. In the absence of donor stipulations regarding how long the contributed assets must be used, the NFP has adopted a policy of implying a time restriction on contributions of such assets that expires over the assets' useful lives. As a result, all contributions of property and equipment, and of assets contributed to acquire property and equipment, are recorded as restricted support.

OR

Contributed property and equipment is recorded at fair value at the date of donation. If donors stipulate how long the assets must be used, the contributions are recorded as restricted support. In the absence of such stipulations, contributions of property and equipment are recorded as unrestricted support.

Example 4—Contributed Services

The NFP recognizes contribution revenue for certain services received at the fair value of those services. Those services include the following items:

	<u>20X1</u>	<u>20X0</u>
Home outreach program:		
Salaries:		
Social work interns—261 and 315 hours at \$12.00 per hour	\$3,132	\$3,780

Registered nurse—200 and 220 hours at \$15.00 per hour	3,000	3,300
Total salaries	6,132	7,080
Management and general:		
Accounting services	10,000	19,000
Total contributed services	\$16,132	\$26,080

In addition, approximately 80,000 hours, for which no value has been assigned, were volunteered by tutors in the home outreach program.

Example 5—Beneficial Interest in Assets Held by Others

In 19XX, the NFP transferred \$1,000,000 from its investment portfolio to the Any Town Community Foundation to establish an endowment fund. Under the terms of the agreement, in the first quarter of each year, the NFP receives a distribution equal to the investment return generated by the transferred assets during the prior year. The NFP can withdraw all or a portion of the original amount transferred, any appreciation on those transferred assets, or both, provided that a majority of the governing boards of the NFP and the Foundation approve of the withdrawal. At the time of the transfer, the NFP granted variance power to the Foundation. That power gives the Foundation the right to distribute the investment income to another not-for-profit entity of its choice if the NFP ceases to exist or if the governing board of Any Town Community Foundation votes that support of the NFP (a) is no longer necessary or (b) is inconsistent with the needs of the Any Town community. At June 30, 20X1, the endowment fund has a value of \$1,234,567, which is reported in the statement of financial position as beneficial interest in assets held by others.

Example 6—Gifts in Kind Accounting Policy Note

Gifts in kind: The NFP receives gifts in kind, such as medical equipment, prescription drugs, and other medical supplies for use in treating disaster victims. Gifts in kind revenue is recognized in circumstances in which the NFP has sufficient discretion over the use and disposition of the items to recognize a contribution in conformity with FASB ASC 958-605-25. Accordingly, the recognition of gifts in kind revenue is limited to circumstances in which the NFP takes constructive possession of the gifts in kind and the NFP is the recipient of the gift, rather than an agent or intermediary (as defined by accounting standards). Gifts in kind received through donations are valued and recorded as revenue at their fair value at the time the contribution is received.

In circumstances in which the NFP is functioning as an agent or intermediary with respect to the gifts in kind, the NFP reports an asset and corresponding liability measured at the fair value at the earlier of the time the goods are promised or received from the resource provider, and until the NFP remits the gifts in kind to the ultimate beneficiary.

In circumstances in which the NFP distributes gifts in kind as part of its own programs, it reports an expense, which is reported in the functional classification for the program in which the gifts in kind were used. Although it is the NFP's policy to distribute gifts in kind as promptly as possible, the NFP may hold some gifts in kind at year-end.

Undistributed gifts in kind at year-end are reported as inventory. Inventory is valued at the lower of cost or market (cost is determined as fair value at the date of gift plus any costs incurred).

Example 7—Gifts in Kind Inventory

	<i>Medical Equipment</i>	<i>Prescription Drugs</i>	<i>Other Medical Supplies</i>	<i>Total</i>
Undistributed gifts in kind inventory, Beginning of year	\$10,000	\$5,000	\$15,000	\$30,000
Gifts in kind:				
Donations				
Agency transactions	150,000	175,000	125,000	450,000
	50,000			50,000
Labor costs added			45,000	45,000
Obsolete inventory written off	(5,000)	--	(1,000)	(6,000)
Gifts in kind distributed:				
Used in NFP's programs	(40,000)	(80,000)	(115,000)	(235,000)
Distributed to other NFPs:				
Contributions				(205,000)
Agency transactions	(75,000)	(90,000)	(40,000)	(50,000)
	(50,000)			
Undistributed gifts in kind inventory, End of year	\$ 40,000	\$10,000	\$29,000	\$79,000

The donations were received from the following sources:

<i>Source</i>	<i>Total</i>	<i>Contribution</i>	<i>Agency Transactions</i>
U.S. Agency for International Development	\$150,000	\$100,000	\$50,000
U.S. Department of Agriculture	25,000	25,000	
Total government	175,000	125,000	50,000
Private corporations	300,000	300,000	
Other NFPs	25,000	25,000	
Total donations	<u>\$500,000</u>	<u>\$450,000</u>	<u>\$50,000</u>

Appendix A — Excerpt from AICPA Financial Reporting White Paper *Measurement of Fair Value for Certain Transactions of Not-for-Profit Entities*^{fn1}

A-1 Not-for-profit entities face various challenges in applying the provisions of Financial Accounting Standards Board *Accounting Standards Codification* 820, *Fair Value Measurement*, in part because markets do not exist for certain assets and liabilities. To assist practitioners, on October 14, 2011, the AICPA issued the white paper *Measurement of Fair Value for Certain Transactions of Not-for-Profit Entities*. The following excerpt provides assistance for measuring unconditional promises to give cash or other financial assets due in one year or more.

Unconditional Promises to Give Cash

1. Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 958-605,¹ in discussing measurement principles for contributions, generally requires not-for-profit entities (NFPs) to measure at fair value recognized contributions of cash or other assets (for example, marketable securities, land, buildings, use of facilities or utilities, materials and supplies, other goods or services) and unconditional promises to give those items in the future.

2. The discussion of fair value measurements in FASB ASC 820-10-35 includes an exit price approach (that is, the price that would be received for a promise to give [asset] in an exchange involving hypothetical market participants, determined under current market conditions). Because no market exists for unconditional promises to give, assumptions about what a hypothetical acquirer would pay for these assets (the right to receive from the donor the cash flow inherent in the promise) are necessary in determining fair value. FASB ASC 820-10-35 and its interpretive guidance in FASB ASC 820-10-55 emphasize that because fair value is a market-based (not an entity-specific) measurement, the exit price is determined without regard to whether an entity intends to sell or hold an asset or a liability that is measured at fair value.

3. Paragraphs 4–32 address the application of FASB ASC 820-10-35 in determining the fair value of a promise to give cash at a date one year or more in the future. This

^{fn1} As a benefit of AICPA membership, all AICPA members can access the AICPA White Paper *Measurement of Fair Value for Certain Transactions of Not-for-Profit Entities* at www.aicpa.org/InterestAreas/FRC/IndustryInsights/Pages/FV_and_Disclosures_NFP.aspx.

¹ Pursuant to Financial Accounting Standards Board (FASB) Statement No. 168, *The FASB Accounting Standards Codification® and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162*, FASB *Accounting Standards Codification™* (ASC) is the sole source of authoritative generally accepted accounting principles. To aid readers in using this white paper, as a drafting convention in referencing FASB ASC, this white paper sometimes references pronouncements that were issued prior to the effective date of FASB ASC and from which the FASB ASC paragraphs are derived.

white paper does not discuss the fair value of a promise to give nonfinancial assets. It also does not discuss how to determine the fair value of unconditional promises to give that are due in less than one year. As explained in FASB ASC 958-605-30-6, unconditional promises to give that are expected to be collected in less than one year may be measured at net realizable value because that amount results in a reasonable estimate of fair value.

What Is the Unit of Account for an Unconditional Promise to Give That Is Expected to Be Collected in One Year or More?

4. For an unconditional promise to give that is expected to be collected in one year or more, the unit of account implied in FASB ASC 958-605 is the individual (stand-alone) promise to give.² That means that the focus of the fair value measurement is on the individual (stand-alone) promise to give in which the exit price represents the amount that a hypothetical market participant would pay to acquire the right to receive from the donor the cash flows inherent in the promise to pay the NFP. The Financial Reporting Executive Committee (FinREC) believes that, consistent with the guidance in FASB ASC 820-10-35-17 on the measurement of the fair value of liabilities, it is appropriate to assume when measuring the fair value of a promise to give that the cash flows received by the hypothetical acquirer would be the same as the cash flows that would be received by the NFP and that no additional credit risk needs to be considered as a result of a hypothetical change in ownership.

What Valuation Technique(s) Should an NFP Use to Measure the Fair Value of an Unconditional Promise to Give That Is Expected to Be Collected in One Year or More?

5. FASB ASC 820-10-35-24A provides that valuation techniques consistent with the market approach, income approach, cost approach, or all three should be used to measure fair value. Paragraphs 3A–3G of FASB ASC 820-10-55 explain those valuation techniques.

6. FASB ASC 820-10-35-24 clarifies that “[a] reporting entity shall use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximizing the use of relevant observable inputs and minimizing the use of unobservable inputs.” For an unconditional promise to give that is expected to be collected in one year or more, FinREC believes that a present value (PV) technique (an application of the income approach) will be the most prevalent valuation technique used to measure fair value. In reaching that conclusion, FinREC observes that the market approach typically would not be operational for measuring the fair value of

² In practice, some not-for-profit entities (NFPs) have pooled unconditional promises to give with certain similar characteristics. The Financial Reporting Executive Committee (FinREC) believes that such pooling is permissible in circumstances in which the measurement of fair value would not be materially different from a measurement that considers each unconditional promise to give as the unit of account.

unconditional promises to give cash because no market exists, and the cost approach is not used for valuing financial assets, such as promises to give.

PV Techniques

7. Paragraphs 4–20 of FASB ASC 820-10-55 discuss PV techniques. FASB ASC 820-10-55-5 states that

[p]resent value (that is, an application of the income approach) is a tool used to link future amounts (for example, cash flows or values) to a present amount using a discount rate. A fair value measurement of an asset or a liability using a present value technique captures all of the following elements from the perspective of market participants at the measurement date:

- a. An estimate of future cash flows for the asset or liability being measured.
- b. Expectations about possible variations in the amount and timing of the cash flows representing the uncertainty inherent in the cash flows.
- c. The time value of money, represented by the rate on risk-free monetary assets that have maturity dates or durations that coincide with the period covered by the cash flows and pose neither uncertainty in timing nor risk of default to the holder (that is, a risk-free interest rate). For present value computations denominated in nominal U.S. dollars, the yield curve for U.S. Treasury securities determines the appropriate risk-free interest rate.
- d. The price for bearing the uncertainty inherent in the cash flows (that is, a risk premium).
- e. Other factors that market participants would take into account in the circumstances.
- f. For a liability, the nonperformance risk relating to that liability, including the reporting entity's (that is, the obligor's) own credit risk.

8. Risk and uncertainty associated with the amount, timing, or both, of cash flows of an asset (or a liability) are key considerations when measuring fair value because risk-averse market participants would demand compensation for bearing the uncertainty inherent in the cash flows (the risk premium).³ Paragraphs 7–8 of FASB ASC 820-10-55

³ The FASB ASC glossary term *promise to give* notes that “the recipient of a promise to give has a right to expect that the promised assets will be transferred in the future, and the maker has a social and moral obligation, and generally a legal obligation, to make the promised transfer.” As noted in paragraph 108 of FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, in developing FASB Statement No. 116, FASB found that although legal remedies are available, they are seldom necessary because promises generally are kept. FinREC believes, however, that in many (if not most) cases, uncertainty will exist; therefore, it will be necessary to consider risk in a fair value measurement.

explain that

[a] fair value measurement using present value techniques is made under conditions of uncertainty because the cash flows used are estimates rather than known amounts. In many cases, both the amount and timing of the cash flows are uncertain. Even contractually fixed amounts, such as the payments on a loan, are uncertain if there is risk of default.

Market participants generally seek compensation (that is, a risk premium) for bearing the uncertainty inherent in the cash flows of an asset or a liability. A fair value measurement should include a risk premium reflecting the amount that market participants would demand as compensation for the uncertainty inherent in the cash flows. Otherwise, the measurement would not faithfully represent fair value. In some cases, determining the appropriate risk premium might be difficult. However, the degree of difficulty alone is not a sufficient reason to exclude a risk premium.

9. FinREC observes that the requisite risk assessment requires judgments and that those judgments are significant in some cases. In making that assessment, consistent with FASB ASC 820-10-35-54A, FinREC believes that an NFP need not undertake exhaustive efforts to obtain information from or about the donor. Rather, the NFP would assess the risk associated with the promise to give using information that is reasonably available in the circumstances, considering factors specific to the donor and promise to give. FinREC believes that those factors may include, but are not limited to, the following:

- The ability of the donor to pay (credit risk), which may be indicated by published credit ratings (for example, a credit rating might be available for an enterprise that is a donor or comparable to the donor); financial analysis (for example, cash flow and ratio analysis); or credit reports for an individual donor
- Factors specific to the donor that might be relevant in assessing the donor's commitment to honor its promise, such as the extent to which the donor is committed to, or otherwise involved in, the activities of the NFP (for example, whether the donor is a member of the governing board); the donor's history of charitable giving and involvement with charitable organizations, including, but not limited to, the NFP; and the donor's financial circumstances and history (past bankruptcies or defaults); financial condition (including other debt); current employment (including its stability); earnings potential over the term of the promise; and personal circumstances (including family situation, age, and health)
- Risk factors that affect certain groups of donors (for example, economic conditions in certain geographical areas or industry sectors)
- The NFP's prior experience in collecting similar types of promises to give,

including the extent to which the NFP has enforced the promises

- Whether the underlying asset is held in an irrevocable trust or escrow, which may reduce default risk

10. FASB ASC 820-10-55 discusses two PV techniques: (a) the traditional or discount rate adjustment (DRA) technique and (b) the expected PV (EPV) technique, which may be applied using one of two methods. Those PV techniques differ in how they adjust for risk. Key differences are summarized in the following table:

	<i>DRA</i>	<i>EPV Method 1</i>	<i>EPV Method 2</i>
Cash Flows	Single set of cash flows (contractual or promised, most likely). ⁴	Expected (probability-weighted) cash flows (or expected value), adjusted for general market (systematic) risk by subtracting the cash risk premium. The risk-adjusted expected cash flows represent a certainty-equivalent cash flow.	Expected (probability-weighted) cash flows (or expected value).
	The single set of cash flows are conditional cash flows (in other words, contractual or promised cash flows are conditional on the event of no default by the debtor).	The risk-adjusted expected cash flows are not conditional upon the occurrence of specific events because they are probability weighted.	The expected cash flows are not conditional upon the occurrence of specific events because they are probability weighted.
Discount Rate	Risk-adjusted discount rate derived from observed rates of return for comparable assets or liabilities that are traded in the market (that is, a market rate of return that corresponds to an observed market rate associated with such conditional cash flows and that, therefore, represents the amount that market participants would demand for bearing the uncertainty inherent in such cash flows).	Risk-free interest rate (for example, yield to maturity on U.S. Treasuries).	Risk-free interest rate (for example, yield to maturity on U.S. Treasuries), adjusted for general market (systematic) risk by adding risk premium. The risk-adjusted discount rate represents the expected rate of return that corresponds to an expected rate associated with such probability-weighted cash flows.

⁴ Such nonprobability-weighted cash flows are referred to in this white paper as projected cash flows to distinguish them from expected cash flows, which are probability weighted.

What Are Some of the Key Issues That an NFP Should Consider in Determining Which PV Technique to Use to Measure the Fair Value of an Unconditional Promise to Give That Is Expected to Be Collected in One Year or More?

11. Conceptually, the three PV methods discussed in the chart in the previous paragraph should give the same results. FinREC observes that in practice, however, certain techniques may be easier, more practical, or more appropriate to apply to certain facts and circumstances. FASB ASC 820-10-55-4 states that the “present value technique used to measure fair value will depend on facts and circumstances specific to the asset or liability being measured (for example, whether prices for comparable assets or liabilities can be observed in the market) and the availability of sufficient data.”

12. A DRA technique using promised cash flows and observable market rates that reflect expectations about future defaults may be easier to apply at initial recognition than the EPV techniques, which require an NFP to probability weight the cash flows or estimate the systematic risk premium. However, to account for the unconditional promises to give in subsequent periods, the NFP must be able to identify when the level of defaults on its promises surpasses the level incorporated in the discount rate that it used for initial recognition, so that it can recognize an allowance for uncollectible promises on a timely basis if the actual uncollectible amounts exceed the amounts originally projected. This can be particularly challenging if the discount rate used is a market rate for which the level of default incorporated in the rate is not publicly available. The use of most likely cash flows, rather than promised cash flows, and a discount rate that is consistent with those cash flows will mitigate some of the challenges for subsequent measurement. That DRA technique is discussed in the next paragraph.

13. Although it might appear that the DRA technique may be easy to apply because it does not require an NFP to probability weight the cash flows or estimate the systematic risk premium, as required by the EPV technique, FinREC observes that the DRA technique using promised cash flows may be impractical to apply. FinREC observes that if an NFP uses the DRA technique with promised cash flows, it must use a discount rate that reflects expectations about future defaults, and the NFP must be able to identify when the level of defaults on its unconditional promises to give surpasses the level incorporated in the discount rate it used. This is particularly challenging if the discount rate used is a market rate, such as for unsecured borrowings in which the level of default incorporated in the rate is typically not available. If the NFP does not identify the level of defaults incorporated in the discount rate, it would be unable to timely report a credit impairment loss when the actual uncollectible amounts exceed the amounts originally projected. Thus, the benefit of avoiding the calculation of probability-weighted cash flows on initial measurement (if using the DRA technique with promised cash flows) would be substantially negated by the fact that the NFP would nevertheless have to

estimate the cash flows initially expected when determining the allowance for doubtful accounts in subsequent measurements.⁵

14. A DRA technique that uses most likely cash flows (rather than promised cash flows) might be practical to apply because the cash flows initially projected are known, but that technique requires the NFP to use a discount rate that reflects market participant assumptions that are consistent with risks inherent in most likely cash flows to avoid double counting or omitting the effects of risk factors. As explained in paragraph 19, the discount rate would be higher than the risk-free rate used in EPV method 1 or the discount rate used in EPV method 2 because most likely cash flows are uncertain, but the discount rate would be lower than the discount rate used with promised cash flows because some of the uncertainty of promised cash flows is removed in the determination of most likely cash flows. Because the three PV techniques trade off the ease of determining a discount rate against the ease of determining the cash flows, FinREC observes that no one PV technique is inherently better than another for measuring unconditional promises to give.

15. FinREC observes that in estimating fair value, an entity is not precluded from using fair value estimates provided by third parties, such as valuation specialists, in circumstances in which a reporting entity has determined that the estimates provided by those parties are determined in accordance with FASB ASC 820-10-35. For example, in using a PV technique, valuation specialists may be helpful in determining a discount rate that is consistent with the cash flows used.

What Are the Key Pricing Inputs When Using a PV Technique?

16. Key pricing inputs should reflect the factors that market participants would consider in setting a price for the promise to give. The FASB ASC 820-10-35 fair value hierarchy prioritizes market observable inputs but also allows for the use of unobservable (internally derived) inputs when relevant market observable inputs are unavailable. When using a PV technique, two key pricing inputs are the cash flows and discount rate. The factors considered in determining the cash flows and discount rate used should be documented.

17. As noted in FASB ASC 820-10-55-6(c), to avoid double counting or omitting the effects of risk factors, discount rates should reflect assumptions that are consistent with those inherent in the cash flows. For example, a discount rate that reflects the uncertainty in expectations about future defaults is appropriate if using contractual cash flows of a loan. That same rate should not be used if using expected (that is, probability-weighted)

⁵ The discussion in paragraphs 12–14 assumes that the NFP does not elect to report contributions receivable pursuant to an election under FASB ASC 825, *Financial Instruments*. Instead, the discussion assumes that an NFP initially measures contributions receivable at fair value using present value techniques, which then is used as cost. In subsequent periods, that cost is amortized, with the interest element reported as additional contribution revenue, and a valuation allowance is reported to reflect credit impairment occurring after initial measurement.

cash flows because the expected cash flows already reflect assumptions about the uncertainty of future defaults.

18. The cash flows used in a PV technique differ depending on the method used. Following is an illustration of cash flow estimates under the three methods (DRA, EPV method 1, and EPV method 2). Assume that an NFP holds a promise to give \$100 in one year. The NFP believes that there is a 70 percent chance that it will collect the full amount, a 20 percent chance that it will collect \$80, and a 10 percent chance that it will collect nothing. Under EPV method 2, expected cash flow would be calculated as follows:

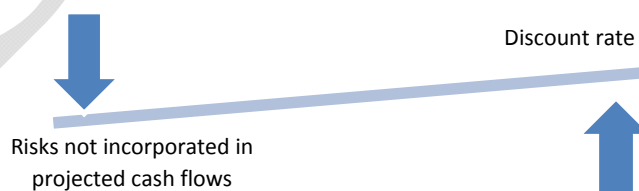
$$\begin{array}{r} \$100 \times 70\% = \$70 \\ \$80 \times 20\% = \$16 \\ \$0 \times 10\% = \$0 \\ \hline \$86 \end{array}$$

Under EPV method 1, the expected cash flow would be less than \$86 because it would be adjusted (reduced) for systematic risk. Because of the challenges in determining an adjustment for systematic risk, utilization of EPV method 1 may not be practical. Under the DRA technique, both the promised cash flow and most likely cash flow are \$100.

19. FASB ASC 820-10-55-6 discusses general principles for determining the discount rate when applying PV techniques. FinREC believes that the discount rate used would fall on a continuum between the risk-free rate (minimum) and unsecured borrowing rate (maximum).



Where the rate falls on the continuum would depend on the extent to which risk factors such as those discussed in paragraph 9 have been incorporated into the projected cash flows. (The lowest discount rate would be used for EPV method 1, and the highest discount rate would be used for the DRA technique using contractual cash flows,⁶ as discussed in paragraphs 21–32.) The relationship between cash flows and discount rates is depicted as follows:



⁶ For an unconditional promise to give, the contractual cash flows are the amounts promised by the donor, which are referred to as promised cash flows in this white paper.

This diagram depicts the inverse relationship between risks being incorporated in projected cash flows and risks being incorporated in discount rates (that is, the discount rate increases as projected cash flows incorporate fewer risk factors and vice versa).

EPV Method 1

20. When using EPV method 1, the risk-adjusted expected cash flows are discounted by the risk-free interest rate, which may be indicated by the yield to maturity on U.S. Treasuries. The risk-free interest rate is appropriate in this case because all risk is built into the expected cash flows, which therefore represent a certainty-equivalent cash flow. As discussed in FASB ASC 820-10-55-15, EPV method 1 adjusts the expected cash flows for the systematic (market) risk by subtracting a cash risk premium in arriving at risk-adjusted expected cash flows. However, as previously discussed, determining a certainty-equivalent cash flow typically would be impracticable for unconditional promises to give.

EPV Method 2

21. When using EPV method 2, the expected cash flows are discounted by a risk-adjusted rate, which is determined based on the risk-free interest rate, adjusted for general market (systematic) risk by adding a risk premium.

22. In EPV method 2, some but not all risk is built into the expected cash flows. The expected cash flows are probability weighted and, therefore, adjusted for the likelihood of possible outcomes affecting the timing and amount of the cash flows. Probability weighting is not enough, however. It is also necessary to adjust for the risk premium that market participants would seek for accepting uncertainty. The following example illustrates this point:

Asset B is a *certain* undiscounted cash flow of \$10,000 due 10 years hence (a U.S. Treasury instrument is an example of asset B). Asset E has an *expected* undiscounted cash flow of \$10,000 due 10 years hence; however, the actual cash flow from asset E may be as high as \$12,000 or as low as \$8,000 or some other amount within that range. A risk-averse individual would pay something less for asset E than asset B because of the uncertainty involved. Although the expected cash flow of \$10,000 incorporates the uncertainty in cash flows from asset E, that amount does not incorporate the premium that market participants demand for bearing that uncertainty.

23. In EPV method 2, the compensation that market participants would seek for accepting uncertainty (the risk premium) is built into the discount rate. The risk-adjusted discount rate represents an expected rate of return that corresponds to an expected rate associated with such probability-weighted cash flows.

DRA

24. When using the DRA technique, the projected cash flows are discounted by a risk-adjusted rate. As discussed in FASB ASC 820-10-55-10

the [DRA] technique uses a single set of cash flows from the range of possible estimated amounts, whether contractual or promised (as is the case for a bond) or most likely cash flows. In all cases, those cash flows are conditional upon the occurrence of specified events (for example, contractual or promised cash flows for a bond are conditional on the event of no default by the debtor).

25. The risk-adjusted discount rate used in the DRA technique is derived from observed rates of return for comparable assets or liabilities that are traded in the market. Accordingly, the contractual, promised, or most likely cash flows are discounted at an observed or estimated market rate for such conditional cash flows (that is, a market rate of return). Therefore, it represents the amount that market participants would demand for bearing the uncertainty inherent in such cash flows. In circumstances in which the projected cash flows already reflect assumptions about future defaults, NFPs should apply a discount rate that is commensurate with the reduced risk inherent in the cash flows that anticipate defaults, in order to avoid double counting that credit risk, as discussed in FASB ASC 820-10-55-6.

26. Determining the observed rate of return for comparable assets that are traded in the market requires an analysis of market data for comparable assets. FASB ASC 820-10-55-11 explains that “[c]omparability is established by considering the nature of the cash flows (for example, whether the cash flows are contractual or noncontractual and are likely to respond similarly to changes in economic conditions), as well as other factors (for example, credit standing, collateral, duration, restrictive covenants, and liquidity).” As a basis for assessing comparability, FinREC believes that best practice is for the NFP to assess the likelihood that the donor will not honor its promise to give (default risk), as well as the risk premium reflecting the amount that market participants would demand because of the risk (uncertainty) in the cash flows.⁷

27. Market comparable data that might be relevant in determining the risk-adjusted discount rate used in the DRA technique will differ depending on the donor (for example, whether the donor is an individual, a corporation, or a foundation). Some examples

⁷ FinREC believes that a promise to give is different from a trade receivable. A promise to give arises from a donative intent. It is not an exchange transaction in which each of the parties to the exchange receives equivalent value and, generally, will be expected to exercise rights created by the exchange to enforce the terms of the transaction. FinREC believes that information derived from a trade receivable might be relevant in determining the discount rate used in the discount rate adjustment technique. However, adjustments to that information might be needed to incorporate the risk inherent in the cash flows in situations in which the NFP does not have a practice of enforcing its rights to receive promises to pay.

follow.

28. If the donor is an individual, FinREC believes that the risk-adjusted discount rate might be determined using unsecured consumer lending rates that are generally available from published sources (major financial institutions). FinREC believes that best practice is to use those unsecured consumer lending rates in circumstances in which the credit characteristics of the donor are similar to the credit characteristics of those with unsecured debt.

29. FinREC believes that in applying the DRA technique using promised cash flows for promises from individuals, an unsecured consumer lending rate might be a starting point for determining an observable market interest rate. The NFP, however, may need to make adjustments to that rate, as discussed in paragraph 32, including, but not limited to, adjustments based on differences in the credit characteristics of the donor compared with the credit characteristics of borrowers of unsecured debt. (FinREC believes that such adjustments might be made based on the average credit characteristics of a homogeneous group of donors in circumstances in which the results would not be materially different from making such adjustments based on the specific credit characteristics of an individual donor.)

30. If the donor is a corporation, and the DRA technique using promised cash flows is used, FinREC believes that the risk-adjusted discount rate might be determined using the yield on publicly traded debt, whether issued by the corporation itself or a comparable corporation. FinREC believes that best practice is to use that yield on publicly traded debt in circumstances in which the promise to give is similar to the publicly traded debt. If the donor is a private foundation, FinREC believes that the risk-adjusted discount rate might be similarly determined using the yield on publicly traded debt, whether issued by the foundation itself, a comparable foundation, or a comparable corporation.⁸

31. In either case (whether the donor is a corporation or foundation), the NFP would consider factors specific to the promise, including its terms and risk, in assessing the extent to which the promise to give is similar to publicly traded debt. For example, FinREC believes that a promise to give a single fixed contribution at a future date likely would be more analogous to publicly traded zero coupon debt that pays a single amount at a future date than to a debt instrument that periodically pays interest or principal, or both.⁹

⁸ In considering the yield on debt issued by a foundation or other NFP, FinREC believes that the relevant input is the taxable yield, not the tax-exempt yield.

⁹ For publicly traded zero coupon debt, comparability should be established based on its remaining term to maturity. For a debt instrument that periodically pays interest, principal, or both, FinREC believes that comparability should be established based on its duration, not its remaining term to maturity. Duration refers to the weighted average term over which the debt cash flows will be received.

32. In all cases, the NFP would evaluate comparability and adjust available market data for differences, so that the risk-adjusted discount rate used to measure fair value (such as unsecured lending rates or yield on publicly traded debt) is reasonable when considered in the context of the donor and cash flows used. For example, as discussed in paragraphs 12–14, if the NFP uses most likely cash flows, rather than promised cash flows, to mitigate some of the challenges for subsequent measurement, an observed market rate based on promised cash flows (such as an unsecured lending rate or a yield on publicly traded debt) would be adjusted downward to reflect the fact that most likely cash flows incorporate an assessment of default.

Chapter 6

Split-Interest Agreements and Beneficial Interests in Trusts

Introduction

6.01 Some donors enter into trust or other arrangements under which not-for-profit entities (NFPs) receive benefits that are shared with other beneficiaries. Recognition and measurement principles for these arrangements, commonly known as *split-interest agreements*, are discussed in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 958-30 and this chapter. The application of these principles to six widely used types of such agreements—charitable lead trusts, perpetual trusts held by third parties,^{fn 1} charitable remainder trusts, charitable gift annuities, pooled (life) income funds, and a gift of real estate with a retained life interest—is also illustrated.

Types of Split-Interest Agreements

6.02 Under a split-interest agreement, a donor makes an initial transfer of assets to a trust, a fiscal agent, or directly to the NFP in which the NFP has a beneficial interest but is not the sole beneficiary. The terms of some agreements do not allow donors to revoke their gifts; other agreements may be revocable by donors in certain situations; still others may be irrevocable by the donor, but the NFP's rights to distributions are revocable because the agreement allows the donor to change the beneficiaries. The time period covered by the agreement is expressed either as a specific number of years (or in perpetuity) or as the remaining life of an individual or individuals designated by the donor. The assets are invested and administered by the NFP, a trustee, or a fiscal agent, and distributions are made to a beneficiary or beneficiaries during the term of the agreement (or in the case of gifts of real estate, the beneficiary may have a use interest). At the end of the agreement's term, the remaining assets covered by the agreement are distributed to or retained by either the NFP or another beneficiary or beneficiaries.

6.03 Under some kinds of agreements, referred to in this guide as *lead interests*, the NFP receives the distributions during the agreement's term. In other kinds of agreements, referred to as *remainder interests*, the donor (or other individuals or entities designated by the donor) receives distributions during the agreement's term and the NFP receives all or a portion of the assets remaining at the end of the agreement's term. Under either kind

^{fn 1} Though perpetual trusts held by third parties may not meet the definition of a *split-interest agreement* because the not-for-profit entity (NFP) may be the sole beneficiary, they are included in this chapter because they present some of the same recognition and measurement issues as do split-interest agreements.

of agreement, donors may impose restrictions on the NFP's use of all or a portion of any assets received.

Recognition and Measurement Principles

- 6.04** In accordance with FASB ASC 958-30-45-7, the contribution portion of a split-interest agreement (that is, the part that represents the unconditional transfer of assets in a voluntary nonreciprocal transaction) should be recognized as revenue or gain. (As discussed in the FASB ASC glossary definition of *contribution*, the term *contribution revenue* in the FASB ASC is used to apply to transactions that are part of the entity's ongoing major or central activities [revenues], or are peripheral or incidental to the entity [gains]. This guide also uses that convention.) In accordance with FASB ASC 958-605-30-2, a contribution should be measured at its fair value.

Use of Fair Value Measures

- 6.05** Recognition of split-interest agreements also requires assets and liabilities to be initially measured at fair value and, in certain cases, requires them to be remeasured at fair value subsequently. FASB ASC 820, *Fair Value Measurement*, establishes a framework for measuring fair value.^{fn2} This guide uses present value techniques as one possible technique to measure the contribution revenue and obligation to other beneficiaries of a split-interest agreement. See paragraphs 4–20 of FASB ASC 820-10-55 for implementation guidance for using present value techniques if the measurement objective is fair value. Other valuation techniques are also available, as described in FASB ASC 820-10-35. For example, paragraphs 71–80 of the AICPA white paper *Measurement of Fair Value for Certain Transactions of Not-for-Profit Entities* (fair value white paper), describes using a market approach and level 2 inputs for valuing certain liabilities under split-interest remainder agreements with fixed payments. Excerpts from the fair value white paper, which are included in appendix A of this chapter, discuss fair value measurement of perpetual and nonperpetual beneficial interests in trusts and the liabilities of split-interest agreements.
- 6.06** Reference to IRS guidelines and actuarial tables or commercially available software that is used in calculating the donor's charitable deduction for income tax purposes may be helpful in assessing the reasonableness of the method used for measuring fair value. However, the objective of those tools (guidelines, tables, and software) is to measure the tax deductibility of the gift, which may not necessarily result in a fair value measurement. To use those tools for measuring in accordance with generally accepted accounting principles (GAAP), NFPs would need to consider the assumptions that are inherent in the calculations (interest rates and mortality) and determine whether those assumptions are market participant assumptions appropriate for the measurement of fair value. .

^{fn2} Paragraphs 3.137–.167 discuss Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurement*, which defines *fair value*, establishes a framework for measuring fair value, and requires disclosures about fair value measurements.

Recognition of Revocable Agreements

- 6.07** FASB ASC 958-30-25-2, FASB ASC 958-30-30-3, and paragraphs 11–12 of FASB ASC 958-30-35 discuss recognition and measurement of revocable split-interest agreements. Revocable split-interest agreements should be accounted for as intentions to give. Assets received by an NFP acting as a trustee under a revocable split-interest agreement should be recognized at fair value when received as assets and as a refundable advance. If those assets are investments, they should be recognized in conformity with FASB ASC 958-320 or 958-325 as appropriate. Contribution revenue for the assets received should be recognized when the agreements become irrevocable or when the assets are distributed to the NFP for its unconditional use, whichever occurs first. Income earned on assets held under revocable agreements that is not available for the NFP's unconditional use, and any subsequent adjustments to the carrying value of those assets, should be recognized as adjustments to the assets and as refundable advances.

Recognition of Irrevocable Agreements

- 6.08** Recognition and measurement of a split-interest agreement varies depending on whether the NFP's rights to distributions in accordance with the agreement is revocable or irrevocable, whether the assets are held by the NFP or a third party, and the type of agreement.
- 6.09** An NFP's interest in the assets of a split-interest agreement is revocable if the donor, a trustee, or a third party can cancel the agreement and redirect the assets. An NFP's interest in the assets of a split-interest agreement can be revocable even if the agreement itself is irrevocable. For example, in a charitable remainder unitrust agreement, a donor can retain, or give to a third party, the power to substitute another charitable beneficiary without jeopardizing the donor's charitable deduction. Unless the use of that power is limited by the agreement to situations that are remote of occurrence (such as the failure of the named charitable beneficiary to qualify as a charitable organization under Internal Revenue Code Section 170) or unless the parties that can change the beneficiary are no longer living, the interest of the named NFP is revocable and the guidance in paragraph 6.07 applies.
- 6.10** If an NFP serves as the trustee for a split-interest trust agreement or if the assets transferred by the donor are otherwise under the NFP's control, the NFP records the assets received from the donor, a liability for the future payments to be made to the donor or third parties designated by the donor, and contribution revenue for the difference (assuming the right to those assets is irrevocable). If a third party appointed by the donor serves as the trustee for a split-interest trust agreement or as a fiscal agent, the NFP records its beneficial interest and contribution revenue.
- 6.11** Serving as the trustee or fiscal agent for a split-interest agreement carries the duties of annual tax filings and, in some states, compliance with state insurance regulations. Some NFPs that are appointed as trustee or fiscal agent under split-interest agreements choose a

bank or other third party to hold the assets and administer those duties. If an NFP has appointed the trustee or fiscal agent and has the ability to replace that party, the NFP follows the guidance for an NFP that is a trustee or fiscal agent because the assets remain under the NFP's control.

6.12 This guide and FASB ASC 958-30 organize and present guidance by type of split-interest agreement. The following classifications are used:

- Pooled income funds or net income unitrusts
- Irrevocable agreements other than pooled income funds or net income unitrusts, which includes guidance for charitable lead trusts, charitable remainder trusts, and charitable gift annuities

Initial Recognition and Measurement of Unconditional Irrevocable Agreements Other Than Pooled Income Funds or Net Income Unitrusts

NFP Is the Trustee or Fiscal Agent

6.13 Paragraphs 4–14 of FASB ASC 958-30-25 discuss recognition of unconditional irrevocable agreements for which the NFP serves as trustee or if the assets contributed by the donor are otherwise under the control of the NFP. Per FASB ASC 958-30-25-4, in the absence of donor-imposed conditions, an NFP should recognize contribution revenue and related assets and liabilities when an irrevocable split-interest agreement naming it trustee or fiscal agent is executed. Assets received under those agreements should be recorded when received. If those assets are investments, they should be recognized in conformity with the guidance in FASB ASC 958-320 or FASB ASC 958-325, as appropriate. The contribution portion of an agreement (that is, the part that represents the unconditional transfer of assets in a voluntary nonreciprocal transaction) should be recognized as revenue or gain.

6.14 Per paragraphs 4–6 of FASB ASC 958-30-30, at the date of initial recognition of a split-interest agreement, contributions should be measured at fair value. The cash and other assets received under split-interest agreements should be recognized at fair value at the date of initial recognition. If the transferred assets, or a portion of those assets, are being held for the benefit of others, such as the donor or third parties designated by the donor, a liability, measured at fair value, should also be recognized at the date of initial recognition. If present value techniques are used to measure fair value, the liability generally is measured at the present value of the future payments to be made to the other beneficiaries. Any present value technique for measuring the fair value of the contribution or payments to be made to other beneficiaries must consider the elements described in FASB ASC 820-10-55-5, including the following:

- a. The estimated return on the invested assets during the expected term of the agreement

restrictions, the contribution should be classified as increases in unrestricted net assets.

- 6.19** As discussed in FASB ASC 958-30-45-2, under many charitable gift annuity agreements, the assets received from the donor are held by the NFP as part of its general assets and are available for its unrestricted use. The contribution portion of a charitable gift annuity agreement should be recognized as unrestricted support if both (a) the donor does not restrict the use of the assets contributed to the NFP and (b) neither the charitable gift annuity agreement nor state law requires the assets received by the NFP to be invested until the income beneficiary's death. If either of those criteria is not met, the contribution should be classified as restricted in accordance with FASB ASC 958-30-45-1.

Unrelated Third Party Is the Trustee or Fiscal Agent

- 6.20** Paragraphs 16–19 of FASB ASC 958-30-25 and FASB ASC 958-30-30-11 discuss recognition and initial measurement of irrevocable split-interest agreements for which a third party maintains control of the donor's contributed assets. In a split-interest agreement in which cash or other assets contributed by a donor are held by an independent trustee (such as a charitable trust for which a bank, trust company, foundation, or private individual is the trustee) or by another fiscal agent of the donor or the cash or other assets are otherwise not controlled by the NFP, the NFP should recognize its beneficial interest in those assets. The contribution should be recognized when the NFP is notified of the agreement's existence. Contribution revenues recognized should be classified in accordance with FASB ASC 958-30-45-1, which is reproduced in paragraph 6.18. If, however, the trustee or fiscal agent has variance power to redirect the benefits to another entity or if the NFP's rights to the benefits are conditional, the NFP should not recognize its potential for future distributions from the split-interest agreement until the NFP has an unconditional right to receive benefits under the agreement. (See FASB ASC 958-605-25-31.)
- 6.21** Occasionally, an NFP is named a beneficiary of a charitable trust without being informed. Also, an NFP may have discussions with donors and potential donors about establishing charitable trusts but may not know if a trust was established. An NFP should make exhaustive efforts to obtain the information necessary to evaluate its beneficial interest if it does not receive a finalized executed copy of the trust agreement, regular trustee investment statements, or both. In some of these situations, donors or their representatives resist disclosing their personal information or their trust arrangements to the NFP.
- 6.22** As discussed in paragraph 6.20, NFPs should report irrevocable beneficial interests in trusts. In some circumstances, however, the NFP may have reliable and verifiable evidence that the beneficial interest exists, but may be unable to obtain the necessary information to measure the interest. The Financial Reporting Executive Committee (FinREC) recommends that if the NFP has reliable and verifiable evidence that the beneficial interest exists but, after making and continuing to make exhaustive efforts, the

NFP is unable to obtain the necessary information to measure such interests, best practice is for the NFP to disclose the known facts and circumstances pertaining to the interest without reporting it as an asset. FinREC believes that, for practical purposes, an NFP generally would need the following information in order to record its beneficial interests in a trust:

- A copy of the executed trust document, a statement from the trustee, or other information, to verify the trust's existence.
- Sufficient information about the trust in order to value the beneficial interest. In circumstances in which fair value is determined using the income approach, such information would include the assets held by the trust, payout rate or amount, and the age(s) of all life beneficiaries.

- 6.23** FinREC believes that if sufficient information was unavailable in the year that the NFP initially became aware of the existence of the trust, the NFP should recognize the beneficial interest in the trust and contribution revenue in the first year in which the necessary information becomes available. The NFP should not report a prior period adjustment to correct an error (pursuant to FASB ASC 250, *Accounting Changes and Error Corrections*) if the NFP made, and continued to make, exhaustive efforts to obtain the necessary information to measure the beneficial interest.
- 6.24** Pursuant to FASB ASC 958-605-30-14, if an NFP is the beneficiary of a split-interest agreement held by a trustee or fiscal agent and has an unconditional right to receive all or a portion of the specified cash flows from the assets held pursuant to that agreement, the NFP should measure its beneficial interest at fair value.
- 6.25** Present value techniques are one valuation technique for measuring the fair value of the contribution and the beneficial interest. If present value techniques are used, the contribution revenue and the beneficial interest in the trust should be measured at the present value of the future distributions expected to be received over the term of the agreement. However, if the trust held by a third party is a perpetual trust, FASB ASC 958-605-30-14 states that the fair value generally can be measured using the fair value of the assets contributed to the trust, unless facts and circumstances indicate that the fair value of the beneficial interest differs from the fair value of the assets contributed to the trust.
- 6.26** As noted in paragraph 49 of the fair value white paper, if present value techniques are used to value a beneficial interest in a charitable trust (or other identifiable pool of assets), it is important to remember when determining the appropriate discount rate that the cash flows from the trust (or pool) to the NFP are at least as risky as the cash flows within the trust (or pool) itself. That is, if the trustee or fiscal agent is receiving a yield to maturity of 4 percent to cover the risk of investing the trust assets, then the risk as a beneficiary of the cash flows from the investments of the trust (or pool) is at least 4 percent. (The risk can be higher because there is a possibility that the trustee or fiscal

agent will not perform its duties as assigned.) In other words, the discount rate should always be greater than or equal to the assumed rate of the return on the trust (or pool) itself. As a result, an estimate of the fair value of the beneficial interest will never exceed the fair value of the trust (or pool) assets (or the proportionate share thereof if there is more than one charitable beneficiary.)

- 6.27** As noted in paragraph 5.09, FASB ASC 958-605-25 establishes standards for a beneficiary's reporting of assets held in trust, but does not establish standards for a trustee's reporting of those assets. Paragraphs 5.32–.37 discuss the requirements for transactions in which a perpetual trust held by a third party (trustee or other recipient entity) is established by an NFP for its own benefit or for the benefit of its affiliate. Paragraphs 6.61–.65 provide an example of a perpetual trust held by a third party.

Initial Recognition and Measurement of Pooled Income Funds and Net Income Unitrusts

- 6.28** Per FASB ASC 958-30-25-15 and FASB ASC 958-30-30-10, the assets received from the donor under a pooled income fund agreement or a net income unitrust should be recognized when received and measured at fair value. An NFP should recognize its remainder interest in the assets received as contribution revenue in the period in which the assets are received from the donor. The contribution should be measured at fair value. Present value techniques are one valuation technique for measuring the fair value of the contribution; other valuation techniques are also available, as described in FASB ASC 820-10-35. If present value techniques are used, the contribution may be measured at the fair value of the assets to be received, discounted for the estimated time period until the donor's death. The contributed assets should be recognized at fair value. The difference between the fair value of the assets when received and the revenue recognized should be recorded as deferred revenue, representing the amount of the discount for future interest. Contribution revenues recognized under a pooled income fund agreement or a net income unitrust should be classified in accordance with FASB ASC 958-30-45-1, which is reproduced in paragraph 6.18.

Recognition and Measurement During the Agreement's Term for Unconditional Irrevocable Agreements Other Than Pooled Income Funds or Net Income Unitrusts

- 6.29** Per FASB ASC 958-30-35-6 and 958-30-45-3, during the term of the agreement, certain transactions and events should be recognized as changes in the value of split-interest agreements in a statement of activities and should be classified as temporarily restricted, permanently restricted, or unrestricted net assets, depending on the classification used when the contribution revenue was recognized initially.
- 6.30** Pursuant to FASB ASC 958-30-45-4, amounts should be reclassified from temporarily restricted net assets to unrestricted net assets as distributions are received by NFPs under the terms of split-interest agreements, unless those assets are otherwise temporarily restricted by the donor. In that case, they should be reclassified to unrestricted net assets when the restrictions expire.

Unrelated Third Party Is the Trustee or Fiscal Agent

- 6.31** Pursuant to FASB ASC 958-30-35-2, in circumstances in which cash or other assets contributed by donors under split-interest agreements are held by independent trustees, such as a charitable trust for which a bank is a trustee, or by other fiscal agents of the donors or otherwise not controlled by the NFP, the measurement objective for the beneficial interest for periods subsequent to the period of initial recognition is fair value. Per FASB ASC 958-30-35-10, the change in the value of split-interest agreements should be the change in the fair value of the NFP's beneficial interest, which should be determined using the same valuation technique that was used to measure the asset initially. In accordance with FASB ASC 958-30-35-3, in circumstances in which the fair value is measured at the present value of the future cash flows, all elements discussed in FASB ASC 820-10-55-5, including discount rate assumptions, should be revised at each measurement date to reflect current market conditions. Distributions from the trust should be reflected as a reduction in the beneficial interest. As discussed in FASB ASC 958-30-45-4, as distributions are received by the NFP under the terms of the split-interest agreement, amounts should be reclassified from temporarily restricted net assets to unrestricted net assets unless those assets are otherwise temporarily restricted by the donor. In that case, they shall be reclassified to unrestricted net assets when the restrictions expire.

NFP Is the Trustee or Fiscal Agent

- 6.32** FASB ASC 958-30-35-4 states that assets held by the NFP under irrevocable split-interest agreements as investments should be subsequently measured in conformity with FASB ASC 958-320-35 or FASB ASC 958-325-35.
- 6.33** Paragraphs 5–8 of FASB ASC 958-30-35 discuss the recognition of transactions and events during the term of a split-interest agreement in circumstances in which assets and related liabilities are recognized under lead and remainder interest agreements for which an NFP serves as a trustee or fiscal agent. Pursuant to FASB ASC 958-30-35-6, if the NFP does not elect to measure the liability at the fair value as described in the next paragraph, the following adjustments to the liability should be recognized as changes in the value of split-interest agreements in a statement of activities: (a) amortization of the discount associated with the contribution and (b) revaluations of future payments to beneficiaries, based on changes in life expectancy, and other actuarial assumptions. In conformity with FASB ASC 310-10-30-6 and FASB ASC 958-30-35-6, the discount rate should not be revised after initial recognition, unless the measurement objective for periods subsequent to the period of initial recognition is fair value.
- 6.34** As discussed in FASB ASC 958-30-35-2, the measurement objective is fair value for the following split-interest obligations:
- a. Embedded derivatives subject to the measurement provisions of FASB ASC 815-15, as discussed in paragraph 6.37

- b. Obligations for which the NFP elects the fair value option pursuant to the “Fair Value Option” subsections of FASB ASC 825-10, as discussed in paragraphs 6.38–.39
 - c. Obligations containing embedded derivatives that the NFP has irrevocably elected to measure in their entirety at fair value in conformity with FASB ASC 815-15-25 as discussed in paragraphs 6.37–.39.
- 6.35** FinREC recommends the use of fair value for measuring the assets and liabilities of split-interest agreements held by an NFP as trustee. Most assets held by NFPs under split-interest agreements are required to be measured at fair value by FASB ASC 958-320-35 or NFPs make an election to report the investments at fair value as permitted by FASB ASC 958-325-35. FinREC believes that reporting unrealized gains and losses on the investments held under a split-interest agreement without reporting the corresponding liability at fair value results in an effect on change in net assets that is not representative of how the NFP is affected by economic events, such as changes in interest rates. (Measuring split-interest obligations at fair value in subsequent periods is discussed in paragraphs 6.38–.39.) FinREC believes that holding an investment that is within the scope of FASB ASC 958-325-15 under a split-interest agreement and reporting it at fair value does not limit the available elections (fair value or cost) described in paragraphs 2, 4, and 6 of FASB ASC 958-325-35 (paragraph 4.37). For example, a house held as an investment of the NFP can be reported at cost even if a house held under a split-interest agreement is reported at fair value (or vice versa).
- 6.36** As discussed in paragraphs 7–14 of FASB ASC 958-30-25, the obligation for certain split-interest agreements contains embedded derivatives. Example 2 (paragraphs 6–29) of FASB ASC 958-30-55 provides illustrations for determining whether a split-interest agreement has an embedded derivative that requires bifurcation. The following paragraph summarizes the subsequent measurement guidance for embedded derivatives, but is not a substitute for the reading of paragraphs 7–8 of FASB ASC 958-30-35 or FASB ASC 815-15.
- 6.37** If an NFP does not elect to report a split-interest obligation at fair value, a split-interest obligation with an embedded derivative (for example, the liability for remainder unitrusts with either period-certain payments or period-certain-plus-life-contingent payments and certain lead interest trusts) is bifurcated into a debt host contract and an embedded derivative that is measured at fair value. (Paragraph 6.34 discusses alternative treatments for reporting split-interest agreements that contain embedded derivatives.) The debt host contract is the liability for the payment to the beneficiary that would be required if the fair value of the trust assets does not change over the specified period. The embedded derivative represents the liability (or contra-liability) for the increase (or decrease) in the payments to the beneficiary due to changes in the fair value of the trust assets over the specified period. Thus, in circumstances in which the liability is measured using present value techniques, the discount rate assumptions on the debt host contract should not be revised subsequent to initial recognition, consistent with paragraphs 5.190 and 6.33. In

accordance with FASB ASC 815-10-35-1, the embedded derivative is subsequently measured at fair value. If the fair value of the embedded derivative is measured using present value techniques, all elements discussed in FASB ASC 820-10-55-5, including the discount rate assumptions on the embedded derivative should be revised at each measurement date to reflect current market conditions. In conformity with FASB ASC 815-15-25-53, if an NFP cannot reliably identify and measure the embedded derivative, the entire split-interest liability should be measured at fair value (that is, all elements discussed in FASB ASC 820-10-55-5, including discount rate assumptions, should be revised to reflect current market conditions).

- 6.38** If the NFP elects the fair value option pursuant to FASB ASC 958-30-35-6 in circumstances in which assets and related liabilities are recognized under lead and remainder interest agreements for which an NFP serves as a trustee or fiscal agent, the liability for future payments to be made to other beneficiaries is measured at fair value. The following paragraph summarizes the guidance for making the election and subsequently measuring at fair value, but is not a substitute for the reading of FASB ASC 815-15 or the “Fair Value Option” subsections of FASB ASC 825-10.
- 6.39** The election may be made on an instrument-by-instrument basis, and should be supported by concurrent documentation or a preexisting documented policy for automatic election. If an NFP elects to measure the obligation for future payments to be made to other beneficiaries at fair value, the entire liability should be remeasured at fair value (that is, if the fair value is measured using a present value technique, all the elements discussed in FASB ASC 820-10-55-5, including the discount rate assumptions for the entire obligation should be revised at each measurement date to reflect current market conditions).^{fn 3}
- 6.40** Per FASB ASC 958-30-35-5, when assets and related liabilities are recognized under charitable gift annuity, charitable lead trust, or charitable remainder trust agreements for which an NFP serves as a trustee or fiscal agent, income earned on those assets, gains and losses, and distributions made to other beneficiaries under the agreements should be reported in the NFP's statements of financial position, activities, and cash flows.

Recognition and Measurement During the Agreement's Term for Pooled Income Funds and Net Income Unitrusts

- 6.41** FASB ASC 958-30-35-4 states that assets held by the NFP under irrevocable split-interest agreements as investments should be subsequently measured in conformity with FASB ASC 958-320-35 or FASB ASC 958-325-35. Per FASB ASC 958-30-35-9, periodic income on a pooled income fund or net income unitrust and payments to the donor should be reflected as increases and decreases in a liability to the donor. Amortization of the discount should be recognized as a reduction in the deferred revenue

^{fn 3} Paragraphs 3.168–.170 provide additional information about FASB ASC 815-15 or the “Fair Value Option” subsections of FASB ASC 825-10.

account and as a change in the value of split-interest agreements. In accordance with FASB ASC 958-30-45-7, changes in the value of split-interest agreements recognized should be reported as separate line items in a statement of activities if not disclosed in the related notes. Pursuant to FASB ASC 958-30-45-3, changes in the value of split-interest agreements should be classified as temporarily restricted, permanently restricted, or unrestricted net assets, depending on the classification used when the contribution revenue was recognized initially.

Recognition Upon Termination of Agreement

- 6.42** Pursuant to FASB ASC 958-30-40-1, upon termination of a split-interest agreement, asset and liability accounts related to the agreement should be closed. Any remaining amounts in the asset or liability accounts should be recognized as changes in the value of split-interest agreements. The changes should be classified as changes in permanently restricted, temporarily restricted, or unrestricted net assets, pursuant to FASB ASC 958-30-45-3, as appropriate. Per FASB ASC 958-30-45-5, if assets previously distributed to the NFP become available for its unrestricted use upon termination of the agreement, appropriate amounts should be reclassified from temporarily restricted to unrestricted net assets.

Purchase of Annuity Contracts to Make Distributions to the Beneficiaries

- 6.43** Some NFPs that serve as trustee or fiscal agents for split-interest agreements enter into annuity contracts with insurance companies or financial institutions to make the required distributions to the beneficiary specified by the donor. The purchase of those contracts is similar to reinsurance. In accordance with FASB ASC 405-20-40 and FASB ASC 944-20-40, an obligation is extinguished only if the debtor or ceding entity is legally relieved of its obligation for the liability. Whether the NFP has been legally relieved of its entire obligation to the beneficiary is a factual question that depends on the settlement's terms.
- 6.44** If the beneficiary legally releases the NFP as trustee from being the primary obligor under the split-interest agreement, the obligation to make payments to the beneficiary is extinguished and a gain or loss on the extinguishment of the obligation can be recognized. However, FASB ASC 405-20-40-2 applies if the NFP remains secondarily liable to the beneficiary. FASB ASC 405-20-40-2 states that whether or not explicit consideration was paid for the guarantee, the original debtor (the NFP) becomes a guarantor. As a guarantor, it should recognize a guarantee obligation in the same manner as would a guarantor that had never been primarily liable to that creditor (beneficiary), with due regard for the likelihood that the third party [the insurance company or financial institution] will carry out its obligations. The guarantee obligation shall be initially measured at fair value, and that amount reduces the gain or increases the loss recognized on extinguishment.
- 6.45** If the NFP as trustee is not relieved from being the primary obligor, the annuity contract is reported as an asset held under a split-interest agreement and the obligation to make

payments continues to be reported as a liability. FASB ASC 210-20-45 permits an asset and a liability to be offset only if a right of setoff exists. That right would not exist in the situation described in paragraphs 6.43–.44 because the NFP as trustee owes the beneficiary, but the annuity contract that is making the payments is between the NFP and an insurance company or financial institution.

Financial Statement Presentation

Statement of Activities

- 6.46** As discussed in footnote 1 to chapter 5, "Contributions Received and Agency Transactions," contributions may be reported as revenues or gains, depending on whether they are part of the NFP's ongoing major activities or are peripheral or incidental transactions. For purposes of this chapter, the term contribution revenue is used to apply to either situation.

Disclosures

- 6.47** The majority of the unique disclosures for split-interest agreements are located in FASB ASC 958-30-50. The following three paragraphs discuss the more common of those disclosures, but are not intended as a substitute for the "Disclosure" sections of the FASB ASC.
- 6.48** The notes to the financial statements should include all of the following disclosures related to split-interest agreements:
- A description of the general terms of existing split-interest agreements
 - Assets and liabilities recognized under split-interest agreements, if not reported separately from other assets and liabilities in a statement of financial position
 - The basis used (for example, cost, lower of cost or market, fair market value) for recognized assets
 - The discount rates and actuarial assumptions used, if present value techniques are used in reporting the assets and liabilities related to split-interest agreements
 - Contribution revenue recognized under such agreements, if not reported as a separate line item in a statement of activities
 - Changes in the value of split-interest agreements recognized, if not reported as a separate line item in a statement of activities

- The disclosures required by the “Fair Value Option” subsections of FASB ASC 825-10, if an NFP elects the fair value option pursuant to FASB ASC 958-30-35-2(b) or 958-30-35-2(c)
 - The disclosures required by paragraphs 1–2, 2B, and 2E of FASB ASC 820-10-50 in the format described in FASB ASC 820-10-50-8, if the assets and liabilities of split-interest agreements are measured at fair value on a recurring basis in periods subsequent to initial recognition or if the fair value of split-interest assets and liabilities are disclosed
- 6.49** Annuity reserves may be required by the laws of the state where the NFP is located or by the state where the donor resides. An NFP that issues split-interest agreement contracts should disclose any legally mandated reserves in the notes to financial statements. If state law imposes other limitations on the NFP, such as limitations on the manner in which some net assets are invested, those limitations also should be disclosed in the notes to financial statements.
- 6.50** In addition, some NFPs voluntarily set aside additional reserves as a cushion against unexpected actuarial losses. Voluntary reserves should be included as part of unrestricted net assets, but may be disclosed as a separate component, such as board-designated unrestricted net assets (see FASB ASC 958-210-55-3).
- 6.51** As noted in paragraph 53 of the fair value white paper, when making disclosures about the inputs to fair value measurement, as required by FASB ASC 820-10-50-1, FinREC believes that if the fair value of the beneficial interest in a perpetual trust is measured using the fair value of the trust assets, best practice is for an NFP to disclose (a) the terms of the trust and practice of the trustee pertaining to distributions, and (b) that the NFP has used the fair value of the trust assets to determine the fair value of the beneficial interest.
- 6.52** If an NFP is unable to obtain sufficient information to make a reasonable estimate of the fair value of a beneficial interest (see paragraphs 6.21–.23), FinREC recommends as a best practice that the NFP disclose the following information about each potentially material beneficial interest or in the aggregate for individually immaterial beneficial interests that are material collectively:
- The characteristics of the agreement, to the extent known
 - What factor(s) are limiting the ability to measure the beneficial interest(s)
 - How much the NFP received from the beneficial interest(s) in each of the periods for which a statement of activities is presented.

Examples of Split-Interest Agreements

- 6.53** Many kinds of split-interest agreements have been developed. The examples in this section demonstrate how the recognition and measurement principles discussed in this chapter apply to some common kinds of agreements. Appendix B, “Journal Entries,” of this chapter provides journal entries related to these examples.

Charitable Lead Trust

- 6.54** A charitable lead trust is an arrangement in which a donor establishes and funds a trust with specific distributions to be made to a designated NFP over a specified period. The NFP's use of the assets distributed may be restricted by the donor. The distributions may be for a fixed dollar amount, an arrangement called a *charitable lead annuity trust*, or for a fixed percentage of the trust's fair market value as determined annually, a *charitable lead unitrust*. Upon termination of the trust, the remainder of the trust assets is paid to the donor or to the beneficiaries designated by the donor.
- 6.55** For example, NFP A receives cash from a donor under an irrevocable charitable lead annuity trust agreement designating NFP A as trustee and lead beneficiary. Under the terms of the trust, NFP A will invest the assets and receive a specified dollar amount each year for its unrestricted use until the death of the donor. At that time, the remaining assets in the trust revert to the donor's estate.
- 6.56** Contribution revenue, assets held in trust, and a liability for amounts held for others should be recognized by NFP A in the period in which the trust is established. Revenue should be reported as temporarily restricted support and measured at fair value. The present value of the specified dollar amount to be received annually over the expected life of the donor is one possible technique to measure the fair value of the contribution. The assets held in trust by NFP A should be recorded at fair value at the date of initial recognition. The difference between the fair value of the assets received and the contribution revenue represents the present value of the liability to pay the donor's estate upon the termination of the trust.
- 6.57** In subsequent periods, both the income earned on the trust assets and recognized gains and losses should be reflected in the trust asset and liability accounts. Adjustments of the liability to reflect amortization of the discount and revaluations of the future cash flows based on revisions in the donor's life expectancy should be recognized as changes in the value of split-interest agreements and classified as changes in temporarily restricted net assets in a statement of activities. Amounts should be reclassified from temporarily restricted to unrestricted net assets as the annual distributions to NFP A are made and recognized during the term of the trust. Upon the death of the donor, the assets are distributed to the donor's estate, the asset and liability accounts are closed, and any difference between the balances in those accounts should be recognized as a change in the value of split-interest agreements in the temporarily restricted net asset class. (In this example, the timing of the distribution of the remainder interest to the beneficiary was dependent on the donor's death. If instead the distribution were required to be paid at the end of a specified period, the liability to the beneficiary would have contained an

embedded derivative as described in paragraph 6.36. Paragraphs 6.34–.39 discuss measuring an obligation that contains an embedded derivative.)

6.58 Paragraph B-2 of appendix B provides the journal entries related to the previous example.

6.59 If NFP A is not the trustee and does not exercise control over the trust's assets, it should recognize its beneficial interest in those assets as temporarily restricted contribution revenue and as a beneficial interest, measured at fair value as discussed in paragraphs 6.20–.27. Distributions from the trust should be reflected as a reduction in the beneficial interest and as reclassifications from temporarily restricted net assets to unrestricted net assets. Changes in the fair value of the beneficial interest should be recognized as adjustments to the beneficial interest in the statement of financial position and as changes in the value of split-interest agreements in the statement of activities in the temporarily restricted net asset class. If present value techniques are used to estimate fair value, those changes would reflect the revision of all elements discussed in FASB ASC 820-10-55-5, including the passage of time, revaluations of expected future cash flows based on revisions in the donor's life expectancy, and discount rate assumptions to reflect current market conditions. Any balance in the beneficial interest account remaining upon termination of the trust should be recognized as a change in the value of split-interest agreements in the statement of activities in the temporarily restricted net asset class. Paragraph B-3 of appendix B provides the journal entries related to this example.

6.60 Paragraphs 6.55–.59 are examples in which the donor specified that the distributions of the charitable lead annuity trust are to be distributed to NFP A for its unrestricted use. Accordingly, the initial contribution and subsequent changes to net assets as a result of this charitable lead annuity trust are reported as changes in temporarily restricted net assets, and amounts were reclassified from temporarily restricted to unrestricted net assets as the annual distributions to NFP A were made during the term of the trust. Had the donor instead specified that the remaining assets of the trust were to be distributed to NFP A to create a permanent endowment, the initial contribution, as well as subsequent changes to net assets as a result of this charitable lead annuity trust, would be reported as changes in permanently restricted net assets. Upon the death of the donor, when the assets are distributed to the donor's estate and the asset and liability accounts are closed, any difference between the balances in those accounts also would be recognized as a change in the value of split-interest agreements in the permanently restricted net asset class.

Perpetual Trust Held by a Third Party

6.61 According to the FASB ASC glossary, a *perpetual trust held by a third party* is an arrangement in which a donor establishes and funds a perpetual trust administered by an individual or entity other than the NFP that is the beneficiary.^{fn 4} Under the terms of the

^{fn 4} Paragraphs 5.32–.37 provide guidance for transactions in which a perpetual trust held by a third party (trustee or other recipient organization) is established by an NFP for its own benefit or for the benefit of its affiliate.

trust, the NFP has the irrevocable right to receive the income earned on the trust assets in perpetuity, but never receives the assets held in trust. Distributions received by the NFP may be restricted by the donor.

- 6.62** For example, a donor establishes a trust with the donor's bank serving as trustee. Funds contributed to the trust are to be invested in perpetuity. Under the terms of the trust, NFP B is to be the sole beneficiary and is to receive annually the income on the trust's assets as earned in perpetuity. NFP B can use the distributions from the trust in any way that is consistent with its mission.
- 6.63** The arrangement should be recognized by NFP B as contribution revenue and as an asset, measured at fair value, when the NFP B is notified of the trust's existence, as discussed in paragraphs 6.20–.27. FASB ASC 958-605-30-14 states that the fair value of a perpetual trust held by a third party generally can be measured using the fair value of the assets contributed to the trust, unless facts and circumstances indicate that the fair value of the beneficial interest differs from the fair value of the assets contributed to the trust. The contribution should be classified as permanently restricted support, because the trust is similar to donor restricted permanent endowment that the NFP B does not control, rather than a multiyear promise to give. Pursuant to FASB ASC 958-605-35-3, annual distributions from the trust are reported as investment income. In this example, the investment income increases unrestricted net assets.
- 6.64** Periodically in conjunction with preparing its financial statements, NFP B should remeasure its beneficial interest at fair value, using the same valuation technique that was used to measure the asset initially, as described in paragraph 6.32. In this example, the adjustment should be recognized as permanently restricted gains or losses.
- 6.65** Paragraph B-4 of appendix B provides the journal entries related to the previous example.

Charitable Remainder Trust

- 6.66** A charitable remainder trust is an arrangement in which a donor establishes and funds a trust with specified distributions to be made to a designated beneficiary or beneficiaries over the trust's term. Upon termination of the trust, an NFP receives the assets remaining in the trust. The NFP may ultimately have unrestricted use of those assets, or the donor may place permanent or temporary restrictions on their use. The distributions to the beneficiaries may be for a specified dollar amount, an arrangement called a *charitable remainder annuity trust*, or for a specified percentage of the trust's fair market value as determined annually, a *charitable remainder unitrust*. 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.
- 6.67** For example, a donor establishes a charitable remainder unitrust, with NFP C serving as trustee. Under the trust's terms, the donor's spouse is to receive an annual distribution equal in value to a specified percentage of the fair market value of the trust's assets each

year until the spouse dies. The income earned on the trust's assets must remain in the trust until the spouse dies. At that time, the remaining assets of the trust are to be distributed to NFP C for use as a permanent endowment.

- 6.68** NFP C should recognize the contribution in the period in which the trust is established. The assets held in trust by NFP C and the liability to the donor's spouse should be recorded at fair value when received, as discussed in paragraphs 6.13–.19. If the liability is measured using present value techniques, the liability to the donor's spouse should be recorded at the present value of the future payments to be distributed over the spouse's expected life. The amount of the contribution is the difference between these amounts and should be classified as permanently restricted support because the donor has specified that NFP C must use the assets to create a permanent endowment.
- 6.69** In subsequent periods, income earned on trust assets, recognized gains and losses, and distributions paid to the spouse should be reflected in the NFP C's statement of financial position. Adjustments to the liability to reflect amortization of the discount, revaluations of the present value of the estimated future payments to the spouse, and changes in actuarial assumptions should be recognized in a statement of activities as a change in the value of split-interest agreements in the permanently restricted net asset class. Upon the death of the spouse, the liability should be closed and any balance should be recognized as a change in the value of split-interest agreements in the statement of activities in the permanently restricted net asset class. (In this example, the period for which distributions were made to the beneficiary was dependent solely on the donor's death and the payment amounts varied based on the fair value of the unitrust assets. If instead the variable-amount distributions were required to be paid for a specified number of years—or for the greater of the donor's life or a specified number of years, the liability to the beneficiary would have contained an embedded derivative, as discussed in paragraph 6.36. Paragraphs 6.34–.39 discuss measuring an obligation that contains an embedded derivative.
- 6.70** Paragraph B-5 of appendix B provides the journal entries related to the previous example.
- 6.71** If NFP C is not the trustee and does not exercise control over the assets contributed to the trust, the agreement should be recognized as a beneficial interest in a trust. NFP C should recognize, as permanently restricted contribution revenue and as a beneficial interest, the fair value of the beneficial interest, as discussed in paragraphs 6.20–.27. Adjustments to the beneficial interest to reflect changes in the fair value should be measured using the same valuation technique as was used to measure the asset initially and recognized as changes in the value of split-interest agreements. For example, if present value techniques were used to estimate fair value, the adjustment would reflect the revision of all elements discussed in FASB ASC 820-10-55-5, including the passage of time, revaluation of the present value of the future payments to the spouse, changes in actuarial assumptions during the term of the trust, and discount rates based on current market conditions. Upon the death of the spouse, the beneficial interest is closed, the assets received from the trust are recognized at fair value, and any difference is reported as a change in the value of

split-interest agreements in permanently restricted net assets. Paragraph B-6 of appendix B provides the journal entries related to this example.

- 6.72** Paragraphs 6.67–.71 are examples in which the donor specified that the remaining assets of the charitable remainder unitrust are to be distributed to NFP C for use as a permanent endowment. Accordingly, the initial contribution and subsequent changes to net assets as a result of this charitable remainder unitrust are reported as changes in permanently restricted net assets. Had the donor instead specified that the remaining assets of the trust were to be distributed to NFP C for its unrestricted use, the initial contribution, as well as subsequent changes to net assets as a result of this charitable remainder unitrust, would be reported as changes in temporarily restricted net assets because their use is time restricted (they must be held in the split-interest trust until the donor’s spouse dies). Upon the death of the spouse, the liability would be closed and any balance would be recognized as a change in the value of split-interest agreements in the statement of activities in the temporarily restricted net asset class, with a reclassification from temporarily restricted net assets to unrestricted net assets to recognize the expiration of the time restriction upon the donor’s death.

Charitable Gift Annuity

- 6.73** A charitable gift annuity is an arrangement between a donor and an NFP in which the donor contributes assets to the NFP in exchange for a promise by the NFP to pay a fixed amount for a specified period of time to the donor or to individuals or entities designated by the donor. The agreements are similar to charitable remainder annuity trusts except that no trust exists, the assets received are held as general assets of the NFP, and the annuity liability is a general obligation of the NFP.
- 6.74** For example, NFP D and a donor enter into an arrangement whereby assets are transferred from the donor to NFP D. NFP D agrees to pay a stated dollar amount annually to the donor's spouse until the spouse dies.
- 6.75** NFP D should recognize the agreement in the period in which the contract is executed. The assets received should be recognized at fair value when received, and an annuity payment liability should be recognized at fair value as discussed in paragraphs 6.13–.19. As noted in paragraphs 71–76 of the fair value white paper, using a market approach and level 2 inputs for valuing certain liabilities under split-interest remainder agreements with fixed payments; for others, the income approach in the form of present value techniques will be the best valuation technique. In this example, unrestricted^{fn 5} contribution revenue should be recognized as the difference between these two amounts.

^{fn 5} Paragraphs 6.12–.13 discuss the classification of the contribution portion of a charitable gift annuity agreement. Paragraphs 6.49–.50 discuss classification and disclosure of reserve requirements or other limitations imposed by state law on NFPs that hold charitable gift annuities.

- 6.76** In subsequent periods, payments to the donor's spouse reduce the annuity liability. Adjustments to the annuity liability to reflect amortization of the discount and changes in the life expectancy of the donor's spouse should be recognized in a statement of activities as changes in the value of split-interest agreements in unrestricted net assets. Upon the death of the donor's spouse, the annuity liability should be closed and a change in the value of split-interest agreements should be recognized in the statement of activities.
- 6.77** Paragraph B-7 of appendix B provides the journal entries related to the previous example.

Pooled (Life) Income Fund

- 6.78** Some NFPs form, invest, and manage pooled (or life) income funds.^{fn 6} These funds are divided into units, and contributions of many donors' life-income gifts are pooled and invested as a group. The FASB ASC glossary defines a *pooled income fund* as a trust in which donors are assigned a specific number of units 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 designated beneficiary or beneficiaries) is paid the actual income (as defined under the arrangement) earned on the donor's assigned units. Upon the donor's death, the value of these assigned units reverts to the NFP.
- 6.79** For example, a donor contributes assets to NFP E's pooled (life) income fund and is assigned a specific number of units in the pool. The donor is to receive a life interest in any income earned on those units. Upon the donor's death, the value of the units is available to NFP E for its unrestricted use.
- 6.80** NFP E should recognize its remainder interest in the assets received as temporarily restricted contribution revenue in the period in which the assets are received from the donor. The contribution should be measured at fair value. Present value techniques are one valuation technique for measuring the fair value of the contribution. If present value techniques are used, the contribution may be measured at the fair value of the assets to be received, discounted for the estimated time period until the donor's death. The contributed assets should be recognized at fair value when received. The difference between the fair value of the assets when received and the revenue recognized should be recorded as deferred revenue, representing the amount of the discount for future interest.
- 6.81** Periodic income on the fund and payments to the donor should be reflected as increases and decreases in a liability to the donor. Amortization of the discount should be recognized as a reduction in the deferred revenue account and as a change in the value of split-interest agreements and reported as a change in temporarily restricted net assets. Upon the donor's death, any remaining balance in the deferred revenue account should be closed and a change in the value of split-interest agreements should be recognized. A

^{fn 6} Net income unitrusts are similar to pooled life-income funds because the corpus is maintained. Accordingly, financial reporting for net income unitrusts is similar to reporting for pooled life-income funds.

reclassification to unrestricted net assets is also necessary to record the satisfaction of the time restriction on temporarily restricted net assets.

6.82 Paragraph B-8 of appendix B provides the journal entries related to the previous example.

Life Interest in Real Estate

6.83 Occasionally an NFP receives a contribution of real estate (such as a personal residence or farm) and the donor retains the right to use the real estate until his or her death (referred to as an irrevocable life interest). Paragraphs 6.84–.87 provide an example showing how that contribution would be reported.

6.84 A donor irrevocably transfers title to her personal residence to NFP G, retaining the right for the donor and the donor's spouse to use the residence until their deaths. The contract between the donor and NFP G specifies that the donor continues to pay the executory costs for the property, including maintenance costs, property taxes, insurance, utilities, and similar costs. NFP G should recognize the agreement in the period in which the contract and deed are executed. The residence received should be recognized at its fair value, and an obligation for the life interest should be recognized at fair value. The fair value of the use obligation for the donor's life interest should consider the fair value rent for similar properties, actuarial life expectancy of the donor and the donor's spouse, as well as whether the donor or the NFP is responsible for any executory costs, and other factors pursuant to FASB ASC 840, *Leases*. Because the use interest is reported as a separate obligation, NFP G should measure the fair value of the residence received without regard to the use interest. The use obligation should be considered deferred revenue. The difference between the fair value of the residence and the fair value of the use obligation for the donor's life interest is recognized as contribution revenue that is temporarily restricted (time restriction that exists until the expiration of the donor's life interest) unless the donor has specified that the proceeds from the sale of the residence must be used by NFP G to create a permanent endowment fund (or other permanent restriction on use), in which case the contribution revenue is permanently restricted.

6.85 In subsequent periods, NFP G should amortize the use obligation based on the actuarial life expectancy of the donor and the donor's spouse. (Because the use interest is a lease, it is not eligible for the fair value option pursuant to the Fair Value Option subsections of FASB ASC 825-10, as discussed in 825-10-15-5, and should not otherwise be adjusted to reflect changes in the rental market.) Adjustments to the use obligation to reflect amortization of the discount, the amortization of the use obligation, and changes in the life expectancy of the donor are recognized in a statement of activities as changes in the value of split-interest agreements in the same class of net assets as the contribution. Because the residence is held as an investment of the trust, the guidance in FASB ASC 958-325-35, which is discussed in paragraph 4.37, should be used for subsequent measurement of the residence. Upon the death of both the donor and the donor's spouse, the use obligation should be closed and a change in the value of split-interest agreements should be recognized in the statement of activities in the same net asset class as the

contribution. If the residence is then available for its unrestricted use (that is, the donor has not further restricted the use of the residence or the proceeds of its sale), the carrying amount of the residence should be reclassified from temporarily restricted to unrestricted net assets. In this example, the donor was responsible for executory costs of the residence. If instead NFP G were responsible, it would report cash flows for maintaining the real estate, such as property taxes, utilities, and repairs and maintenance as period costs (as opposed to initially recognizing a liability for future period expenses).

6.86 FinREC believes that NFP G should disclose the following information pertaining to a life interest in real estate. The disclosures may be aggregated if the NFP holds more than one life interest in real estate.

- The carrying amount of property (fair value at date of gift plus any capitalized additions) and the amount of accumulated depreciation, as of the date of the latest balance sheet presented
- The property should not be included in the statement of financial position with property and equipment used in operations, but it may be included with investments
- The amount of the use obligation at the date of the latest balance sheet presented, if not separately displayed on the face of the statement of financial position
- That the donor and the donor's spouse are responsible for executory costs
- In accordance with FASB ASC 958-210-45-6, the donor-imposed restrictions on the use of the residence and that it cannot be sold until the death of both the donor and the donor's spouse

6.87 Paragraph B-9 of appendix B provides the journal entries related to the previous example.

Appendix A — Excerpt from AICPA White Paper *Measurement of Fair Value for Certain Transactions of Not-for-Profit Entities*^{fn1}

A-1 Not-for-profit entities (NFPs) face various challenges in applying the provisions of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurement*, in part because markets do not exist for certain assets and liabilities. To assist practitioners, on October 14, 2011, the AICPA issued a white paper, *Measurement of Fair Value for Certain Transactions of Not-for-Profit Entities*. The following excerpt provides assistance for measuring beneficial interests in trusts and the liabilities of split-interest agreements.

Beneficial Interests in Trusts

33. An NFP may have a beneficial interest in a trust that is reported at fair value, pursuant to FASB ASC 958-605-30-14. A beneficial interest is recognized by an NFP if a donor transfers cash or other assets to an independent trustee (such as a bank, trust company, foundation, or private individual) or other fiscal agent of the donor,¹⁰ and the donor specifies that the NFP will receive a distribution from the trust assets. In such circumstances, the NFP's asset is the irrevocable right to the stream of cash flows (an interest in the cash flows). The trustee typically controls the investment decisions and timing of distributions to the NFP, and the NFP cannot transfer its interest. Although the cash or other assets in the trust are not controlled by the NFP, the NFP recognizes as its asset the beneficial interest in the trust assets. (If, however, the trustee has variance power to redirect the benefits to another entity, or if the NFP's rights to the benefits are conditional, the NFP would not recognize its potential for distributions from the trust until the NFP has received a distribution or otherwise receives an unconditional right to distributions under the trust agreement.)

34. For purposes of the discussion in this white paper, charitable trusts fall into one of two types: nonperpetual trusts or perpetual trusts. In a nonperpetual trust held by a third party, the NFP will receive its distributions during the term of the trust agreement, and at some point, no later than the end of the term specified in the trust agreement (for example, the end of a specified number of years or upon the death of the donor), the distributions to the NFP will cease. Interests in charitable lead trusts and charitable remainder trusts are examples of these types of beneficial interests in trusts. In contrast, the distributions from a perpetual trust never end. Beneficial interests in perpetual trusts

^{fn1} As a benefit of AICPA membership, all AICPA members can access the AICPA Financial Reporting white paper *Measurement of Fair Value for Certain Transactions of Not-for-Profit Entities* at www.aicpa.org/InterestAreas/FRC/IndustryInsights/Pages/FV_and_Disclosures_NFP.aspx.

¹⁰ To ease readability, this white paper uses the term *trustee* to encompass both a trustee and fiscal agent of the donor that is not a trustee.

exist because the NFP has the irrevocable right to receive the income earned on trust assets in perpetuity, but the NFP will never receive the assets held in trust.

35. Paragraphs 36–54 address questions related to the application of FASB ASC 820-10-35 in determining the fair value of a beneficial interest in a trust held by a third party.

What Is the Unit of Account for a Beneficial Interest in a Trust?

36. The subject of the fair value measurement (unit of account) for a beneficial interest in a trust is each individual beneficial interest. An NFP that receives distributions from three trusts has three beneficial interests and three units of account for which it must determine fair value.

37. There currently is no market in which beneficial interests in charitable trusts trade; therefore, no observable exit price will exist for a beneficial interest. The fair value of a beneficial interest in trust must be determined by assuming a hypothetical transaction at the measurement date, considered from the perspective of a hypothetical market participant that would purchase the beneficial interest. The objective of a fair value measurement is to determine the price that would be received to sell the beneficial interest at the measurement date, even though it is not possible to sell the beneficial interest because of donor-imposed or legal restrictions.

38. The NFP's asset is the right to receive cash flows from the trust, not the assets of the trust itself. Although the trust assets may be investments for which quoted prices in an active market are available, the NFP does not control those investments; they are not the NFP's assets, and they are not the unit of account for the fair value measurement.

How Should NFPs Estimate the Fair Value of Interests in Perpetual Trusts?

39. FASB ASC 958-605-30-14 (footnote 7 to paragraph 6.45 of the AICPA Audit and Accounting Guide *Not-for-Profit Entities*¹¹) discusses circumstances in which an NFP has the irrevocable right to receive the income earned on trust assets in perpetuity but never receives the assets held in trust. It provides as follows:

The fair value of a perpetual trust held by a third party generally can be measured using the fair value of the assets contributed to the trust, unless facts and circumstances indicate that the fair value of the beneficial interest differs from the fair value of the assets contributed to the trust.

40. FinREC believes that this guidance continues to be relevant in measuring an NFP's interest in a perpetual trust, in accordance with FASB ASC 820, *Fair Value Measurement*. FinREC believes that in practice, the fair value of the assets in the trust

¹¹ References are to the 2011 edition of the AICPA Audit and Accounting Guide *Not-for-Profit Entities*, unless otherwise noted.

can be used as an input when measuring a beneficial interest in a perpetual trust, generally without further adjustment (see paragraphs 50–51 for adjustments that FinREC considered and rejected). Circumstances may exist, however, in which the fair value of the beneficial interest differs from the fair value of the assets held by the trust.

41. For example, if the trustee has been instructed not to distribute assets from the trust for a period of years or to distribute only a minor portion of the income that is available for distribution from the trust, the fair value of the beneficial interest may differ from the fair value of the assets contributed to the trust. Similarly, in circumstances in which the trustee has the ability to determine the amount of the distributions and chooses not to distribute assets from the trust or to distribute only a minor portion of the income available for distribution from the trust, the fair value of the beneficial interest may differ from the fair value of the assets in the trust. The fair value of the beneficial interest will also differ from the fair value of the assets of the trust if the trust distributions are shared among two or more NFPs; in that case, the proportionate share of the trust assets may be used to measure the beneficial interest.

42. If facts and circumstances indicate that the fair value of the beneficial interest differs from the fair value of the assets contributed to the trust, the income approach (PV technique) may also be utilized to measure the fair value of the beneficial interest in the trust. If the PV technique is used, a beneficial interest in a trust would be measured as the PV of the future distributions projected to be received, discounted at an appropriate rate. For a perpetual trust, the formula for an annuity in perpetuity would be used.¹² Assuming that payments begin at the end of the current period, the formula for an annuity in perpetuity is simply the distribution amount divided by the appropriate discount rate or yield (paragraphs 48–49 discuss determining an appropriate discount rate).

43. If an NFP is uncertain whether facts and circumstances indicate that the fair value of the beneficial interest differs from the fair value of the assets contributed to the trust, the NFP might compute the fair value of the trust under both methods. Then, as instructed in FASB ASC 820-10-35-24B, the results of the valuation techniques (respective indications of fair value) would be evaluated, considering the reasonableness of the range of values indicated by those results. A fair value measurement is the point within that range that is most representative of fair value in the circumstances.

How Should NFPs Estimate the Fair Value of Interests in Nonperpetual Trusts?

44. If a charitable trust exists for a term, the income approach for measuring the fair value (PV techniques) is likely the most practical method for measuring the beneficial interest in the trust. The beneficial interest in the trust would be measured as the PV of

¹² The value of the distributions in perpetuity is measurable because the distributions that are anticipated far in the future have extremely low present value. Because the corpus of the trust is never paid, there is no present value for the corpus.

the future distributions projected to be received over the expected term of the agreement, discounted at an appropriate rate (paragraphs 48–49 discuss determining an appropriate discount rate). The fair value of the assets of a trust would not be used to measure a beneficial interest unless that interest was in a perpetual trust. The following example uses a discount rate adjustment technique (paragraphs 24–32 and the appendix “Present Value Techniques in Paragraphs 4–20 of Financial Accounting Standards Board *Accounting Standards Codification* 820-10-55” provide additional information about the discount rate adjustment technique).

45. For example, assume that a donor establishes a charitable lead unitrust with assets valued at \$100,000, naming Main Bank as trustee, the donor as the noncharitable beneficiary, and Charity as the charitable beneficiary. Main Bank is to invest and manage the trust assets, paying out 5 percent of the fair value of the trust assets as of the valuation date each year to Charity until the donor’s death and then paying the remaining trust assets to the donor’s estate. The donor’s life expectancy is 10 years. For information about determining life expectancy, see paragraph 92.

46. To use PV techniques, Charity would begin by estimating the cash flows that it will receive. Main Bank has invested the trust assets in its collective trust, and it estimates that the trust will have an average return of 4 percent, net of trustee fees, over the next 5 years. For simplicity’s sake, assume that the valuation date is as of the beginning of the year.

<i>Date</i>	<i>Projected Trust Income</i>	<i>Projected Payout</i>	<i>Projected Fair Value of the Trust</i>
Beginning			\$100,000
Year 1			
	\$4,000	\$5,000	99,000
Year 2			
	3,960	4,950	98,010
Year 3			
	3,920	4,900	97,030
Year 4			
	3,881	4,851	96,060
Year 5			
	3,842	4,803	95,099
Year 6			
	3,804	4,756	94,147
Year 7			
	3,766	4,707	93,206
Year 8			
	3,728	4,660	92,274
Year 9			
	3,691	4,614	91,351
Year 10			
	3,654	4,568	90,437

Charity would then apply a discount rate to the projected payouts. The discount rate should reflect the risks associated with the cash flows; it cannot be less than 4 percent

because that is the rate of return of the trust assets (see paragraphs 48–49). The PV of the projected payments is computed as follows, using PV factors for a single amount due in the future at 4 percent:

<i>Date</i>	<i>Projected Payout</i>	<i>PV Factor</i>	<i>PV of Payout</i>
Year 1	\$5,000	0.96154	\$4,808
Year 2	4,950	0.92456	4,577
Year 3	4,900	0.88900	4,356
Year 4	4,851	0.85480	4,147
Year 5	4,803	0.82193	3,948
Year 6	4,756	0.79031	3,759
Year 7	4,707	0.75992	3,577
Year 8	4,660	0.73069	3,405
Year 9	4,614	0.70259	3,242
Year 10	4,568	0.67556	3,086
Estimate of fair value			\$38,905

Charity would recognize \$38,905 as the fair value of the beneficial interest and its contribution when notified of the irrevocable gift at the beginning of year 1.

47. The preceding method can also be used to estimate the fair value of remainder interests in charitable trusts that are held by third-party trustees. Assume the same trust as in paragraph 46 but that Charity holds the remainder interest. Using the first table in paragraph 46, Charity computes the amount that it expects to receive upon the death of the donor as \$90,437. To estimate the fair value of that payment, Charity uses the factor for a single payment of \$90,437 due in 10 years at 4 percent (0.67556) and computes a fair value of the remainder interest of \$61,095. Note that the values of the lead interest (\$38,905) and remainder interest (\$61,095) equal the value of the trust assets (\$100,000).

If PV Techniques Are Used to Measure a Beneficial Interest in a Trust, How Is the Appropriate Discount Rate Determined?

48. Much of the discussion about PV techniques in paragraphs 7–15 is equally applicable when using PV techniques to measure beneficial interests in trusts. When estimating future distributions from the trust and discount rates, assumptions that market participants would use in their estimates should be used, and the discount rates should

reflect assumptions that are consistent with those inherent in the cash flows. This prevents double counting or omitting the effects of risk factors.

49. When determining the appropriate discount rate to be used to value a beneficial interest in a charitable trust, it is important to remember that the cash flows from the trust to the NFP beneficiary are at least as risky as the cash flows within the trust itself. That is, if the trustee is receiving a yield to maturity of 4 percent to cover the risk of investing the trust assets, then the risk as a beneficiary of the cash flows from the investments of the trust is at least 4 percent. Risks that change the pattern of the cash flows can cause the discount rate to be higher. In other words, the discount rate should always be greater than or equal to the assumed rate of the return on the trust itself. As a result, an estimate of the fair value of the beneficial interest in the trust assets should never exceed the fair value of the trust assets (or the proportionate share thereof if there is more than one charitable beneficiary).

What Other Factors Did FinREC Consider Regarding the Measurement of the Fair Value of a Beneficial Interest in a Trust?

50. FinREC considered whether the fact that the trustee controls the investment decisions should affect the fair value of the NFP's beneficial interest in the trust. FinREC believes the fact that the trustee controls the investment decisions typically has no effect on the fair value of the asset (the beneficial interest in the trust). Assuming that the trustee exercises its fiduciary responsibilities, FinREC believes that the trustee's control over such investment decisions generally is neither an enhancement nor a diminishment of the NFP's interest in the trust.

51. FinREC also considered whether the risk premium related to the individual investments held in the trust should be considered in estimating the fair value of the beneficial interest in the trust. FinREC believes that the risk premium related to the individual investments held in the trust should not be separately considered in estimating the fair value of the asset (interest in the trust) because that risk premium is already built into the price of each individual investment held in the trust. However, as noted in paragraphs 48–49, the rate of return on the assets of the trust is a consideration when determining the appropriate discount rate if the income approach and PV techniques are used to measure fair value.

How Are Subsequent Measurements of Fair Value Made?

52. FASB ASC 958-30-35-2 and 958-605-35-3 require that an NFP remeasure at fair value at each reporting date its beneficial interest in a trust held by a third-party trustee. The NFP should remeasure its beneficial interest by applying the same technique that it used upon initial measurement, but it should update all the assumptions, including the discount rate, to reflect current market conditions. However, a change in a valuation technique or its application (for example, a change in its weighting when multiple valuation

techniques are used or a change in an adjustment applied to a valuation technique) is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. For further information, see paragraph 103.

What Considerations, if Any, Are There for Making Required Disclosures of Fair Value When the Asset Measured Is a Beneficial Interest in a Perpetual Trust Held by a Third Party?

53. An NFP should make the disclosures about fair value measures required by FASB ASC 820-10-50. In making disclosures about the inputs to fair value measurement, as required by FASB ASC 820-10-50-1, FinREC believes that if the fair value of the beneficial interest in a perpetual trust is measured using the fair value of the trust assets, best practice is for an NFP to disclose (a) the terms of the trust and practice of the trustee pertaining to distributions and (b) that the NFP has used the fair value of the trust assets to determine the fair value of the beneficial interest.

54. As noted in paragraphs 36–38, the unit of account is the beneficial interest in the trust itself. In making the disclosures about the level of the fair value hierarchy within which the fair value measurements are categorized in their entirety, as required by FASB ASC 820-10-50-2, FinREC believes that it is reasonable to analogize to the guidance in FASB ASC 820-10-35-54B, which addresses how a fair value measurement should be categorized if net asset value per share is used as a practical expedient to measure an investment in an entity that measures all of its investments at fair value. That guidance says that if a reporting entity will never have the ability to redeem its investment at net asset value per share (or its equivalent), the fair value measurement of the investment should be categorized as a level 3 fair value measurement. Accordingly, by analogy, the measurement for a beneficial interest in a perpetual trust should also be categorized as a level 3 fair value measurement because the NFP will never receive the trust's assets.

55. Because a beneficial interest in a perpetual trust is categorized as a level 3 measure, an NFP is required to disclose the information required for recurring fair value measurements using significant unobservable inputs. NFPs that are public entities are required to disclose the sensitivity of the fair value measurement to changes in unobservable inputs; other NFPs are not so required.

Split-Interest Agreements

56. *Split-interest agreements* (sometimes referred to as deferred giving) are agreements in which a donor makes an initial gift to a trust or directly to an NFP in which the NFP has a beneficial interest but is not the sole beneficiary. The period covered by the agreement is expressed either as a specific number of years or the remaining life of an individual or individuals designated by the donor. The assets are invested and administered by the NFP, a trustee, or a fiscal agent. Under agreements referred to as lead interests, the NFP receives any distributions or income during the agreement's term, and the donor (or

other individuals or entities designated by the donor) receives all or a portion of the assets remaining at the end of the agreement's term. In agreements referred to as remainder interests, the donor (or other individuals or entities designated by the donor) receives the distributions during the term, and the NFP receives all or a portion of the assets remaining at the end of the agreement's term. Split-interest agreements, therefore, are a combination of a contribution and an exchange transaction.

Remainder Interests

57. Three primary types of remainder agreements exist: charitable remainder trusts, charitable gift annuities, and pooled income funds.

Charitable Remainder Trusts

58. Under charitable remainder trusts, as described in the glossary of FASB ASC and paragraph 6.47 of the Audit and Accounting Guide *Not-for-Profit Entities*, the donor establishes and funds a trust, the terms of which provide that specified distributions are to be made to a designated beneficiary or beneficiaries over the trust's term. The distributions to the beneficiaries may be for a specified dollar amount (an arrangement called a charitable remainder annuity trust) or specified percentage of the trust's fair market value, as determined annually (an arrangement called a charitable remainder unitrust). Some charitable remainder unitrusts limit the annual payout to the lesser of the stated percentage or actual income earned. Obligations to the beneficiaries are limited to the trust's assets.

Charitable Gift Annuities

59. Charitable gift annuities are similar to charitable remainder trusts except that, as described in FASB ASC 958-30-05-11 (paragraph 6.52 of the Audit and Accounting Guide *Not-for-Profit Entities*), no trust exists. The assets received are held as general assets of the NFP, and the annuity liability is a general obligation of the NFP. Under charitable gift annuities, the NFP agrees to pay a fixed amount for a specified period of time to the donor or to individuals or entities designated by the donor.

Pooled Income Funds

60. The third type of remainder agreement, described in the FASB ASC glossary and paragraph 6.56 of the Audit and Accounting Guide *Not-for-Profit Entities*, is a pooled income fund. A *pooled income fund* is a trust for which the NFP is trustee. These trusts pool the contributions of many donors and invest 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 his or her death, the donor (or the donor's designated beneficiary or beneficiaries) is paid the actual income (as defined under the arrangement) earned on the donor's assigned units. Upon the donor's death, the

value of the assigned units reverts to the NFP.

Lead Interests

61. The most common type of lead interest arrangement is one in which a donor establishes and funds a trust with specific distributions to be made to a designated NFP over a specified period. The distributions may be a fixed dollar amount (an arrangement called a charitable lead annuity trust) or fixed percentage of the trust's fair market value, as determined annually (a charitable lead unitrust). Upon termination of the trust, the remainder of the trust assets is paid to the donor or beneficiaries designated by the donor.

Recognition of Split-Interest Agreements

62. As noted in FASB ASC 958-30-30 (chapter 6, "Split-Interest Agreements," of the Audit and Accounting Guide *Not-for-Profit Entities*), recognition of split-interest agreements generally requires the assets, liabilities, and contribution to be initially measured at fair value. FASB ASC 958-30 provides guidance for determining the fair value of the contribution of either a lead or remainder interest.

63. Prior to FASB Statement No. 157, which is reflected in FASB ASC 820, the fair value of the contribution inherent in a split-interest agreement was estimated using the income approach (PV technique). Beginning with the 2007 edition, the Audit and Accounting Guide *Not-for-Profit Organizations* was conformed to FASB Statement No. 157, and it (and FASB ASC) indicates that PV techniques are one valuation technique for measuring the fair value of the contribution and liability; other valuation techniques are also available, as described in FASB Statement No. 157.

64. Paragraphs 6.10–.11 of the 2011 edition of the Audit and Accounting Guide *Not-for-Profit Entities*, which has been conformed to FASB ASC, in discussing initial measurement of lead and remainder agreements (other than pooled income funds or net income unit trusts), provide as follows:

6.10 Per FASB ASC 958-30-30-7, under a lead interest agreement, the 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. Under lead interest agreements, the future payments to be made to other beneficiaries will be made by the NFP only after the NFP receives its benefits. In those situations, the present value of the future payments to be made to other beneficiaries may be estimated by the fair value of the assets contributed by the donor under the agreement less the fair value of the benefits to be received by the NFP. If present value techniques are used, the fair value of the benefits to be received by the NFP should be measured at the present value of the benefits to be received over the expected term of the agreement.

6.11 Per FASB ASC 958-30-30-8, under remainder interest agreements, the present value of the future payments to be made to other beneficiaries can be estimated directly based on the terms of the agreement. Future distributions will be received by the NFP only after obligations to other beneficiaries are satisfied. In those cases, the fair value of the contribution may be estimated based on the fair value of the assets contributed by the donor less the fair value of the payments to be made to other beneficiaries.

65. Prevalent practice is to measure the fair value of the contribution and liability using commercially available software aimed at determining the amount of the donor's tax deduction. The objective of that software is to measure the tax deductibility of the gift, which may not necessarily result in a fair value measurement. To use that software for measuring in accordance with generally accepted accounting principles (GAAP), NFPs would need to consider the assumptions that are inherent in the software's calculations (such as interest rate and mortality) and determine whether those assumptions are market participant assumptions that are appropriate for the measurement of fair value. If the assumptions are inappropriate, the NFP must determine whether the output from the software can be adjusted to reflect a fair value measurement that complies with GAAP. The NFP must consider whether the differences in the resulting values are significant enough that the software should not be used to determine the fair value of the contribution for financial statement purposes. One method to test whether the software can be used would be to use sampling to select split-interest agreements for testing and then compare the measurements arrived at using the methods described in this white paper with the measurements from the software.

66. Paragraphs 67–102 of this white paper address questions related to the application of FASB ASC 820-10-35 in determining the fair value of split-interest agreements.

Can the Market Approach Be Used to Value the Liability?

67. In some respects, assets and liabilities related to split-interest agreements are similar to assets and liabilities related to fixed- and variable-rate annuity contracts that are sold by insurance companies. However, certain differences exist between annuities offered by insurance companies and annuities offered by NFPs. The following are the most significant differences:

- For most types of agreements, a donor who enters into a split-interest agreement is able to take a charitable contribution deduction on his or her tax return in the year that the agreement is signed and funded. Split-interest agreements that do not result in an initial charitable contribution deduction have other tax benefits. Insurance company contracts are investment vehicles, some of which offer tax-deferral opportunities.
- Annuities offered by insurance companies generally pay out at a higher rate of return than annuities offered by NFPs. Because of the individual's intention to

make a tax-deductible contribution, an individual generally is willing to accept a lower payout rate from an NFP than he or she would accept from an insurance company.

- The insurance industry is highly regulated, and states have insurance guarantee associations that provide the purchasers of insurance company products with varying degrees of limited protection against the inability of the insurance company to pay its obligations under the agreements. (As of May 2011, 22 of the 50 states provided protection for the PV of an annuity contract to a maximum of \$100,000, and another 18 provided protection of \$250,000. The other 10 states provided higher degrees of protection. Most states, however, restrict insurance agents and companies from advertising the existence of that protection.) Some states do not regulate split-interest agreements; other states regulate them but not to the extent that insurance companies are regulated. For example, a state may require the NFP to do one, two, or all of the following: maintain minimum reserves, create a segregated trust, or limit its investment options to those perceived to be conservative. Those NFP requirements, however, are not as pervasive or extensive as requirements for insurance companies, and reserves, when required, typically are held by the NFP rather than a third party.
- An insurance company typically includes fees, a profit margin, or both in its contracts, whereas an NFP that enters into an annuity or unitrust agreement typically does not build any fees (or only very low fees to cover costs) into the agreement because the NFP will receive its benefits via the contribution portion of the agreement.
- It may be difficult to find a marketplace for annuities offered by insurance companies that is similar to the marketplace for variable annuities offered by NFPs (unitrusts). Variable annuities offered by insurance companies include a plethora of investment returns, tax deferral strategies, and payout terms. In addition, variable annuities offered by insurance companies are structured differently than variable annuities offered by NFPs. Variable annuities offered by NFPs hold the assets funding the annuity in trust. Further, variable annuities offered by NFPs pay an agreed-upon rate that is applied to the fair value of the trust assets on the annual measurement date. In comparison, variable annuities offered by insurance companies generally have a guaranteed lifetime income component that results in a liquidation of the assets. The variable component of such annuities offered by insurance companies generally increases in circumstances in which the total return on the assets exceeds a defined value.

68. FASB ASC 820-10-35-50 requires an entity using a market approach to adjust the observed market prices for the differences between the item being measured and the item for which the price was observed. It is unclear whether and how the NFP should adjust for the tax deductibility, adjust for the protection provided by the guarantee association, and remove the profit and fee components from the observed market prices for the insurance company contracts. FinREC observes that for these reasons, it may not be

practical to utilize the market approach for all split-interest agreements.

69. FinREC believes that the market approach is generally not feasible for split-interest agreements with variable payments. Variable annuities offered by insurance companies include a plethora of investment returns, tax deferral strategies, and payout terms. In addition, variable annuities offered by insurance companies are structured differently than variable annuities offered by NFPs. Variable annuities offered by NFPs pay an agreed-upon rate that is applied to the fair value of the trust assets on the annual measurement date. In comparison, variable annuities offered by insurance companies generally have a guaranteed lifetime income component that results in a liquidation of the assets. The variable component of annuities offered by insurance companies generally increases in circumstances in which the total return on the assets exceeds a defined value. The market approach, therefore, is not feasible for split-interest agreements with variable payments because prices in an active market for obligations similar to split-interest agreements with variable payments cannot be observed with a reasonable cost and effort.

70. In contrast to split-interest agreements with variable payments, FinREC observes that there are many similarities between annuities offered by insurance companies and split-interest agreements with fixed payments. Given these similarities, FinREC believes that NFPs may use market information about annuities offered by insurance companies as inputs into a fair value measurement when determining the fair value of the liabilities under split-interest remainder agreements with fixed payments. FinREC believes that the fair value of a liability for a series of fixed payments would be similar, assuming the risk of nonperformance (credit standing) was the same. (Paragraphs 73–77 discuss credit standing.) Thus, the market approach is feasible for certain split-interest agreements with fixed payments.

How Should NFPs Estimate the Fair Value of Liabilities Under Split-Interest Remainder Agreements With Fixed Payments?

71. For liabilities under split-interest remainder agreements with fixed payments, FinREC believes that one of two approaches will be the best valuation technique for measuring fair value. In the circumstances described in paragraph 76, FinREC believes that a market approach using level 2 inputs, as described in paragraphs 3A–3C of FASB ASC 820-10-55, will provide the best measure. In other circumstances, as described in paragraph 78, FinREC believes that the income approach, in the form of PV techniques using level 2 inputs for interest rates, yield curves, and life expectancy tables, will provide the best measure. NFPs could, of course, use other valuation techniques to measure the fair value of liabilities under split-interest remainder agreements with fixed payments.

72. FinREC notes that observable prices are readily available from the websites of insurance companies and brokers for annuities with fixed payments and terms that are similar to split-interest liabilities with fixed payments. FinREC believes that for split-

interest agreements with fixed payments, those quoted prices may be considered level 2 inputs, pursuant to the FASB ASC glossary definition of *level 2 inputs* and FASB ASC 820-10-35-48, because they are an observable quoted price for a similar liability and in an active market.

73. NFPs should consider the need to make adjustments to market prices of annuities offered by insurance companies (level 2 inputs) in estimating the fair value of liabilities under split-interest remainder agreements with fixed payments to reflect the difference in credit risk.

74. Market participants may have reasons for placing little or no emphasis on the credit standing of the payer, such as the following:

- Historically and in the current market, few defaults are observed on annuities from either NFPs or insurance companies.
- If an NFP is the payer, their affinity for the NFP and their donative intent.
- If an insurance company is the payer, the high degree of regulation of the insurance industry, including the protection provided by state guarantee associations that assume some or all of the liability to the annuitant if the insurance company defaults.

75. Even though market participants may place little or no emphasis on the credit standing of the payer, the following characteristics may cause annuity obligations of an NFP to have a different risk profile than annuities offered by insurance companies:

- Differences in credit standing
- The existence and extent of insurance company regulation, including protection provided by state guarantee associations
- Whether the NFP annuity obligation is adequately funded through a trust
- The existence and extent of minimum reserve requirements related to NFP annuity obligations

Therefore, it may be difficult to find a marketplace for annuities offered by insurance companies that is similar to the marketplace for annuities offered by NFPs, and market quotes for fixed payment annuities offered by insurance companies may need to be adjusted for credit quality or credit enhancement features.

76. FASB ASC 820-10-35-50 requires that observed market prices be adjusted if they are for liabilities that are similar to, rather than the same as, the liability being measured (level 2 measures). FinREC observes that the insurance industry is highly regulated, which results in (a) annuities being offered by insurance companies that have a strong, superior, or excellent capacity to meet their financial commitments (creditworthiness), or (b) market participants viewing insurance companies as equally creditworthy because of

protection provided by a state guarantee association. Thus, FinREC believes that the use of market quotes for fixed payment annuities offered by insurance companies should be limited to situations for which the credit risk associated with an NFP's obligation to make fixed payments is similarly low. Specifically, FinREC believes that the market quotes for fixed payment annuities offered by insurance companies will be most representative for measuring split-interest obligations in any of the following situations:

- The annuity obligation is adequately funded from assets held in an irrevocable trust, and the NFP is observing its fiduciary responsibilities as trustee.
- The NFP has a credit standing similar to that of the insurance companies whose quotes are observed in the marketplace. That is, the NFP has an "investment grade" credit standing reflecting strong, superior, or excellent capacity to meet financial commitments. Note that the NFP's credit standing may be based on the NFP's own assessment, rather than a rating by a third-party rating agency.
- The NFP holds a commercially available annuity that provides cash flows to the beneficiary in the amount of and for the entire term of the agreement.

77. In situations similar to those in the preceding paragraph, facts and circumstances may lead to a conclusion that an NFP would make no adjustment for credit risk to the market prices of annuities offered by insurance companies when it estimates the fair value of liabilities under split-interest remainder agreements with fixed payments.

78. In situations dissimilar to those described in paragraph 76, FinREC believes that the income approach, in the form of PV techniques that maximize the use of observable inputs for interest rates, yield curves, and life expectancy tables, will be the best valuation technique for split-interest agreements with fixed payments. The income approach, including considerations for determining the discount rate, is discussed further in paragraphs 93–102.

79. FinREC believes that when using PV techniques to determine the fair value of a split-interest agreement's obligation to make fixed payments, NFPs should consider the risk premium that hypothetical market participants would demand for bearing the uncertainty inherent in the cash flows of the obligation. For example, a market participant would likely demand a premium to be compensated for uncertainties associated with the life span of an annuitant. Market quotes for annuities of insurance companies already include this risk premium.

80. Some NFPs have used tables provided by the IRS or similar tables in planned giving software to estimate the fair value of liabilities under split-interest remainder agreements with fixed payments. FinREC believes that such tables may be inappropriate for estimating the fair value of liabilities under split-interest remainder agreements with fixed payments because they are not regularly updated and are based on the population at large, rather than the population likely to buy an annuity or enter into a split-interest agreement. FinREC believes that quoted market prices for fixed-payment annuities in

active markets appropriately consider the expected life of the relevant pool of annuitants. As a result, entities may want to use the life expectancy date from other sources, such as those discussed in paragraph 92.

How Should Discount Rates Be Determined if the Income Approach Is Used, Including Should Any Risk Premium That Hypothetical Market Participants Would Demand for Bearing the Inherent Uncertainties Be Incorporated in the Cash Flows?

81. In discussing discount rates used in PV measurements, FASB ASC 958-30-30-6 (paragraph 6.09 of the Audit and Accounting Guide *Not-for-Profit Entities*) specifies that a discount rate commensurate with the risks involved should be used if PV techniques are used to measure the fair value of split-interest obligations. In practice, some NFPs have used surrogates for a discount rate commensurate with the risks involved, such as average rate of return on the investment portfolio or average interest rate on outstanding borrowings, asserting that those surrogates generally did not result in measures that resulted in material misstatements in the financial statements.

82. FASB ASC 820-10-55-5 lists the elements that a fair value measurement of an asset or a liability should capture when using PV techniques (see paragraph 7).

83. In determining fair value, entities should consider the risk that actual cash flows (in both timing and amount) may differ from the cash flows used in the PV calculation. All other factors being equal, therefore, the higher the risk that actual cash flows may differ from the cash flows used in the PV calculation, the higher the discount rate or rate of return.

How Should NFPs Account for the Changes in the Liabilities Under Split-Interest Agreements With Fixed Payments in Subsequent Periods?

84. FASB ASC 958-30-35 (chapter 6 of the Audit and Accounting Guide *Not-for-Profit Entities*) discusses recognition and measurement during the term of a split-interest agreement. The NFP has two options available for reporting the liabilities under split-interest agreements with fixed payments: it can elect the fair value option, pursuant to FASB ASC 825-10-25, or amortize the discount associated with the obligation (remainder trust) or contribution (lead interest) and adjust for changes in life expectancies (if payments are life dependent).

85. FASB ASC 820-10-35-25 requires that valuation techniques be applied consistently, unless a change in valuation techniques results in a measurement that is equally or more representative of fair value in the circumstances (also see “Changes in Valuation Techniques” in exhibit 3). If the NFP elects to report the annuity payment liability at fair value in subsequent periods, it should use the same method to determine fair value as it used at initial recognition, unless a change in valuation techniques results in a measurement that is equally or more representative of fair value in the circumstances.

That is, if, at initial recognition, the NFP used market quotations gathered from the Internet for commercially available annuity products with similar terms, it should repeat that process, unless a change in valuation techniques results in a measurement that is equally or more representative of fair value in the circumstances, and the liability would be adjusted upward or downward to reflect the new market quote. If, at initial recognition, the NFP used PV techniques to estimate the fair value, it should update all the elements described in paragraph 81, including the discount rate assumptions, in arriving at the current fair value estimate.

86. If the NFP does not elect to report the annuity liability at fair value, it should not adjust the discount rate assumptions. It should update only the actuarial assumptions, including life expectancy. FinREC observes that if the NFP initially measured the liability using market quotes, it would determine the imputed discount rate to be used in amortizing the liability.¹³ To do so, the NFP might solve for the discount rate using the fixed payment amount; the life expectancies at the inception of the contract (obtained from a reliable published source, such as the National Center for Health Statistics [NCHS]); and the market quote (the PV at initial measurement). That imputed discount rate would be used in the subsequent periods' remeasurements over the life of the agreement.

How Should NFPs Estimate the Fair Value of Split-Interest Liabilities With Variable Payments?

87. For liabilities under split-interest agreements with variable payments (sometimes referred to as charitable unitrusts), FinREC believes that an income approach, using PV techniques and level 2 inputs for interest rates, as described in the FASB ASC glossary and paragraphs 3F–3G of FASB ASC 820-10-55, often will be the best valuation technique for measuring fair value. This white paper, therefore, discusses various techniques under an income approach for measuring the fair value of liabilities under split-interest remainder agreements with variable payments.

88. All variable payment split-interest agreements hold the assets in trust; therefore, the trust is the obligor, not the NFP that serves as trustee. Holding the assets in trust provides significant protection (similar to collateral) against the risk of default because

- the variable payments are computed as a percentage of the trust assets; thus, the payments decrease if investment losses cause a decrease in the trust assets.
- split-interest remainder agreements that result in tax deductions must have a remainder interest equal to or greater than 10 percent of the fair value of the assets initially transferred to the trust, which provides additional protection against default.

¹³ Accounting for split-interest agreements with embedded derivatives is outside the scope of this white paper.

89. To use the income approach to measure the fair value of the contribution and obligation of a split-interest agreement with variable payments, an NFP must make assumptions about the following inputs to the PV techniques:

- Projected rate of return on the investments in the trust
- Discount rate for the obligation
- The expected mortality of the individual on which termination of the agreement depends, if the agreement is life dependent

90. In circumstances in which cash is invested, the investor is subject to various types of risk, including market risk, credit risk, inflation risk, and so forth. FinREC observes that because the payments to the beneficiary depend upon the assets in the trust, the cash flows from the trust are at least as risky as the cash flows of the trust investments. That is, if the trustee expects, for example, a rate of return on the trust investments of 6 percent (due to the risk of investing the trust assets), then the beneficiary of the cash flows from the trust also bears at least that same risk. FinREC believes that because the beneficiary also bears that risk, best practice is for the discount rate to also reflect that risk; therefore, the discount rate in this example would be at a minimum 6 percent.

91. FinREC observes that defaults rarely occur on split-interest agreements with variable payments because they are collateralized obligations, and NFPs generally perform their trust duties as assigned. Therefore, FinREC believes that if the NFP is complying with all of its fiduciary duties as trustee, best practice is to use the same rate for the projected rate of return on the investments and discount rate. The NFP can use either the risk-neutral rate or projected earnings rate on the trust assets.

92. Life expectancy information can be obtained from various sources, such as recent annuity tables published by the Society of Actuaries, including the Annuity 2000 Mortality Table (adopted by the National Association of Insurance Commissioners in 1996), or the NCHS (“United States Life Tables” in the *National Vital Statistics Reports*). The Annuity 2000 Mortality Tables reflect the fact that individuals who purchase annuities tend to be wealthier and, thus, healthier than the general public.¹⁴ The tables published by the NCHS are based on the general public. Some sources suggest that a minimum of two years and a maximum of six years would be added to the life expectancies in mortality tables based upon the general public to reflect annuitants’ expected longer lives.

93. An example of an income approach calculation for a charitable remainder unitrust appears in exhibit 1; the example uses a discount rate adjustment technique. Paragraphs 24–32 and appendix A provide additional information about the discount rate adjustment technique.

¹⁴ This mortality table can be adjusted to reflect the fact that mortality rates improve over time. For example, projection scale G is used to adjust annual rates of mortality in individual annuity tables.

EXHIBIT 1

FACT SET

94. James Joyce establishes a charitable remainder unitrust with assets valued at \$100,000, naming ABC Charity as the remainder beneficiary and trustee. The unitrust agreement specifies that Mr. Joyce will receive 6 percent of the value of the trust assets annually, based on the fair value of the trust assets on the measurement date. Mr. Joyce is 75 years old when the agreement is signed. Payments are made at the end of the year.

95. The following table provides information for determining a risk-neutral rate, which is measured as the risk-free rate adjusted for the credit swap spread rate.¹ The credit swap spread measures a more liquid market in which AA banks lend to each other. The credit swap spread rate is measured as the difference between the London Interbank Offered Rate (LIBOR) and the Treasury bill (T bill) rate. The boxes indicate observable market returns.

Portfolio return and discount rate:

Assume constant by duration	LIBOR	0.83%
	T-bill	0.16%
	Swap spread	0.67%
Linear interpolation between years 3 and 5	1-year Treasury	0.47%
	2-year Treasury	0.86%
	3-year Treasury	1.29%
	4-year Treasury	1.64%
	5-year Treasury	1.98%
Linear interpolation between years 5 and 10	6-year Treasury	2.21%
	7-year Treasury	2.44%
	8-year Treasury	2.67%
	9-year Treasury	2.90%
	10-year Treasury	3.12%
Linear interpolation between		

¹ The Treasury yield curve rates published by the U.S. Treasury are an alternative set of risk-free rates.

years 10 and 30

30-year Treasury

4.07% 0.048% per year

The preceding observable market rates are used to compute the return on the investments in the portfolio for purposes of estimating the trust assets at the beginning of the year. They are also used to develop the discount factors. For example, the trust assets at the beginning of year 2 are computed as \$100,000 x (1 + 0.0047 [the 1-year Treasury rate] + 0.0067 [the swap spread]) – \$100,000 x 6% payment. The discount factor for year 2 is computed as the year 1 discount factor x (1 / (1 + 0.0086 [the 2-year Treasury rate] + 0.0067 [the swap spread])).

Estimate of Fair Value of Obligation to the Beneficiary and ABC Charity's Contribution

<i>Yr.</i>	<i>Mortality</i>	<i>Probability of Payment</i>	<i>Trust Assets at Beginning of the Year</i>	<i>Trust Return/Discount Rate</i>	<i>Payout</i>	<i>Projected Payment</i>	<i>Discount Factor</i>	<i>Present Value of Payout</i>
	A	B = 1 – A	C = C_{prev} x (1 + D_{prev}/100) – E_{prev}	D	E = 6% x C	F = B x E	G	H = F x G
1	0.028304	0.971696	\$100,000	1.140	\$6,000	\$5,830	0.98873	\$5,764
2	0.030830	0.941739	95,140	1.530	5,708	5,376	0.97383	5,235
3	0.033570	0.910125	90,887	1.960	5,453	4,963	0.95511	4,740
4	0.036543	0.876867	87,215	2.305	5,233	4,589	0.93359	4,284
5	0.039760	0.842002	83,993	2.650	5,040	4,243	0.90949	3,859
6	0.043231	0.805602	81,179	2.878	4,871	3,924	0.88405	3,469
7	0.046962	0.767769	78,645	3.108	4,719	3,623	0.85740	3,106
8	0.050960	0.728644	76,370	3.338	4,582	3,339	0.82970	2,770
9	0.055233	0.688399	74,337	3.568	4,460	3,070	0.80112	2,460
10	0.059782	0.647245	72,529	3.790	4,352	2,817	0.77186	2,174
11	0.064614	0.605424	70,926	3.838	4,256	2,576	0.76637	1,974
12	0.069729	0.563208	69,393	3.885	4,164	2,345	0.76055	1,783
13	0.075129	0.520895	67,925	3.933	4,076	2,123	0.75442	1,602
14	0.081346	0.478522	66,521	3.980	3,991	1,910	0.74799	1,429
15	0.087988	0.436418	65,177	4.028	3,911	1,707	0.74126	1,265
16	0.095054	0.394935	63,891	4.075	3,833	1,514	0.73425	1,112

17	0.102537	0.354440	62,661	4.123	3,760	1,333	0.72696	969
18	0.110440	0.315295	61,485	4.170	3,689	1,163	0.71940	837
19	0.117691	0.278188	60,360	4.218	3,622	1,007	0.71159	717
20	0.125100	0.243386	59,284	4.265	3,557	866	0.70354	609
21	0.132647	0.211102	58,255	4.313	3,495	738	0.69525	513
22	0.140309	0.181482	57,272	4.360	3,436	624	0.68673	428
23	0.148066	0.154611	56,333	4.408	3,380	523	0.67800	354
24	0.163725	0.129297	55,436	4.455	3,326	430	0.66907	288
25	0.182176	0.105742	54,579	4.503	3,275	346	0.65995	229
26	0.204277	0.084142	53,762	4.550	3,226	271	0.65064	177
27	0.231053	0.064701	52,983	4.598	3,179	206	0.64117	132
28	0.263745	0.047636	52,239	4.645	3,134	149	0.63154	94
29	0.287334	0.033949	51,532	4.693	3,092	105	0.62176	65
30	0.314649	0.023267	50,858	4.740	3,051	71	0.61185	43
31	0.346177	0.015212	50,217	4.788	3,013	46	0.60181	28
32	0.382403	0.009395	49,608	4.835	2,976	28	0.59167	17
33	0.423813	0.005413	49,030	4.883	2,942	16	0.58142	9
34	0.470893	0.002864	48,482	4.930	2,909	8	0.57108	5
35	0.524128	0.001363	47,964	4.978	2,878	4	0.56067	2
36	0.584004	0.000567	47,473	5.025	2,848	2	0.55019	1
37	0.651007	0.000198	47,010	5.073	2,821	1	0.53965	0
38	0.725622	5.43E-05	46,574	5.120	2,794	0	0.52907	0

							Total Fair Value of Donor's Interest	<u>\$52,543</u>
Life expectancy	<u>13.441806</u>						Total Fair Value of ABC Charity's Interest	<u>\$47,457</u>

96. The calculation in exhibit 1 incorporates a yield curve and mortality probabilities. The Financial Reporting Executive Committee believes that a shortcut method would provide an adequate estimate of fair value in circumstances in which the results would not be materially different than the more precise method illustrated in exhibit 1. Exhibit 2 presents a shortcut calculation for the same fact set as exhibit 1.

EXHIBIT 2

97. Rather than using annual mortality statistics, the beneficiary's life expectancy is used, and 13.44 years (exhibit 1) is rounded to 14 years. Instead of using the yield curve used in exhibit 1, the average return over the life of the beneficiary is projected. The boxes indicate observable market returns. As in exhibit 1, the return on Treasuries after year 10 is imputed using a linear interpolation of the 10-year and 30-year rates. Thus, the average return is computed as follows:

1-year Treasury	0.47%
2-year Treasury	0.86%
3-year Treasury	1.29%
4-year Treasury	1.64%
5-year Treasury	1.98%
6-year Treasury	2.21%
7-year Treasury	2.44%
8-year Treasury	2.67%
9-year Treasury	2.90%
10-year Treasury	3.12%
11-year Treasury	3.17%
12-year Treasury	3.22%
13-year Treasury	3.26%
14-year Treasury	3.31%
	32.55%
Average Treasury	2.32%
Swap spread	0.67%

Average return	<u>2.99%</u>
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The average return is used to compute the return on the investments in the portfolio for purposes of estimating the trust assets at the beginning of the year. It is also used as the discount rate, which is computed using the formula $1 / (1 + \text{interest rate})^n$, in which n is the number of years. The estimate of the obligation to the beneficiary and ABC Charity's contribution is as follows, using the shortcut method:

Estimate of Fair Value of Obligation to the Beneficiary and ABC Charity's Contribution

	<i>Projected Trust Balance: Beginning of Year</i>	<i>Projected Trust Income</i>	<i>Projected Trust Payout</i>	<i>Present Value Factor</i>	<i>Present Value of Payout</i>
	$A = A_{\text{prev}} + B_{\text{prev}} - C_{\text{prev}}$	$B = A \times 2.993\%$	$C = A \times 6\%$	D	E = C x D
Year 1	\$100,000	\$2,993	\$6,000	0.9709	\$5,826
Year 2	96,993	2,903	5,820	0.9427	5,486
Year 3	94,077	2,816	5,645	0.9153	5,167
Year 4	91,249	2,731	5,475	0.8887	4,866
Year 5	88,505	2,649	5,310	0.8629	4,582
Year 6	85,844	2,570	5,151	0.8378	4,315
Year 7	83,263	2,492	4,996	0.8135	4,064
Year 8	80,760	2,417	4,846	0.7898	3,827
Year 9	78,331	2,345	4,700	0.7669	3,604
Year 10	75,976	2,274	4,559	0.7446	3,394
Year 11	73,692	2,206	4,422	0.7229	3,196
Year 12	71,476	2,140	4,289	0.7019	3,010
Year 13	69,327	2,075	4,160	0.6815	2,835
Year 14	67,243	2,013	4,035	0.6617	<u>2,670</u>
Total Fair Value of Donor's Interest					<u>\$56,842</u>

98. The shortcut method in exhibit 2 results in an obligation to the beneficiary of \$56,842 as compared with \$52,543 in the more exact method in exhibit 1, which is a difference of \$4,299 or 8 percent. The primary reason for the difference is the use of the average return over the life expectancy of the beneficiary instead of the yield curve. In circumstances in which the average return is used, and the yield curve is upward sloping (as is typical), the trust assets are not depleted as rapidly, and the projected payments to the beneficiary are larger.

99. Exhibits 1 and 2 used a risk-neutral rate adjusted by the swap spread as the projected return on the trust assets and discount rate. As discussed in paragraph 90, if a not-for-profit entity (NFP) uses the projected earnings rate on the trust assets in the PV calculation, and the NFP is complying with all its fiduciary duties as trustee, best practice is to use that projected earnings rate as the discount rate. Exhibit 3 presents a shortcut calculation for the same fact set as exhibits 1 and 2 but uses the projected earning rate on the trust assets as the discount rate, rather than the risk-neutral rate.

EXHIBIT 3

100. The beneficiary's life expectancy from exhibit 1 (13.44 years) is rounded to 14 years. Instead of using the yield curve used in exhibit 1 or the average return over the life of the beneficiary used in exhibit 2, the projected return on the portfolio of 4 percent is used as the discount rate and rate of return on the trust assets.

101. The shortcut method in exhibit 3 results in an obligation to the beneficiary of \$56,479 as compared with \$52,543 in the more exact method in exhibit 1, a difference from exhibit 1 of \$3,936 or 7.5 percent. The primary reason for the difference is the use of the average return on trust investments over the life expectancy of the beneficiary instead of the yield curve. In circumstances in which the average return is used, and the yield curve is upward sloping (as is typical), the trust assets are not depleted as rapidly, and the projected payments to the beneficiary are larger. The difference from the shortcut method using the risk-neutral rate is negligible (\$56,842 compared with \$56,479).

Estimate of Fair Value of Obligation to the Beneficiary and ABC Charity's Contribution

	<i>Projected Trust Balance: Beginning of Year</i>	<i>Projected Trust Income</i>	<i>Projected Trust Payout</i>	<i>Present Value Factor</i>	<i>Present Value of Payout</i>
	$A = A_{\text{prev}} + B_{\text{prev}} - C_{\text{prev}}$	$B = A \times 4\%$	$C = A \times 6\%$	D	$E = C \times D$
Year 1	\$100,000	\$4,000	\$6,000	0.9615	\$5,769

Year 2	98,000	3,920	5,880	0.9246	5,436
Year 3	96,040	3,842	5,762	0.8890	5,123
Year 4	94,119	3,765	5,647	0.8548	4,827
Year 5	92,237	3,689	5,534	0.8219	4,549
Year 6	90,392	3,616	5,424	0.7903	4,286
Year 7	88,584	3,543	5,315	0.7599	4,039
Year 8*	86,813	3,473	5,209	0.7307	3,806
Year 9	85,076	3,403	5,105	0.7026	3,586
Year 10	83,375	3,335	5,002	0.6756	3,380
Year 11	81,707	3,268	4,902	0.6496	3,185
Year 12	80,073	3,203	4,804	0.6246	3,001
Year 13	78,472	3,139	4,708	0.6006	2,828
Year 14	76,902	3,076	4,614	0.5775	2,665
Total Fair Value of Donor's Interest					<u>\$56,479</u>
Total Fair Value of ABC Charity's Interest					<u>\$43,521</u>

102. To determine the sensitivity of the fair value measurements to changes in the rate used for the investment return, a not-for-profit entity (NFP) or its auditors can perform a sensitivity analysis by substituting different rates of return and discount rates into the spreadsheet used to compute the fair value estimates. Doing so results in the following values of the obligation, using the shortcut method, and the following rates. Readers are reminded that the discount rate would equal the projected rate of return on the investments if the NFP is complying with all of its fiduciary duties as trustee.

<i>Portfolio Return</i>	<i>Discount Rate</i>	<i>Obligation</i>
2.99%	2.99%	\$56,842
1.00	1.00	57,574
2.00	2.00	57,205
4.00	4.00	56,479

Changes in Valuation Techniques

103. In accordance with paragraphs 25–26 of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820-10-35, a change in a valuation technique or its application (for example, a change in its weighting when multiple valuation techniques are used or a change in an adjustment applied to a valuation technique) is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. That might be the case if, for example, any of the following events occur:

- a. New markets develop.
- b. New information becomes available.
- c. Information previously used is no longer available.
- d. Valuation techniques improve.
- e. Market conditions change.

Revisions resulting from a change in the valuation technique or its application are accounted for as a change in accounting estimate. The disclosure provisions of FASB ASC 250, *Accounting Changes and Error Corrections*, for a change in accounting estimate are not required for revisions resulting from a change in a valuation technique or its application.

6.89

Appendix B — Journal Entries

B-1 This appendix provides journal entries related to the examples in paragraphs 6.53–.87.

B-2 *Charitable Lead Trust (not-for-profit entity [NFP] is trustee)* (paragraphs 6.54–.57).

NFP A enters into an irrevocable charitable lead annuity trust arrangement with a donor whereby

- the donor establishes a trust with NFP A serving as trustee.
- the terms of the trust are that NFP A is to receive an annuity of \$X per year until the donor's death.

- distributions received from the trust by NFP A are unrestricted.
- upon the death of the donor, the remaining balance in the trust passes to the donor's estate.

Solution:

Creation of the trust:

dr.	Assets Held in Charitable Lead Trust	
		cr.
		Liability for Amounts Held for Others
		cr.
		Contribution Revenue—Temporarily Restricted

(Assets and revenue measured at fair value when received, as discussed in paragraphs 6.13–.15)

Over the term of the trust:

dr.	Assets Held in Charitable Lead Trust	
		cr.
		Liability for Amounts Held for Others
	(Trust income and changes in fair value of assets held in trust, to the extent recognized)	
dr.	Cash	
		cr.
		Assets Held in Charitable Lead Trust
	(Distribution of income to NFP)	
dr.	Temporarily Restricted Net Assets—Reclassifications Out	
		cr.
		Unrestricted Net Assets—Reclassifications In
	(Reclassification of amounts received by NFP)	
dr.	Liability for Amounts Held for Others	
		cr.
		Change in Value of Split-Interest Agreements—Temporarily Restricted

(Amortization of discount and revaluation based on changes in actuarial assumptions—debit and credit could be reversed)

Termination of the trust:

dr.	Liability for Amounts Held for Others	
dr.	Change in Value of Split-Interest Agreements—Temporarily Restricted (or cr.)	
cr.		Assets Held in Charitable Lead Trust
(Return of assets to donor's estate)		

B-3 Charitable Lead Trust (NFP is not trustee) (paragraph 6.59).

The fact situation is the same as in the previous example except that the NFP is not the trustee.

Solution:

Creation of the trust:

dr.	Beneficial Interest in Lead Trust	
cr.		Contribution Revenue—Temporarily Restricted
(Beneficial interest in trust assets measured at fair value, as discussed in paragraphs 6.20–.27.)		

Over the term of the trust:

dr.	Cash	
cr.		Beneficial Interest in Lead Trust
(Distribution of income to NFP)		
dr.	Temporarily Restricted Net Assets—Reclassifications Out	
cr.		Unrestricted Net Assets—Reclassifications In
(Reclassification of amount received by NFP)		
dr.	Beneficial Interest in Lead Trust	
cr.		Change in Value of Split-Interest Agreements—Temporarily Restricted

(Change in fair value—debit and credit could be reversed)

Termination of the trust:

dr.	Change in Value of Split-Interest Agreements—Temporarily Restricted	
	cr.	Beneficial Interest in Lead Trust
		(Closeout interest)

B-4 Perpetual Trust Held by a Third Party (paragraphs 6.61–.64).

Donor enters into an irrevocable perpetual trust agreement with a third-party trustee with NFP B as the income beneficiary whereby

- the donor establishes a trust with its bank serving as trustee, with a payment to the trust to be invested in perpetuity by the trustee.
- the terms of the trust are that NFP B is to be the sole beneficiary and receive the income on the trust assets as earned in perpetuity with no restrictions on its use.

Solution:

Creation of the trust:

dr.	Beneficial Interest in Perpetual Trust	
	cr.	Contribution Revenue— Permanently Restricted
		(Assets and revenue measured at fair value, as discussed in paragraphs 6.24–.27 and in paragraph 6.63.)

Each period:

dr.	Cash	
	cr.	Investment Income (Unrestricted)
		(Income received from trust [net asset class based on stipulations of the trust])
dr.	Beneficial Interest in Perpetual Trust	
	cr.	Gain or Loss—Permanently Restricted

(To adjust asset for changes in fair value—debit and credit could be reversed)

B-5 Charitable Remainder Trust (NFP is trustee) (paragraphs 6.66–.69).

NFP C enters into a charitable remainder unitrust agreement with a donor whereby

- a trust is established by the donor to be administered by NFP C.
- the donor's spouse is to receive an annual distribution of X percent of the fair market value of the trust's assets each year until the spouse dies.
- at the time of death of the donor's spouse, the remaining assets of the trust are to be distributed to NFP C as permanent endowment.

Solution:

Creation of the trust:

dr.	Assets Held in Charitable Remainder Trust	
	cr.	Liability Under Unitrust Agreement
		Contribution Revenue—
	cr.	Permanently Restricted
(Assets and liability, as discussed in paragraphs 6.13–.18.)		

Over the term of the trust:

dr.	Assets Held in Charitable Remainder Trust	
	cr.	Liability Under Unitrust Agreement
(Trust income and change in fair value of assets held in trust, to the extent recognized)		

dr.	Liability Under Unitrust Agreement	
		Assets Held in Charitable
	cr.	Remainder Trust

(Payment to beneficiary)

dr.	Liability Under Unitrust Agreement	
		Change in Value of Split-Interest
	cr.	Agreements—Permanently

Restricted

(Amortization of discount and adjustment of liability to reflect change in actuarial assumptions—debit and credit could be reversed)

Termination of the trust:

dr. Liability Under Unitrust Agreement

cr. Change in Value of Split-Interest
Agreements—Permanently
Restricted

(To close liability)

dr. Endowment Assets

cr. Assets Held in Charitable
Remainder Trust

(To close trust and recognize assets as endowment)

B-6 Charitable Remainder Trust (NFP is not trustee) (paragraph 6.71).

The fact situation is the same as in the previous example, except that the NFP does not serve as trustee.

Solution:

Creation of the trust:

dr. Beneficial Interest in Remainder Trust

cr. Contribution Revenue—
Permanently Restricted

(Beneficial interest measured at fair value, as discussed in paragraphs 6.20–.27.)

Over the term of the trust:

dr. Beneficial Interest in Remainder Trust

cr. Change in Value of Split-Interest
Agreements—Permanently
Restricted

(Change in fair value—debit and credit could be reversed)

Termination of the trust:

dr. Endowment Assets

cr. Beneficial Interest in Remainder
Trust

cr. Change in Value of Split-Interest
Agreements—Permanently
Restricted

(NFP receives distribution of trust assets from trustee, measured at fair value; the receivable account is closed and the change in value of split-interest agreements reflects the difference)

B-7 *Charitable Gift Annuity* (paragraphs 6.73–.76).

NFP D enters into a charitable gift annuity contract with a donor whereby

- assets are transferred to NFP D and are available for unrestricted use by NFP D.
- NFP D agrees to pay a stated dollar amount annually to the donor's spouse until the spouse dies, at which time the remaining assets are available for the unrestricted use of NFP D.

Solution:

Creation of the annuity:

dr. Assets

cr. Annuity Payment Liability

cr. Contribution Revenue—
Unrestricted

(Assets and liabilities are measured at fair value when received, as discussed in paragraphs 6.13–.19.)

Over the term of the annuity:

dr. Annuity Payment Liability

cr. Cash

(Payment to annuity beneficiary)

dr. Change in Value of Split-Interest Agreements—Unrestricted

cr. Annuity Payment Liability

(Amortization of discount on liability and recording of any change in the life expectancy of the beneficiary—debit and credit could be reversed)

Termination of the annuity:

dr.	Annuity Payment Liability	
		Change in Value of Split-Interest Agreements—Unrestricted
	cr.	

(To close the annuity payment liability)

B-8 Pooled (Life) Income Fund (paragraphs 6.78–.81).

NFP E forms, invests, and manages a pooled income (or life-income) fund. The fund is divided into units, and contributions from many donors are pooled. Donors are assigned a specific number of units based on the proportion of the fair market value of the contribution to the total fair market value of the fund. A donor makes a contribution to the fund, is assigned a specific number of units, and will receive the actual income earned on those units until his or her death. The assets contributed must be invested in the fund until the donor's death. At that time, the value of the units assigned to the donor will revert to NFP E, and those assets will be available to NFP E without restriction.

Solution:

Contribution of assets:

dr.	Assets of Pooled Income Fund	
		Contribution Revenue—Temporarily Restricted
	cr.	
		Discount for Future Interest (Deferred Revenue)
	cr.	

(Assets and contribution revenue recorded at fair value on date of receipt, as discussed in paragraph 6.28.)

Over the term of the agreement:

dr.	Assets of Pooled Income Fund	
		Liability to Life Beneficiary
	cr.	

(Income earned on units assigned to donor)

dr.	Liability to Life Beneficiary	
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	cr.	Assets of Pooled Income Fund
	(Payment to life beneficiary)	
	dr.	Discount for Future Interest (Deferred Revenue)
		Change in Value of Split-Interest Agreements—Temporarily Restricted
	cr.	
	(Amortization of discount and changes in the life expectancy of the beneficiary)	
Termination of the agreement:		
	dr.	Discount for Future Interest (Deferred Revenue)
		Change in Value of Split-Interest Agreement—Unrestricted
	cr.	
	(To close discount upon the death of the life beneficiary)	
	dr.	Cash or Investment Assets
	cr.	Assets of Pooled Income Fund
	(To recognize assets available for use upon the death of the life beneficiary)	
	dr.	Temporarily Restricted Net Assets—Reclassification Out
	cr.	Unrestricted Net Assets—Reclassification In
	(Reclassification based on the expiration of the time restriction)	

B-9 *Life Interest in Real Estate* (paragraphs 6.83–.86).

A donor irrevocably transfers title to her personal residence to NFP G, retaining the right for the donor and the donor's spouse to use the residence until their deaths. The contract between the donor and NFP G specifies that the donor pays continues to pay the executory costs for the property, including maintenance costs, property taxes, insurance, utilities, and similar costs.

Solution:

Contribution of assets:

dr.	Residence Held Subject to a Life Interest
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cr. Contribution Revenue—Temporarily Restricted

cr. Use Interest of Beneficiary (Deferred Revenue)

(Assets and contribution revenue recorded at fair value on date of receipt, as discussed in paragraph 6.84)

Over the term of the agreement:

dr. Use Interest of Beneficiary (Deferred Revenue)

cr. Change in Value of Split-Interest Agreements—Temporarily Restricted

(Amortize use obligation for donor's use of residence for a year)

dr. Use Interest of Beneficiary (Deferred Revenue)

cr. Change in Value of Split-Interest Agreements—Temporarily Restricted

(Amortization of discount and changes in the life expectancy of the beneficiary)

Termination of the agreement:

dr. Use Interest of Beneficiary (Deferred Revenue)

cr. Change in Value of Split-Interest Agreement—Temporarily Restricted

(To close use interest upon the death of both the donor and the donor's spouse)

dr. Temporarily Restricted Net Assets—Reclassification Out

cr. Unrestricted Net Assets—Reclassification In

(Reclassification based on the expiration of the time restriction)

dr. Investment or Assets Held for Sale

cr. Residence Held Subject to Life Interest

(To recognize assets available for use upon the death of donor and the donor's spouse)

Chapter 7

Other Assets

Introduction

- 7.01** Some assets held by not-for-profit entities (NFPs) are similar to those held by for-profit entities. This chapter considers assets that are not discussed elsewhere in this guide and that present accounting issues unique to NFPs.

Inventory

- 7.02** NFPs may acquire merchandise inventory for resale; for example, items held for sale by a bookstore, dining service, kitchen, or thrift shop. Merchandise inventory may be acquired by NFPs in exchange transactions or from contributions. Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 330, *Inventory*, discusses the general principles applicable to inventory.
- 7.03** Pursuant to FASB ASC 958-605-25-2 and FASB ASC 958-605-30-2, contributions of inventory should be reported in the period received and should be measured at fair value. The FASB ASC glossary defines *fair value* as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” Consistent with the FASB ASC glossary definition of fair value, the fair value of contributed inventory is its estimated selling price. (Paragraphs 3.137–.167 discuss FASB ASC 820, *Fair Value Measurement*, which defines fair value, establishes a framework for measuring fair value, and identifies required disclosures about fair value measurements.)
- 7.04** Pursuant to FASB ASC 958-605-25-4, a major uncertainty about the existence of value may indicate that an item received or given should not be recognized. For example, a gift of clothing or furniture has no value unless it can be utilized in either of the following ways: (a) used internally by the NFP or for program purposes or (b) sold by the NFP. (Paragraphs 5.122–.148 discuss gifts in kind.)
- 7.05** Pursuant to FASB ASC 958-605-30-9, inputs for measuring fair value may be obtained from published catalogs, vendors, independent appraisals, and other sources. If methods such as estimates, averages, or computational approximations, such as average value per pound or subsequent sales, can reduce the cost of measuring the fair value of inventory, use of those methods is appropriate, provided the methods are applied consistently, and the results of applying those methods are reasonably expected not to be materially different from the results of a detailed measurement of the fair value of contributed inventory.

- 7.06** FASB ASC 330-10-35-1 states that when there is evidence that the utility of goods, in their disposal in the ordinary course of business, will be less than cost, whether due to physical deterioration, obsolescence, changes in price levels, or other causes, the difference should be recognized as a loss of the current period. This is generally accomplished by stating such goods at a lower level commonly designated as market. The term *market* means current replacement cost (by purchase or by reproduction, as the case may be) provided that it meets both of the following conditions: (a) market should not exceed the net realizable value, and (b) market should not be less than net realizable value reduced by an allowance for an approximately normal profit margin. Technical Questions and Answers (TIS) section 6140.01, “Inventory Valuation for a Not-for-Profit Scientific Entity” (AICPA, *Technical Practice Aids*), provides an example of an NFP that produces products that are sold at a price less than cost. The difference between cost and sale proceeds is covered by contributions. TIS section 6140.01 states that the fact that the difference between the sales proceeds and the costs is covered by contributions does not change the application of the requirements of FASB ASC 330-10, and that inventories should be valued at lower of cost or market.
- 7.07** Consistent with FASB ASC 958-225-45-4, sales of inventory or other assets that are part of an NFP’s ongoing major or central operations and activities should be reported separately from (and therefore in addition to) the reporting of the contribution of the inventory items, with a corresponding cost of sales. As noted in paragraphs 5.149–.150, sales of tickets, gift certificates, works of art, and other merchandise that were contributed for the purpose of being transferred to others during fund-raising events should be recognized as adjustments to the original contributions when the items are sold to the ultimate resource providers (recipients) during the fund-raising event. For other sales of inventory, either gross or net reporting is permitted if the sales are incidental or peripheral transactions. The Financial Reporting Executive Committee (FinREC) recommends that sales that result from incidental or peripheral transactions be reported net, similar to gains and losses.
- 7.08** Examples of transactions that typically result in reporting the sale of contributed assets as sales and costs of sales (gross reporting) include the following:
- Items produced or processed in vocational training workshops that are part of the NFP’s mission
 - Items contributed to the NFP and subsequently sold in its thrift shops that are operated as part of the NFP’s mission
 - Used cars contributed and sold by an NFP that has a vehicle donation program
- 7.09** Examples of transactions that typically result in reporting the sale of contributed assets as a gain or loss (net reporting) include the following:

- Excess food, medicine, clothing, and so on that was received by the NFP as a contribution but that is beyond the NFP's current needs, assuming the transaction is peripheral or incidental
- Sales of long-lived assets, such as office equipment or real estate, that was received by the NFP as a contribution but that is beyond the NFP's current needs, assuming the transaction is peripheral or incidental
- A used car sold by an NFP that only occasionally receives donated vehicles

Acting as an Agent in a Sale of Commodities

- 7.10** Some NFPs receive commodities subject to agreements that require that the commodities be sold (monetized) upon receipt and the proceeds be used to perform under a grant agreement. Commodities received for monetization usually have specific limitations on their sale, such as limiting the sale to purchasers in a specific country, specifying a minimum price that must be obtained upon sale, and requiring that the NFP perform a study to ensure that the sale will not disrupt the marketplace in that country. The NFP typically is acting as an agent in the transaction to monetize the commodities, and does not recognize revenue or cost of goods sold for the sale of the commodities. Instead the cash proceeds of the sale are recognized as if the grant were a cash grant. If the NFP holds title to the commodities at the reporting date, FinREC recommends that the NFP include the value of the commodities on the statement of financial position as an asset and an offsetting liability. The amount to be reported would be the value of the commodities as contractually agreed upon with the principal in the transaction.

Prepaid Expenses, Deferred Costs, and Similar Items

- 7.11** NFPs may incur costs that will result in benefits to future periods rather than solely to current-period activities. Except as discussed elsewhere in this guide, the recognition and measurement principles for those costs are similar to those used by business entities. Accordingly, amounts expended for prepaid expenses and deposits should be reported as assets. Prepaid expenses are typically used up or expire within the normal operating cycle of an entity. The term *prepaid expense* derives from the fact that they are paid in advance of their use or consumption.
- 7.12** For example, a performing arts organization might report as assets production costs relating to performances that will occur in the next fiscal period; or a museum might report exhibit costs for hosting an upcoming traveling exhibit. (Certain of these costs might be characterized as property, plant, or equipment, or as start-up costs.) Whether the costs of such activities should be reported as assets, rather than expensed, depends on whether a future economic benefit exists, either in the form of future cash inflows or service potential.

- 7.13** Future benefits of prepaid assets may be realized through service potential by providing desired or needed goods or services to beneficiaries or other constituents, particularly if the NFP does not intend to charge a fee for the future activity to which the costs relate. Accordingly, deferral of costs may be appropriate even in circumstances in which the activity is expected to generate no net cash inflows.
- 7.14** NFPs should consider the following guidance when determining whether they have transactions and activities that result in prepaid expenses and deferred costs as of the date of the statement of financial position:
- Chapter 13, “Expenses, Gains and Losses,” which provides specific guidance pertaining to fund-raising costs, advertising costs, start-up activities, organization costs, and internal-use computer software costs.
 - FASB ASC 985-20, which applies to computer software to be sold, leased, or otherwise marketed as a separate product or as part of a product or process.
 - FASB ASC 985-705-S99, which applies to film and software costs associated with developing entertainment and educational software products. Although that guidance applies only to public registrants, FinREC believes it provides appropriate guidance for NFPs undertaking similar projects.
 - FASB ASC 926-20, which applies to costs incurred by producers or distributors of feature films, television specials, television series, or similar products (including animated films and television programming) that are sold, licensed, or exhibited, regardless of whether the content is produced on film, videotape, digital or other video recording format.
 - FASB ASC 350-50, which applies to website development costs.
- 7.15** If an NFP has prepaid expenses or deferred costs, it should determine the period over which the asset is consumed (and therefore amortized) based on how the economic benefit underlying the asset is used up or lost. Long-term prepaid assets are subject to impairment tests under FASB ASC 360-10.

Collections and Works of Art, Historical Treasures, or Similar Assets

- 7.16** The FASB ASC glossary defines *collections* as follows:

Works of art, historical treasures, or similar assets that meet all of the following criteria: (a) They are held for public exhibition, education, or research in furtherance of public service rather than financial gain, (b) They are protected, kept unencumbered, cared for, and preserved, and (c) They are subject to an organizational policy that requires the proceeds of items that are sold to be used to acquire other items for collections.

- 7.17** FASB ASC 958-360-25-3 states that an NFP that holds works of art, historical treasures, and similar items that meet the definition of a collection has the following three alternative policies for reporting that collection: (a) capitalization of all collection items, (b) capitalization of all collection items on a prospective basis (that is, all items acquired after a stated date), or (c) no capitalization. Capitalization of selected collections or items is precluded.
- 7.18** Accounting for collections depends on whether an NFP adopts a policy of recognizing collections as assets. If an NFP adopts a policy of capitalizing collections, items acquired in exchange transactions should be recognized as assets in the period in which they are acquired and should be measured at cost. Per FASB ASC 958-605-25-19 and FASB ASC 958-605-30-2, contributed collection items should be recognized as assets and as revenues or gains if collections are capitalized^{fn 1} and should be measured at fair value. Items acquired in a nonmonetary exchange should be measured in accordance with FASB ASC 845-10-30. As discussed in FASB ASC 958-605-25-4, if an item is accepted solely to be saved for its potential future use in scientific or educational research and has no alternative use, it may have uncertain value, or perhaps no value, and should not be recognized.
- 7.19** As discussed in FASB ASC 820-10-35-9, an NFP should measure the fair value of an asset using the assumptions that market participants would use in pricing the asset, assuming that market participants act in their economic best interest. In developing those assumptions, an NFP need not identify specific market participants. Rather, the reporting entity should identify characteristics that distinguish market participants generally. Market participant assumptions should include assumptions about the effect of a restriction on the sale or use of an asset if market participants would consider the effect of the restriction in pricing the asset. Example 6 (paragraphs 51–55) of FASB ASC 820-10-55 explains that restrictions that are a characteristic of an asset, and therefore would transfer to a market participant, are the only restrictions reflected in fair value. Donor restrictions that are specific to the donee are reflected in the classification of net assets, not in the measurement of fair value. For example, a donor contributes a painting to a museum and specifies that the painting be added to the museum's permanent collection and, if it is sold, the proceeds of the sale be used to purchase another collection item. That restriction is not a characteristic of the painting itself and would not transfer to a purchaser of the painting; therefore, the donor-imposed restriction has no effect on the

^{fn 1} As discussed in paragraphs 3–6 of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 958-605-45, contributions should be classified as increases in unrestricted, temporarily restricted, or permanently restricted net assets, depending on the existence and type of restrictions imposed by donors. Chapter 5, "Contributions Received and Agency Transactions," provides guidance concerning accounting for contributions with donor-imposed restrictions.

fair value of the painting (or the amount of the permanently restricted contribution if the museum capitalizes its collections).

- 7.20** FASB ASC 958-605-25-19 states that contributed collection items should not be recognized as revenues or gains if collections are not capitalized.
- 7.21** FASB ASC 958-230-55-5A states that cash flows from purchases, sales, and insurance recoveries of unrecognized, noncapitalized collection items should be reported as investing activities in a statement of cash flows. Additional disclosures described in paragraphs 7.26–.27 should be made if an NFP elects not to capitalize collections.
- 7.22** If collection items are capitalized, FASB ASC 958-360-35-5 requires depreciation to be recognized. The future economic benefits or service potentials of individual items comprising collections, works of art, historical treasures, and similar items—including those designated as landmarks, monuments, cathedrals, or historical treasures—are used up not only by wear and tear in intended uses but also by the continuous destructive effects of pollutants, vibrations, and so forth. The cultural, aesthetic, or historical values of those assets can be preserved, if at all, only by periodic major efforts to protect, clean, and restore them, usually at significant cost. Additionally, when collection items are capitalized, they should be tested for impairment in accordance with FASB ASC 360-10-35.
- 7.23** Per paragraphs 2–3 of FASB ASC 958-360-40, a contribution made by an NFP of a previously recognized collection item should be reported as an expense and a decrease in assets in the period in which the contribution is made, and should be measured at fair value. A gain or an impairment loss should be recognized on that contribution made if the collection item's fair value differs from its carrying amount. A contribution made by an NFP of a previously unrecognized collection item should not be recognized on the face of the financial statements. FASB ASC 958-360-50-6 requires disclosure of those contributions in notes to the financial statements.
- 7.24** FASB ASC 958-605-25-18 requires that contributions of works of art, historical treasures, and similar assets that are not part of a collection should be recognized as assets and as revenue or gains.^{fn 2} Per FASB ASC 958-605-30-2, those contributions should be measured at fair value. Items acquired in exchange transactions should be measured at cost. Works of art, historical treasures, and similar items that are not added to collections should be accounted for as either held for sale or held and used in accordance with FASB ASC 360-10-35, as discussed in chapter 9, “Plant, Property, and Equipment.”

Financial Statement Presentation of Collections

^{fn 2} See footnote 1.

7.25 In accordance with FASB ASC 958-360-45-3, if an NFP adopts a policy of capitalizing collections (as defined in the FASB ASC glossary) a statement of financial position should include the total amount capitalized on a separate line item, "Collections" or "Collection Items." Per FASB ASC 958-360-45-4, the amount capitalized for works of art, historical treasures, and similar assets that do not meet the definition of a collection should be disclosed separately on the face of the statement of financial position or in the notes.

7.26 FASB ASC 958-360-45-5 states that an NFP that does not recognize and capitalize its collections should report the following on the face of its statement of activities, separately from revenues, expenses, gains, and losses:

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

Similarly, an entity that capitalizes its collections prospectively should report proceeds from sales and insurance recoveries of items not previously capitalized separately from revenues, expenses, gains, and losses. Example 1 (paragraph 2) of FASB ASC 958-360-55 illustrates a statement of activities that satisfies these requirements. The statement of activities in that example reports purchases of collection items as a decrease in permanently restricted net assets if the collection items were purchased with contributions restricted for that purpose and the entity does not capitalize collections. It reports the proceeds of sales of collection items that had not been capitalized as increases in permanently restricted net assets if those collection items were contributed (or purchased with contributions restricted for that purpose). Purchases of collection items and proceeds of their sale are changes in unrestricted net assets if the collection items were neither donated nor purchased with contributions restricted for that purpose.

7.27 FASB ASC 958-360-50-6 states that an NFP that does not recognize and capitalize its collections or that capitalizes collections prospectively should describe its collections, including their relative significance, and its stewardship policies for collections. If collection items not capitalized are deaccessioned during that period, it also should describe the items given away, damaged, destroyed, lost, or otherwise deaccessioned during the period or disclose their fair value. In addition, FASB ASC 958-360-45-3 requires that a line item should be shown on the face of the statement of financial position that refers to the disclosures required by this paragraph. That line item should be dated if collections are capitalized prospectively, for example, "Collections acquired since January 1, 19X1 (Note X)." FASB ASC 958-360-50-1 requires that an NFP disclose (its chosen)

capitalization policy for collections (capitalization, prospective capitalization, or no capitalization).

Illustrative Disclosures About Collections

- 7.28** This section provides examples of notes to the financial statements that illustrate some of the financial statement disclosures concerning collection items.

Example 1—NFPs That Capitalize Collections

Note X: Summary of Significant Accounting Policies

The organization has capitalized its collections since its inception. If purchased, items accessioned into the collection are capitalized at cost, and if donated, they are capitalized at their fair value on the accession date (the date on which the item is accepted by the Acquisitions Committee of the Board of Trustees). Gains or losses on the deaccession of collection items are classified on the statement of activities as unrestricted or temporarily restricted support depending on donor restrictions, if any, placed on the item at the time of accession.

Example 2—NFPs That Capitalize Collections Retroactively

Note X: Summary of Significant Accounting Policies

In 19X1, the organization capitalized its collections retroactively. To the extent that reliable records were available, the organization capitalized collection items acquired prior to 19X1 at their cost at the date of purchase or, if the items were contributed, at their fair value at the accession date (the date on which the item was accepted by the Acquisitions Committee of the Board of Trustees). Other collection items, particularly those acquired prior to 19X1 when detailed curatorial records began to be maintained, have been capitalized at their appraised or estimated current market value. In some cases, collection items held solely for their potential educational value or historical significance were determined to have no alternative use and were not assigned values for the purpose of capitalization. The collection items capitalized retroactively were determined to have a total value of \$11,138,100.

Example 3—NFPs That Capitalize Their Collections Prospectively

Note X: Summary of Significant Accounting Policies

Collection items acquired on or after July 1, 19X0: Accessions of these collection items are capitalized at cost, if the items were purchased, or at their fair value on the accession date (the date on which the item is accepted by the Acquisitions Committee of the Board of Trustees), if the items were contributed. Gains or losses from deaccessions of these items are reflected on the statement of activities as changes in the appropriate net asset classes, depending on the existence and type of donor-imposed restrictions.

Collection items acquired prior to July 1, 19X0: Collection items purchased prior to July 1, 19X0, were recorded as decreases in unrestricted net assets. No financial statement recognition was made for contributed collection items. Proceeds from insurance recoveries or deaccessions of these items are reflected on the statements of activities as changes in the appropriate net asset classes, depending on the existence and type of donor-imposed restrictions.

Note Z: Collections

The organization's collections are made up of artifacts of historical significance, scientific specimens, and art objects. Each of the items is cataloged for educational, research, scientific, and curatorial purposes, and activities verifying their existence and assessing their condition are performed continuously.

During 20X1, a significant number of American pioneer artifacts from the 1800s were destroyed while in transit to an exhibition in which they were to be displayed. Because those items were purchased prior to July 1, 19X0, the insurance proceeds of \$22,000, which reimbursed the organization in full for the artifacts' fair value, are reflected as an increase in unrestricted net assets on the statement of activities. No other collection items were deaccessioned in 20X1 or 20X0.

Example 4—NFPs That Do Not Capitalize Collections

Note X: Summary of Significant Accounting Policies

The collections, which were acquired through purchases and contributions since the organization's inception, are not recognized as assets on the statement of financial position. Purchases of collection items are recorded as decreases in unrestricted net assets in the year in which the items are acquired, or as temporarily or permanently restricted net assets if the assets used to purchase the items are restricted by donors. Contributed collection items are not reflected on the financial statements. Proceeds from deaccessions or insurance recoveries are reflected as increases in the appropriate net asset classes.

Note Z: Collections

The organization's collections are made up of artifacts of historical significance, scientific specimens, and art objects that are held for educational, research, scientific, and curatorial purposes. Each of the items is cataloged, preserved, and cared for, and activities verifying their existence and assessing their condition are performed continuously. Collection items are subject to a policy that requires proceeds from their sales to be used to acquire other items for collections.

During 20X1, a significant number of American pioneer artifacts from the 1800s were destroyed while in transit to an exhibition in which they were to be displayed. These artifacts were contributed in 20XX, with a restriction that limited any future proceeds from deaccessions to acquisitions of artifacts from a similar period. As a result, the

insurance proceeds of \$22,000, which reimbursed the organization in full for the artifacts' fair value, are reflected as an increase in temporarily restricted net assets on the statement of activities. No other collection items were deaccessioned in 20X1 or 20X0.

Goodwill

- 7.29** As discussed in paragraph 3.132, goodwill is immediately charged to the statement of activities as of the acquisition date if the operations of the acquiree as part of the combined entity are expected to be predominantly supported by contributions and returns on investments. Per FASB ASC 958-805-25-9, *predominantly supported by* means that contributions and returns on investments are expected to be significantly more than the total of all other sources of revenues. If, instead, the operations of the acquiree are not expected to be predominantly supported by contributions and returns on investments, in conformity with FASB ASC 958-805-25-28, an NFP acquirer should recognize goodwill as an asset. FASB ASC 350-20 provides guidance for measuring goodwill subsequent to its acquisition. The following paragraphs summarize the guidance in FASB ASC 350-20, but are not a substitute for reading that guidance.
- 7.30** Goodwill that is recognized as an asset on the acquisition date should not be amortized. Instead, it should be tested annually for impairment at a level of reporting referred to as a reporting unit. (Paragraphs 33–46 of FASB ASC 350-20-35 provide guidance on determining reporting units.) Impairment is the condition that exists when the carrying amount of goodwill exceeds its implied fair value. The fair value of goodwill can be measured only as a residual and cannot be measured directly. Therefore, FASB ASC 350-20 includes a methodology to determine an amount that achieves a reasonable estimate of the value of goodwill for purposes of measuring an impairment loss. That estimate is referred to as the implied fair value of goodwill. Paragraphs 4–19 of FASB ASC 350-20-35 describe a two-step impairment test used to identify potential goodwill impairment and measure the amount of an impairment loss to be recognized (if any). An NFP has an unconditional option to assess qualitative factors before performing the two-step impairment test. If the NFP chooses to assess qualitative factors, it would assess relevant events and circumstances that could affect the fair value of the reporting unit, such as those in FASB ASC 350-20-35-3C. If, after assessing the qualitative factors, an entity determines that it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then the two-step goodwill impairment test is unnecessary. If an entity determines that it is more likely than not that the fair value of a reporting unit is less than its carrying amount, the two-step impairment test should be used to identify potential goodwill impairment and measure the amount of a goodwill impairment loss to be recognized (if any). If desired, an NFP may bypass the qualitative assessment described for any reporting unit in any period and proceed directly to performing the two-step goodwill impairment test.

Intangible Assets Other Than Goodwill

- 7.31** Some common examples of intangible assets of NFPs are brand identification (such as trademarks, service marks, collective marks, Internet domain names, and other marketing-related intangibles), donor lists, copyrights, and similar artistic-related intangibles, noncommercial broadcasting licenses, and patents.^{fn3} The cost of an intangible asset acquired other than in an acquisition by an NFP is capitalized in accordance with FASB ASC 350-30-25 and should be initially measured using the guidance in FASB ASC 805-50-15-3 and paragraphs 1–4 of FASB ASC 805-50-30. Capitalization of an intangible asset acquired in an acquisition by an NFP is discussed in paragraphs 3.125–.133.) After initial recognition and measurement, FASB ASC 350-30 provides the accounting and reporting of intangible assets other than goodwill. The following paragraphs summarize the guidance in FASB ASC 350-30, but are not a substitute for reading that guidance.
- 7.32** Under the requirements of FASB ASC 350-30, accounting for a recognized intangible asset is based on its useful life to the reporting entity. An intangible asset with a finite useful life should be amortized; an intangible asset with an indefinite useful life should not be amortized. FASB ASC 350-30-55 provides examples of intangible assets other than goodwill. If an intangible asset has a finite useful life, but the precise length of that life is not known, that intangible asset should be amortized over the best estimate of its useful life. The method of amortization should reflect the pattern in which the economic benefits of the intangible asset are consumed or otherwise used up. If that pattern cannot be reliably determined, a straight-line amortization method should be used. An intangible asset that is subject to amortization should be reviewed for impairment in accordance with the “Impairment or Disposal of Long-Lived Assets” subsections of FASB ASC 360-10 by applying the recognition and measurement provisions in paragraphs 17–35 of FASB ASC 360-10-35.
- 7.33** If an intangible asset is determined to have an indefinite useful life, it should not be amortized until its useful life is determined to be no longer indefinite. Instead, an intangible asset that is not subject to amortization should be tested for impairment annually (or more frequently if events or changes in circumstances indicate that the asset might be impaired), as described in paragraphs 15–20 of FASB ASC 350-30-35. FASB ASC 360-10-35-21 includes examples of impairment indicators. The impairment test should consist of a comparison of the fair value of an intangible asset with its carrying amount. If the carrying amount of an intangible asset exceeds its fair value, an impairment loss should be recognized in an amount equal to that excess.

^{fn3} In accordance with FASB ASC 350-30-25-3, costs of internally developing, maintaining, or restoring intangible assets that are not specifically identifiable, that have indeterminate lives, or that are inherent in a continuing business or nonprofit activity and related to an entity as a whole, should be recognized as an expense when incurred. Thus, many internally developed intangible assets are never recognized as assets.

Chapter 8

Programmatic Investments

Introduction

8.01 Instead of making cash grants to other entities, some not-for-profit entities (NFPs) provide benefits to their constituencies in the form of financial instruments. Like grants, these financial instruments have as their primary purpose the achievement of the NFP's programmatic mission. For example, an NFP might make a seed money grant to support a new performing arts organization or it might instead make a seed money loan. A foundation might make a grant to capitalize a community development loan fund or it might make long-term low interest loan to serve a similar purpose. However, as financial instruments, these other forms of financial support have the possibility of producing financial returns, and thus they share characteristics with an NFP's traditional investments. These financial instruments, referred to as programmatic investments, offer both financial and programmatic returns.

8.02 Examples of those types of programmatic investments include the following:

- Low-interest or interest-free loans to students with demonstrated financial need
- Student loans that will be forgiven upon the completion of a defined amount of community service after graduation
- Investments in nonprofit, low income housing projects
- Loans to small businesses owned by members of economically disadvantaged groups or individuals who are members of those groups, for whom commercial loans are not available or are not available at affordable interest rates
- Loans, typically of small dollar amounts, made to small businesses or individuals who lack access to banking and related services as a way to help the borrower out of poverty (referred to as microfinance)
- Investments in businesses in deteriorated urban areas under a plan to improve the economy of the area by providing employment or job training for residents
- Investments in NFPs that have a mission of combating community deterioration
- Guarantees of an NFP's debt, which increases the amount of credit available to that NFP because the guarantor assumes part or all of the third-party lender's risk

- 8.03** For the recipient, the primary benefit of a programmatic investment is access to capital, typically at more affordable terms than might otherwise be available. For the NFP investor, the principal benefits are the achievement and sustainability of the mission-related program—the repayment of the loan or the return of equity can be used again for a future charitable purpose. Thus, programmatic investments are a means of leveraging philanthropic dollars.
- 8.04** Some NFPs maintain formal programs that make programmatic investments on an annual basis. Others make programmatic investments when the opportunity presents itself.
- 8.05** As with any transfer of assets, a programmatic investment may not be used to generate significant private inurement or private benefit for any entity. (Private inurement and private benefit are discussed in paragraphs 15.08–.11.) When considering whether a programmatic investment results in private benefit or private inurement, the overall objectives of the investment should be documented. In Revenue Ruling 74-587, the IRS found that although some of the individuals receiving financial assistance may not themselves qualify for charitable assistance, that fact did not detract from the charitable character of the organization's program because the assistance to area businesses helped to relieve poverty, provide employment opportunities, and combat community deterioration, as well as helped to lessen prejudice and discrimination against minority groups.

Background

- 8.06** This chapter discusses the three most common types of programmatic investments—those in the form of loans, equity interests, or guarantees—and the accounting and disclosures by the investor. This chapter does not provide guidance for the investees.
- 8.07** Programmatic investments are defined for the purpose of this chapter as any investment by an NFP that meets the following two criteria:
- Its primary purpose is to further the tax exempt objectives of the NFP.
 - The production of income or the appreciation of the asset is not a significant purpose (that is, an investor seeking a market return would not enter into the investment).

The preceding definition is similar to that of the term *program-related investment*, which is defined in IRS Section 4944(c).

Core Considerations for Accounting and Reporting

- 8.08** The following are core considerations for determining the proper accounting for programmatic investments, regardless of their form:

- An assessment of whether an investment is programmatic or not is made when the initial investment transaction occurs.
- Because one of the goals of making programmatic investments is furthering the mission of the NFP and because, by definition, the production of income or the appreciation of the asset is not a significant consideration in the determination of whether to invest, programmatic investments often have a contribution element. If they do, the contribution made should be accounted for in accordance with the standards in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 720-25 and FASB ASC 958-720.
- Programmatic investments are subject to the same accounting standards as similar financial instruments, except for the contribution element, if any. Thus, loans are within the scope of the standards in FASB ASC 310, *Receivables*; ownership interests are subject to the standards for reporting relationships with related entities, including consolidation, equity method, and so forth (discussed in paragraphs 3.57–.120); and guarantees are subject to the standards in FASB ASC 460, *Guarantees*.
- The relative significance of the investments to an NFP's operations and financial position and the quantitative and qualitative risks arising from them is considered when determining the type of financial statement presentation and the extent of the disclosures. Thus, even though the amount of programmatic investments might quantitatively be considered immaterial, user needs for qualitative information are a consideration in determining the appropriate financial reporting.

Loans

- 8.09** Loans are the most common programmatic investment. Stated interest rates on programmatic investments may be below market when compared to loans to entities of similar credit risk, and often are set at very low interest rates. Loan terms vary considerably, based both on the needs of the borrower, the type of project and the needs and expectations of the NFP investor. Terms can range from periods of a few months to more than a decade. Longer term loans are typically associated with community development and real estate development projects.
- 8.10** When accounting for programmatic loans, NFPs look to two areas of FASB ASC, which may result in diversity of practice. Some NFPs look to the standards for loan accounting in FASB ASC 310 and to FASB ASC 835-30 on imputation of interest, and they impute a market interest rate on the loan that incorporates the risk that the NFP may be unable to collect from the borrower all contractually required payments of principal and interest, as discussed in paragraphs 8.11–.17. Other NFPs look to the FASB ASC definition of an inherent contribution, and they recognize the transaction as entirely a loan receivable, entirely a contribution, or in part a contribution and in part a loan receivable, as discussed in paragraphs 8.18–.33.

Effective Interest Rate Method

Loan Origination (Initial Recognition and Measurement)

- 8.11** In some cases, a programmatic loan (a) bears a market interest rate, and (b) the NFP expects at origination to collect all contractually required payments when due. In that case, at origination, the loan should be recognized at the amount of cash (or other assets) transferred to the borrower. In other cases, programmatic loans are interest free or have below-market interest rates, because a loan at an interest rate commensurate with the risk inherent in the expected cash flows would be unaffordable by the borrowers. FASB ASC 835-30-05-3 states that the use of an interest rate that varies from prevailing interest rates warrants evaluation of whether the face amount and the stated interest rate of a note or obligation provide reliable evidence for properly recording the exchange and subsequent related interest.
- 8.12** FASB ASC 835-30 provides guidance on the imputation of interest for receivables that are contractual rights to receive money on fixed or determinable dates, whether or not there is any stated provision for interest. As noted in paragraphs 2–3 of FASB ASC 835-30-25, when notes are traded in an open market, the market rate of interest and market value of the notes provide the evidence of the present value. When notes have no ready market, the problem of determining present value is more difficult. To estimate the present value of a note under such circumstances, an applicable interest rate is approximated that may differ from the stated rate. This process of approximation is called *imputation*, and the resulting rate is called an *imputed interest rate*.
- 8.13** Although, as noted in FASB ASC 835-30-25-6, a note issued solely for cash equal to its face amount is presumed to earn the stated rate of interest, in some cases the parties may also exchange unstated (or stated) rights or privileges, which are given accounting recognition by establishing a note discount or premium account. In the case of a programmatic loan, the difference between the cash transferred to the borrower and the present value of the contractual payments for the loan at the effective interest rate is typically recognized as a contribution expense.
- 8.14** Guidance for determining the appropriate rate to use in a present value calculation can be found in the following sources:
- Paragraphs 4–20 of FASB ASC 820-10-55
 - Paragraphs 12–13 of FASB ASC 835-30-25
 - Paragraphs 16–32 of the nonauthoritative AICPA White Paper *Measurement of Fair Value for Certain Transactions of Not-for-Profit Entities*, which are reproduced in appendix A of chapter 5, “Contributions Received and Agency Transactions”

When determining an appropriate interest rate, to the extent possible, an NFP would consider market inputs of the jurisdiction in which the loan is made. These might include the time value of money, credit standing of the borrower, collateral, duration of the loan, restrictive covenants, and liquidity. In the absence of market inputs, the NFP would use its own assumptions about the assumptions that market participants would use in the jurisdiction in which the loan is made.

- 8.15** For example, an arts organization borrows \$100,000 from a community foundation. The note is noninterest bearing, is unsecured, and a balloon payment is due at the end of the 5-year term. The community foundation determines that a market rate for a loan with the same terms and a borrower of equal credit worthiness as the arts foundation is 15 percent. The present value of the contractual payments due under the loan is \$49,720. Using the effective interest method, the community foundation would make the following entry:

Loan receivable	\$100,000	
Contribution expense	50,280	
Cash		\$100,000
Discount on loan receivable		50,280

Use of the Interest Method While the Loan is Outstanding

- 8.16** The discount on the loan is amortized as interest income over the life of the note in such a way as to result in a constant rate of interest when applied to the amount outstanding at the beginning of any given period, as described in FASB ASC 835-30-35-2. The difference between the periodic interest cost calculated using the interest method and the nominal interest on the outstanding amount of the debt is the amount of periodic amortization.
- 8.17** Continuing the example in paragraph 8.15, at the end of year 1, the community foundation would make the following entry to record the imputed interest income at 15 percent and the periodic amortization of the discount:

Discount on loan receivable	\$7,458	
Interest income		\$7,458

The carrying value of the loan after the previous entry is \$57,178 (\$100,000 – \$50,280 + \$7,458). This is the amount used when the community foundation tests for impairment, which is discussed in paragraphs 8.37–.46.

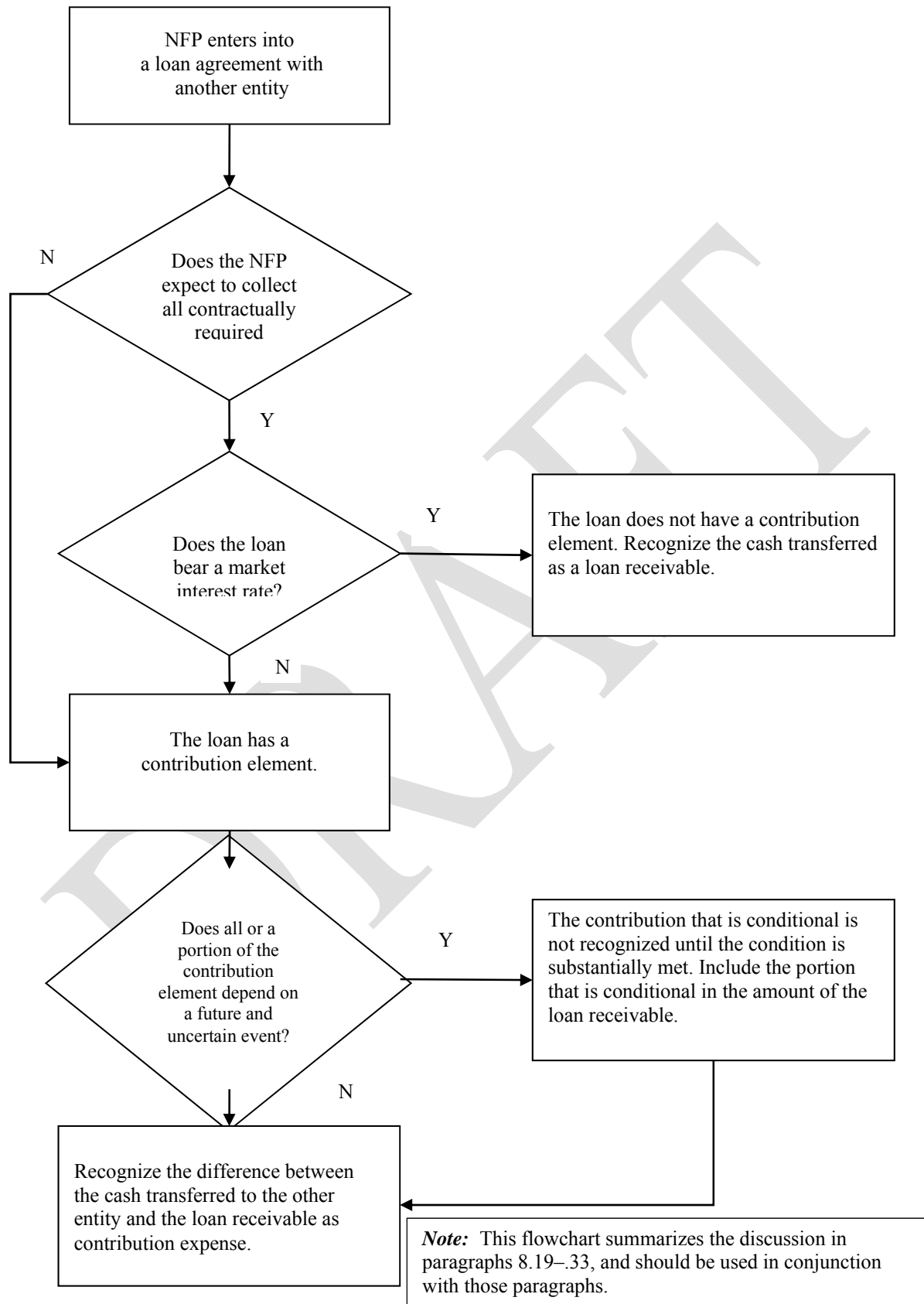
Inherent Contribution Method

Loan Origination (Initial Recognition and Measurement)

8.18 At origination, programmatic loans fit into one of following three categories—entirely a loan receivable, entirely a contribution, or in part a contribution and in part a loan receivable. Which of those is appropriate is determined by management’s best judgment after evaluation of the facts and circumstances available at the time of first accounting for the loan. Flowchart 8-1, which should be used in conjunction with the discussion in paragraphs 8.19–.33, may be helpful in making that determination.

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Flowchart 8-1: Origination of a Programmatic Loan, Inherent Contribution Method



- 8.19** In some cases, a programmatic loan (a) bears a market interest rate, and (b) the NFP expects at origination to collect all contractually required payments when due. Those loans do not contain a contribution element, and the NFP recognizes a loan receivable for the amount of the cash (or other assets) transferred to the borrower. For many programmatic loans, however, one or both of those criteria are not met at origination, and the amount of the loan receivable recognized will differ from the amount of cash (or other assets) transferred to the borrower.

Loans for Which the NFP Does Not Expect to Collect All Required Payments

- 8.20** In some cases, upon origination of a programmatic loan, it is probable that the NFP investor will be unable to collect from the borrower^{fn1} all contractually required payments of principal and interest. Those loans typically have a contribution element. The timing of recognition of the contribution element depends upon whether the contribution is unconditional or depends upon the occurrence of a specified future and uncertain event (conditional). Some loans contain both unconditional and conditional contribution elements. Paragraphs 8.13–.16 provide examples that help to determine when to recognize the contribution element(s).
- 8.21** Some NFPs make contributions to individuals or other entities and use a loan format even though the NFPs have little or no expectation of repayment. Those NFPs prefer to provide financial assistance in a loan format because loans are thought to be more effective instruments than grant agreements if the goal is helping the individual or entity achieve economic productivity and self-reliance. The body empowered to approve loan applications typically does not consider the so-called borrower's creditworthiness when determining whether to make the loan, and often does not intend to pursue collection if the loan becomes past due. In those facts and circumstances, the loan may be considered in substance a contribution to the borrower. At the origination date, those NFPs typically report the value of the cash (or other assets) transferred to the borrower as a contribution made.
- 8.22** In other cases, NFPs make loans to individuals or other entities with an expectation that some, but generally not all, of the principal and interest will be collected. The borrowers may be marginally creditworthy, but there is a lot of risk inherent in the expected cash flows, and it is probable or reasonably possible that the borrower will default. In those facts and circumstances, the loan contains a contribution element that is unconditional. At the origination date, those NFPs typically recognize the loan receivable at the present value of the cash flows most likely to be collected. The difference between the present value and the cash advanced (or fair value of other assets transferred to the borrower) would be recognized as a contribution made. It would not be appropriate, at origination, to establish a loss allowance.

^{fn1} This chapter uses the term *borrower* for the individual or entity to whom a loan is made, even though at origination there may be no expectation that the loan will be repaid.

- 8.23** Repeating the example in paragraph 8.15 using the inherent contribution method, an arts organization borrows \$100,000 from a community foundation. The note is noninterest bearing, is unsecured, and a balloon payment is due at the end of the 5-year term. The community foundation anticipates that at the due date of the balloon payment, it will most likely receive \$57,640. The present value of that most likely cash flow using the interest rate commensurate with the risks (3 percent) is also \$49,720.^{fn2} Using the inherent contribution method, the community foundation would make the following entry:

Loan receivable	\$57,640
Contribution expense	50,280
Cash	\$100,000
Discount on loans receivable	7,920

Use of the Interest Method While the Loan is Outstanding

- 8.24** The discount on the loan is amortized as interest income over the life of the note in such a way as to result in a constant rate of interest when applied to the amount outstanding at the beginning of any given period, as described in FASB ASC 835-30-35-2. The difference between the periodic interest cost so calculated using the interest method and the nominal interest on the outstanding amount of the debt is the amount of periodic amortization.
- 8.25** Continuing the example in paragraph 8.23, at the end of year 1, the community foundation would make the following entry to record the imputed interest income at 3 percent and the periodic amortization of the discount:

^{fn 2} Conceptually, the effective interest method and the inherent contribution method should yield the same loan value at origination because the objective of both measurements is to estimate the fair value (market value) of the loan at the origination date. The effective interest method uses contractual cash flows, which have a high uncertainty of collection. Therefore, the interest rate associated with contractual cash flows reflects that uncertainty, and is 15 percent in this example. In contrast, the inherent contribution method uses most likely cash flows, which incorporate some of the uncertainty of collection into the amount recognized as the inherent contribution. The interest rate associated with most likely cash flows is correspondingly lower, and is 3 percent in this example. Paragraphs 11-32 of the nonauthoritative AICPA White Paper *Measurement of Fair Value for Certain Transactions of Not-for-Profit Entities* provide additional information about the relationship between cash flows and interest rates when using present value techniques. Although those paragraphs discuss the present value concepts in terms of promises to give, the concepts themselves are the same. Those paragraphs are reproduced in appendix A of chapter 5, "Contributions Received and Agency Transactions."

Discount on loan receivable	\$1,492
Interest income	\$1,492

The carrying value of the loan after the previous entry is \$51,212 (\$57,640 – \$7,920 + \$1,492). This is the amount used when the community foundation tests for impairment, which is discussed in paragraphs 8.37–.46.

- 8.26** Still, in other cases, NFPs make loans to creditworthy borrowers, but to encourage the borrower to take a specific action that achieves programmatic objectives, the loan document includes conditions upon which all or a portion of the loan principal will be forgiven. Those loan documents contain conditional promises to give. Pursuant to FASB ASC 720-25-25 and FASB ASC 958-605-25-11, conditional promises to give, which depend on the occurrence of a specified future and uncertain event to bind the promisor, should be recognized when the conditions on which they depend are substantially met. Imposing a condition creates a barrier that must be overcome before the recipient of the transferred assets (in this case, the borrower) has an unconditional right to retain the promised assets (the loan proceeds). Thus, at origination, the loan typically would be recognized at the amount of cash (or other assets) transferred to the borrower. In other words, if there is a possibility that the loan will not be forgiven, the NFP would account for the loan at origination as described in this paragraph. The forgiveness of the principal amount would be recognized as a contribution made by reducing the loan's carrying amount and recognizing contribution expense when the condition(s) for forgiveness are substantially met; that is, when the conditional promise becomes unconditional.
- 8.27** For example, a loan would be recognized at the amount of cash (or other assets) transferred to a law school student even though the loan agreement contains a clause that a portion of the loan principal will be forgiven if the student graduates, passes the bar, and performs pro bono services for one year. Because it is at least possible, and perhaps even probable, that the student will not complete all the necessary conditions for forgiveness (that is, the possibility that the condition[s] for forgiveness will not be met is other than remote), the forgiveness of the loan is not recognized at the origination of the loan.
- 8.28** However, FASB ASC 958-605-25-12 provides that a conditional promise to give is considered unconditional if the possibility that the condition will not be met is remote. Therefore, if the contribution portion of a loan is unconditional because the chance that it will not be forgiven is remote, the loan would be initially recognized at the present value of the cash flows expected to be collected. Contribution expense is recognized at origination in the amount of the difference between the present value of the cash flows expected to be collected and the cash (or other assets) transferred to the borrower.

Loans That Do Not Bear a Market Interest Rate but the NFP Expects to Collect All Required Payments

- 8.29** Programmatic investments may be in the form of loans that are interest free or have below-market interest rates. The NFP expects to collect all the payments required under the terms of the loan agreement, but because a loan at an interest rate commensurate with the risk inherent in the expected cash flows would be unaffordable by the borrowers, the NFP reduces the interest rate. To estimate the present value of a note under such circumstances, an applicable market interest rate is approximated that may differ from the stated or coupon rate. This process of approximation, which is discussed in FASB ASC 835-30, is called *imputation*, and the resulting rate is called an *imputed interest rate*.
- 8.30** An interest-free or below-market interest rate loan issued to an NFP in exchange for cash has an unstated (or stated) right or privilege, which is its contribution element. The contribution element is given accounting recognition by recognizing a contribution made and establishing a valuation discount. The valuation discount and contribution expense should be reported regardless of whether the loan is between related parties. The valuation discount should be amortized as interest income by the NFP lender over the life of the note, as required by FASB ASC 835-30-35. The difference between the periodic interest cost calculated using the market rate and the interest method and the interest at the stated or coupon interest rate on the outstanding amount of the loan is the amount of periodic amortization. Paragraph 8.14 provides sources for guidance for determining the appropriate rate to use.
- 8.31** In accordance with FASB ASC 720-20-25-1, contributions made should be recognized as expenses in the period made and as decreases of assets or increases of liabilities depending on the form of the benefits given. In practice, the difference between the fair value of the loan at a market interest rate and the present value of the loan at its stated rate is often used to determine the fair value of the contribution. (Donee accounting for below-market interest rate loans is discussed in paragraphs 5.170–.172.)
- 8.32** The following example of the NFP lender’s accounting uses the same fact set as that in paragraph 5.171. On January 1, 20X8, an NFP lender with a December year-end makes an interest-free programmatic loan of \$200,000, payable on December 31, 20Y0. The purpose of the loan is to support the borrower’s operating expenses and the appropriate imputed market rate of interest is 6 percent. The journal entries over the life of the loan would be as follows.

1/1/X8

Loan receivable	167,924	
Contribution expense	32,076	
Cash		200,000

(Transfer of cash; receivable reported at the fair value of the loan using the present value of \$200,000 due in 3 years, discounted at 6 percent. Alternatively, as discussed in FASB ASC 835-30-55-8, the loan receivable could be recognized at \$200,000, with an offsetting discount for imputed interest of \$32,076. In that case, accretion in future periods

would be recognized by reducing the discount account and reporting interest income.)

12/31/X8

Loan receivable	10,075	
Interest income		10,075

(Accretion of loan using the effective interest method.)

12/31/X9

Loan receivable	10,680	
Interest income		10,680

(Accretion of loan using the effective interest method.)

12/31/Y0

Loan receivable	11,321	
Interest income		11,321

(Accretion of loan using the effective interest method.)

Cash	200,000	
Loan receivable		200,000

(Payment of the loan.)

8.33 The following example of the NFP lender's accounting uses the same fact set as that in paragraph 5.172. On January 1, 19X8, an NFP lender with a December year-end makes an interest-free loan of \$200,000. The purpose of the loan is to support the borrower's operating expenses, and the appropriate imputed rate of interest is 6 percent. Unlike the example in paragraph 8.32, the loan is payable on demand. Because the NFP can demand the full \$200,000 at any time, the loan amount is not discounted at inception and interest is therefore calculated on the full original balance. The loan is repaid on December 31, 20Y0.

1/1/X8

Loan receivable	200,000	
Cash		200,000

(Transfer of cash.)

12/31/X8

Contribution expense	12,000	
Interest income		12,000

(Contribution expense for below-market rate of interest on loan [loan balance \times interest rate: $\$200,000 \times .06$].)

12/31/X9

Contribution expense	12,000	
Interest income		12,000

(Contribution expense for below-market rate of interest on loan.)

12/31/Y0

Contribution expense	12,000	
Interest income		12,000

(Contribution expense for below-market rate of interest on loan.)

Cash	200,000	
Loan receivable		200,000

(Payment of the loan.)

Loans That Contain a Right to Profit From the Sale or Refinancing of Property

- 8.34** If the loan contains a right to participate in expected residual profit from the sale or refinancing of property, the “Acquisition, Development, and Construction Arrangements” subsections of FASB ASC 310-10 provide guidance for determining whether an NFP

lender should account for an acquisition, development, and construction arrangement as a loan or as an investment in real estate or a joint venture.

Forgiveness of Programmatic Loans

- 8.35** In some cases, the terms of a programmatic loan include forgiveness, in whole or in part, upon the occurrence of a specified future and uncertain event. As discussed in paragraphs 8.26–.28, those promises to forgive future payments are conditional promises to give.
- 8.36** In other cases, the terms of a programmatic loan do not include forgiveness, but the NFP investor decides to forgive all or a portion of the loan amount. Determining whether a loan is forgiven or is impaired (as discussed in paragraphs 8.37–.46) is a matter of judgment, and sometimes challenging as a loan impairment and decision to forgive may occur in a short period of time. However, if a loan is forgiven and the body empowered to forgive the loan communicates to the borrower that the amount is forgiven, the NFP investor would recognize a contribution made that would be classified as a program expense. Communication of the forgiveness to the borrower is key to the classification, because in accordance with FASB ASC 405-20-40-1, the debt is not extinguished until the debtor is legally released from being the primary obligor under the liability. In the absence of that communication, the NFP continues to act as a lender rather than a donor.

Impairment of Programmatic Loans

- 8.37** Typically, programmatic loans would not meet the definition of a security, as defined in FASB ASC 958-320-20, and therefore are not subject to the standards in FASB ASC 958-320 for debt securities. As a result, unless the NFP has elected to report programmatic investments at fair value by making an election pursuant to the “Fair Value Option” subsections of FASB ASC 825-10 (the fair value option), programmatic loans are reported at amortized cost.
- 8.38** FASB ASC 310-10-35 provides standards for impairment of loans. The guidance is divided into parts, as follows:
- Paragraphs 7–11 of FASB ASC 310-10-35 apply to groups of smaller-balance homogeneous loans, as well as loans that are not identified for evaluation or that are evaluated but are not individually considered impaired.
 - Paragraphs 12–40 of FASB ASC 310-10-35 apply to loans that are identified for evaluation or that are individually deemed to be impaired. An NFP might evaluate programmatic investments using these standards if the loan amount crosses a size criterion or delinquency criterion (or both) identified by the NFP.

Smaller-Balance Loans

- 8.39** FASB ASC 310-10-35-9 requires that losses from uncollectible receivables be accrued when both of the following conditions are met:

- Information available before the financial statements are issued or are available to be issued indicates that it is probable that an asset has been impaired at the date of the financial statements.
- The amount of the loss can be reasonably estimated.

Those conditions may be considered in relation to individual receivables or in relation to groups of similar types of receivables. If the conditions are met, accrual should be made even though the particular receivables that are uncollectible may not be identifiable.

- 8.40** FASB ASC 310-10-35-10 provides further guidance. If, based on current information and events, it is probable that the NFP will be unable to collect all amounts due according to the contractual terms of the receivable, the probability condition is met. All amounts due according to the contractual terms means that both the contractual interest payments and the contractual principal payments will be collected as scheduled according to the receivable's contractual terms. However, a creditor need not consider an insignificant delay or insignificant shortfall in amount of payments as meeting the probability condition. Whether the amount of loss can be reasonably estimated will normally depend on, among other things, the experience of the entity, information about the ability of individual debtors to pay, and appraisal of the receivables in light of the current economic environment. In the case of an entity that has no experience of its own, reference to the experience of other entities in the same business may be appropriate.

Loans That Are Identified for Evaluation and That Are Individually Deemed to be Impaired

- 8.41** FASB ASC 310-10-35-14 provides a list of characteristics that an entity might use to identify loans for evaluation of impairment. Those characteristics include, among others, a specific materiality criterion; loans to borrowers in industries or countries experiencing economic instability; borrowers experiencing problems such as operating losses, marginal working capital, inadequate cash flow, or business interruptions; and internally generated listings such as watch lists, past due reports, and overdraft listings.
- 8.42** FASB ASC 310-10-35-16 states that upon evaluation, a loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. (See paragraph 8.40 for further guidance about the meaning of all amounts due according to the contractual terms.)
- 8.43** When a loan is impaired, FASB ASC 310-10-35-22 requires that impairment be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate. Paragraphs 23–29 of FASB ASC 310-10-35 provide further guidance on how to calculate that present value amount. However, as a practical expedient, a creditor may measure impairment based on a loan's observable market price, or the fair value of the collateral if the loan is a collateral-dependent loan. If the loan is collateral dependent and the creditor determines that foreclosure is probable, the creditor should measure impairment based on the fair value of the collateral.

- 8.44** Continuing the example in paragraph 8.17, which uses the effective interest method, the community foundation identifies this loan for evaluation of impairment at the end of year 1. Because the community foundation believes that it will collect only \$57,640 at the due date 4 years from now, it determines that the loan is impaired. The community foundation is required to measure the impairment based on the \$57,640 payment at the loan's effective interest rate of 15 percent, which is \$32,956. The carrying value of the loan is \$57,178, so the community foundation recognizes a valuation allowance of \$24,222.
- 8.45** In contrast, if the inherent contribution method has been used, as in paragraph 8.25, and the community foundation identifies this loan for evaluation of impairment at the end of year 1, there is no impairment to recognize at this time. The community foundation expects to receive a \$57,640 payment 4 years from now. The present value of \$57,640 at 3 percent is \$51,212, which is the loan's carrying value. The loan will not be impaired until the amount expected to be collected at the due date is less than \$57,640.
- 8.46** Paragraphs 37–40 of FASB ASC 310-10-35 describe accounting for a loan after the initial measurement of impairment. If there is a significant change (increase or decrease) in the amount or timing of an impaired loan's expected future cash flows, or if actual cash flows are significantly different from the cash flows previously projected, a creditor should recalculate the impairment by re-applying the procedures specified in paragraphs 21–22 and paragraphs 24–26 of FASB ASC 310-10-35 and adjusting the valuation allowance. Similarly, if a creditor measured the impairment based on the observable market price of an impaired loan or the fair value of the collateral, the valuation allowance should be adjusted if there is a significant change (increase or decrease) in either of those bases. However, the net carrying amount of the loan should at no time exceed the recorded investment in the loan, which is the amount of the loan disregarding the valuation allowance.

Disclosures About Programmatic Loans

- 8.47** Programmatic loans are subject to the standards in FASB ASC 310-10-50, including its requirements for financing receivables and loan products that have contractual terms that expose entities to risks and uncertainties. Further, if loans are made to related parties, the NFP should also consider the requirements of FASB ASC 850, *Related Party Disclosures*. In implementing those requirements, an NFP investor would consider the relative significance of programmatic loans to its mission-related operations and to its financial position, and the quantitative and qualitative risks arising from the transactions. For example, disclosures about the allowance for credit losses related to financing receivables (paragraphs 11A–14 of FASB ASC 310-10-50), disclosures about impaired loans (paragraphs 14A–20 of FASB ASC 310-10-50), and disclosures about credit quality indicators (paragraphs 27–30 of FASB ASC 310-10-50) are required unless the amount of programmatic loans is immaterial to the financial statements.

8.48 If making programmatic loans is one of the NFP’s major class of programs,^{fn3} FinREC recommends that, in addition to the disclosures in FASB ASC 310-10-50, an NFP disclose the following:

- The number of loans outstanding
- The average face amount and average carrying amount of the loans at origination and the reason for the difference
- The program purpose that is being accomplished by the loan activity
- The amount of impairment losses in total and by program expense line item(s)

Equity Instruments

8.49 By definition, programmatic investments that are equity instruments are interests in entities that provide goods or services that accomplish the purpose or mission for which the NFP exists or that serve the NFP’s administrative purposes. Thus, when determining the proper accounting and reporting, an NFP investor follows the guidance in chapter 3, “Financial Statements, the Reporting Entity, and General Financial Reporting Matters.” Exhibit 3-2, “Relationships of a Not-for-Profit Reporting Entity,” describes some common relationships with other entities and identifies where these relationships are discussed in chapter 3 and in FASB ASC. Exhibit 3-2 and chapter 3 summarize certain guidance in FASB ASC but are not a substitute for reading the guidance itself.

8.50 Programmatic equity interests typically are in for-profit entities and, therefore, generally would not have a contribution element at origination. In some cases, the agreement for the equity interest will contain additional rights or privileges, such as the investor’s right to obtain future services from the investee at reduced rates. In those cases, those additional rights and privileges should be accounted for in accordance with relevant generally accepted accounting principles and the consideration specified in the agreement is allocated between the equity interest and those additional rights and privileges.

Programmatic Equity Investments That Are Consolidated

8.51 Although unusual, a programmatic equity investment in another entity might provide the NFP investor with sufficient control that consolidation is required. The standards for consolidation are discussed in chapter 3. NFPs can use exhibit 3-2 to assist with the determination of which investees are required to be consolidated.

Programmatic Equity Investments Reported Using the Equity Method

8.52 NFPs can use exhibit 3-2 to assist with the determination of which investees are required to be reported using the equity method. FASB ASC 323-10-35 provides guidance for the

^{fn 3} Guidance for determination of a not-for-profit entity’s major classes of programs is included in paragraphs 13.48–.58.

application of the equity method. Because programmatic equity investments are often made to newly created entities or entities in economic distress, the investee may experience losses rather than net income. Paragraphs 19–30 of FASB ASC 323-10-35 provide standards if an NFP investor's share of losses of an investee equals or exceeds the carrying amount of a programmatic investment; that is, the losses have reduced the carrying amount of the equity-method investment to zero. An NFP investor ordinarily should discontinue applying the equity method if the investment (and net advances) is reduced to zero. It should not provide for additional losses unless it has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee. However, if the imminent return to profitable operations by an investee appears to be assured, the NFP investor should provide for additional losses. (For example, a material, nonrecurring loss of an isolated nature may reduce an investment below zero even though the underlying profitable operating pattern of an investee is unimpaired.) If the investee subsequently reports net income (or an increase in net assets), the NFP investor should resume applying the equity method only after its share of that net income (or increase in net assets) equals the share of net losses not recognized during the period the equity method was suspended.

- 8.53** Timely identification of impairment is a consideration for any interest that is reported using the equity method. Impairment of equity method investments is discussed in paragraphs 31–32A of FASB ASC 323-10-35. A decrease in value of an equity method investment should be recognized if that decrease is other than temporary, even though the decrease in value is in excess of what would otherwise be recognized by application of the equity method.
- 8.54** A series of operating losses of an investee or other factors may indicate that a decrease in value of a programmatic equity investment has occurred. Evidence of a loss in value might include, but would not necessarily be limited to, absence of an ability to recover the carrying amount of the investment or inability of the investee to sustain an earnings capacity that would justify the carrying amount of the investment. Although programmatic equity investments seldom have readily determinable fair values, a current fair value that is less than the carrying amount also may indicate a loss in value of the investment. All are factors that should be evaluated.

Programmatic Equity Investments Reported Using Fair Value

- 8.55** Typically, programmatic equity investments do not meet the definition of an equity security with readily determinable fair value, as defined in FASB ASC 958-320-20, and therefore are not subject to the fair value measurement requirements in FASB ASC 958-320. An NFP that would otherwise be required to use the equity method or the cost method for an equity instrument may be permitted to report at fair value by making an election pursuant to FASB ASC 825-10-25-1 (the fair value option).

Programmatic Equity Investments Reported Using a Cost Method

8.56 Timely identification of impairment is a consideration for any equity interest that is reported using the cost method. Impairment of cost-method investments is discussed in paragraphs 8-13 of FASB ASC 958-325-35. Because the fair value of cost-method investments is not readily determinable, the evaluation of whether an investment is impaired should be determined in accordance with FASB ASC 320-10-35-25. If the value is impaired, the NFP investor should determine whether the impairment is other than temporary using the guidance in paragraphs 30–33 of FASB ASC 320-10-35. If the impairment is other than temporary, a loss is recognized in accordance with FASB ASC 320-10-35-34. The fair value of the investment would then become the new amortized cost basis of the investment and should not be adjusted for subsequent recoveries in fair value.

Disclosures About Programmatic Equity Instruments

8.57 The disclosures for programmatic equity instruments are the same as those required for other equity instruments (that is, disclosures for consolidated subsidiaries, equity-method investments, related parties, and so forth, as applicable). In addition to the disclosures required by those other topics in FASB ASC, the Financial Reporting Executive Committee (FinREC) recommends that an NFP that makes programmatic equity investments disclose the following:

- The number of programmatic equity investees
- The carrying amount recognized in the statement of financial position for the programmatic equity instruments
- The program purpose that is being accomplished by the programmatic equity relationship(s)
- The amount of impairment losses in total and by program expense line item(s)

Guarantees

8.58 Some programmatic investments take the form of guarantees. FASB ASC 460 establishes the accounting and disclosure requirements to be met by a guarantor for certain guarantees issued and outstanding. Those standards are briefly discussed in paragraphs 10.90–91.

Concentrations of Risk

8.59 As explained in FASB ASC 825-10-55-1, the terms of certain loan products increase a reporting entity's exposure to credit risk, and thereby may result in a concentration of credit risk. FASB ASC 825-10-50-20 requires entities to disclose all significant concentrations of credit risk arising from all financial instruments, whether from an individual counterparty or groups of counterparties. Group concentrations of credit risk exist if a number of counterparties are engaged in similar activities and have similar

economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. Judgment is required to determine whether loan products have terms that give rise to a concentration of credit risk.

Presentation of Programmatic Investments

Contributed Resources for Making Programmatic Investments

- 8.60** If the resources to make a programmatic investment are provided by donors, the net assets related to the contributed resources should be reported as restricted until the restrictions are met, in accordance with FASB ASC 958-210-45-1.
- 8.61** Therefore, FinREC believes that if a donor provides resources with a restriction that the resources be used to make a programmatic investment, the net assets would be reported as temporarily restricted until that investment is made. However, if the donor specifies that the contributed resources should create a revolving fund, such that repayments of loans or proceeds from sales of programmatic investments must be reinvested to make additional programmatic investments, the net assets related to the revolving fund are subject to a permanent restriction. Although the net assets may be reduced from time to time by losses, and may eventually be exhausted, the resources are capable of providing economic benefits indefinitely and the donor has instructed that the fund should be revolving in duration. (Paragraphs 5.79–.82 provide additional information about the classification of net assets as permanently restricted.)
- 8.62** In some cases, a donor that provides resources restricted to making a programmatic investment will also restrict the use of the income earned by the programmatic investment or the proceeds of its sale or maturity. If so, those restrictions on income, gains, and losses should be recognized in accordance with FASB ASC 958-320-45 when the income, sale, or maturity is recognized.

Agency Resources for Making Programmatic Investments

- 8.63** In some cases, the NFP investor is acting as an agent for a principal (often a governmental entity) when it makes programmatic investments. If so, any cash received by the NFP prior to making the investment is reported as an agency liability, as described in paragraphs 10.80 and 10.87. The Federal Perkins Loan Program, the Health Professions Loan Program, and the Nursing Student Loan Program are examples of revolving funds that are recorded as agency transactions.
- 8.64** In accordance with FASB ASC 958-325-25-2, when a programmatic investment is made using resources supplied by the principal, cash is reduced and the investment recognized. If the programmatic investment has a contribution element, the contribution made is not the agent's contribution expense; the contribution has been made by the principal. If an agreement for an equity interest provides the principal with additional rights and privileges that require separate accounting, those rights and privileges are not the agent's

assets. To the extent that a programmatic investment reduces the assets held on behalf of the principal, the offsetting liability to the principal is also reduced. The liability to the principal is typically satisfied by transferring the programmatic investment(s) or the cash received at maturity or sale of the programmatic investment to the principal. In some cases in which the principal is a government agency, the government agency might forgive the liability.

- 8.66** In accordance with FASB ASC 958-325-35-16, if an NFP is holding an investment as an agent and has little or no discretion in determining how the investment income, unrealized gains and losses, and realized gains and losses resulting from that investment will be used, those investment activities should be reported as agency transactions and, therefore, as changes in assets and liabilities, rather than as changes in net assets. If the programmatic investment is funded in part by the NFP and in part by the principal, the investment income, unrealized gains and losses, and realized gains and losses would be shared between the two entities in accordance with their agreement.

Program-Related Investments of Private Foundations

- 8.67** In the year that a program-related investment is made, the IRS allows private foundations to count the investment as part of the required 5 percent charitable distribution. Principal repayments on program-related loans count as “recaptured distributions,” increasing the payout requirement in the years that the principal repayments are made by the amount of the repayment. (That is, the amount of any principal repayment will be effectively added to that year's minimum distribution requirement.) Interest and dividend payments are considered regular income. The IRS exempts program-related investments from the “prudent man” rule on investments.

Chapter 9

Property, Plant, and Equipment

Introduction

9.01 Not-for-profit entities (NFPs) use various kinds of property and equipment to provide goods and services to beneficiaries, customers, and members. Property and equipment includes all long-lived tangible assets held by NFPs, except collection items^{fn 1} and assets held for investment purposes.

9.02 Property and equipment commonly held by NFPs includes the following:

- Land and land improvements
- Buildings and building improvements, equipment, furniture and office equipment, library books, motor vehicles, and similar depreciable assets
- Leased property and equipment (capitalized in conformity with Financial Accounting Standards Board [FASB] *Accounting Standards Codification* [ASC] 840-30)
- Improvements to leased property
- Construction in process
- Contributed use of facilities and equipment (recognized in conformity with the “Contributions Received and Agency Transactions” subsections of FASB ASC 958-605, as illustrated in paragraphs 23–25 of FASB ASC 958-605-55)

Recognition and Measurement Principles

9.03 NFPs acquire the use of property and equipment through purchases, trade-ins, self-construction, leases, and contributions. NFPs should apply the guidance in FASB ASC 360, *Property, Plant, and Equipment*, except when it conflicts with the specialized guidance for NFPs in FASB ASC 958-360.

Contributed Property and Equipment

^{fn 1} Because of their unique nature, collection items are reported differently than how other long-lived tangible assets are reported. Chapter 7, “Other Assets,” discusses accounting for collection items.

- 9.04** Pursuant to FASB ASC 958-605-25-2; 958-605-30-2; and 958-605-45-3, contributions of property and equipment (including unconditional promises to give property and equipment) should be recognized at fair value^{fn 2} at the date of contribution and, depending on donor restrictions and the NFP's accounting policy, should be included in permanently restricted, temporarily restricted, or unrestricted net assets. If the donors stipulate how or how long contributed property and equipment must be used by the NFP, the contribution should be reported as restricted support. If the donors do not specify such restrictions, the contribution should be reported as restricted support if the NFP has adopted an accounting policy of implying a time restriction on the use of such assets that expires over the assets' useful lives. (The policy is discussed further in paragraphs 5.85–.87.) In the absence of donor restrictions or an NFP's policy of implying time restrictions, contributions of long-lived assets should be reported as unrestricted support.
- 9.05** In practice, contributions of depreciable assets generally do not increase permanently restricted net assets. As noted in paragraph 5.80, only contributions of assets that are not by their nature used up in carrying out the NFP's activities and thus are capable of providing economic benefits indefinitely should be classified as increases in permanently restricted net assets. For example, if a donor contributes a depreciable long-lived asset and specifies that it is to be sold and the proceeds used to create a permanent endowment, that contribution would be capable of providing economic benefits indefinitely and would increase permanently restricted net assets.
- 9.06** Unconditional promises to give property and equipment to an NFP should be recognized by the NFP as receivables in conformity with paragraphs 8–10 of FASB ASC 958-605-25. Contributions of the use of property and equipment in which the donor retains legal title to the assets are discussed in paragraphs 5.162–.164.
- 9.07** Per FASB ASC 958-360-30-1, similar to items acquired in exchange transactions, the amount initially recognized for contributed property and equipment should include all the costs incurred by the entity to place those assets in use. Examples of such costs include the freight and installation costs of contributed equipment and cataloging costs for contributed library books.

Use of Property, Plant, and Equipment Owned by Others

- 9.08** An NFP may have access to use property or equipment that it does not own. If the property or equipment is used under the terms of a lease agreement that at its inception requires lease payments at fair value, the NFP should apply the guidance in FASB ASC 840, *Leases*. In many cases, an NFP has the right to use property without making lease

^{fn 2} Financial Accounting Standards Board (FASB) *Accounting Standards Codification (ASC) 820, Fair Value Measurement*, defines *fair value* and establishes a framework for measuring fair value. Paragraphs 3.137–.167 discuss those standards. In addition, chapter 5, "Contributions Received and Agency Transactions," discusses measuring the fair value of contributed assets.

payments or makes lease payments that are significantly below market rates. For example, property or equipment may be provided by a donor, by a related NFP, by an unrelated entity under an affiliation program, by a sponsor of research, or by a governmental agency or unit.

- 9.09** Contributed use of property is discussed in paragraphs 5.162–.164. If the NFP is not required to make lease payments or if lease payments are significantly below fair value, a contribution is inherent in the use of the property, unless the agreement includes other rights or privileges of a commensurate value. For example, an NFP may receive use of a vehicle for a year from a local car dealer, and no lease payments are required. In determining whether lease payments are below fair value, the payments would be compared to payments for similar property that is rented under similar terms.
- 9.10** In other cases, an NFP uses property owned by another entity to fulfill its obligations under an agreement with that entity. For example, some NFPs provide research or testing services using property owned by the entity that sponsors the research or testing. FASB ASC 958-605-55-25 applies if the agreement between the owner of the property (sponsor) and the NFP is an exchange transaction and it is probable that the NFP will be permitted to keep the asset when the arrangement terminates. The paragraph states that property and equipment used in exchange transactions (other than lease transactions), such as federal contracts, in which the resource provider retains legal title during the term of the arrangement, should be reported as a contribution at fair value at the date received by the NFPs only if it is probable that the NFP will be permitted to keep the assets when the arrangement terminates. Per FASB ASC 958-360-50-4, the terms of such arrangements should be disclosed in notes to the financial statements.
- 9.11** In many cases, the sponsoring entity transfers cash to the NFP rather than the property or equipment itself, with the directive that the cash be used to buy the property and equipment to be used in the exchange transaction. The sponsoring entity will retain legal title to the property and equipment during the term of the arrangement. Analogizing to the guidance in FASB ASC 958-605-55-25 (which is discussed in the preceding paragraph), if it is probable that the NFP will be permitted to keep the asset when the arrangement terminates, the cash received would be reported as revenue (for example, a contribution or grants and contracts revenue) and the property, when purchased, would be capitalized in accordance with the NFP's capitalization policy and depreciated in subsequent periods. At the completion of the arrangement, the NFP should test the equipment for recoverability if, as expected, the NFP is permitted to keep the asset. If the sponsoring entity requires return of the equipment, the equipment would be derecognized when it ceases to be used and is returned to the sponsoring entity.
- 9.12** When making a determination of whether it will be permitted to keep the asset when the arrangement terminates, the NFP would consider facts and circumstances that include the following:

- The NFP's prior experience with the sponsoring entity and whether the sponsoring entity typically transfers title to the property at the end of the agreement's term
- The experience of other NFPs who have contracted with the same sponsoring entity
- The term of the agreement as compared to the useful life of the property, and the expected salvage value of the property at the end of the term
- Whether the property will be technologically obsolete at the end of the term of the agreement

9.13 If after considering the facts and circumstances the NFP concludes that it is not probable that it will be permitted to keep the asset when the arrangement terminates, the NFP should report the transaction as an agent. It would report an asset (first cash, and then property held as an agent upon the property's purchase) and an offsetting liability (amount owed pursuant to an agency transaction). During the term, the NFP would decrease the asset to reflect its use, charging an expense such as rent expense. A decrease in the liability of a similar amount would also be recognizing, crediting the same revenue source that is used for the contract revenue. At the end of the term, the NFP would derecognize any amount remaining for the property held as an agent and the offsetting liability. If the sponsoring entity transfers title at the end of the term, the NFP would report revenue, measuring the property at its fair value at that time.

Capitalized Interest

9.14 Many NFPs finance acquisitions, additions, and renovations of facilities by issuing tax-exempt debt, as discussed in chapter 10, "Debt and Other Liabilities." If the proceeds of tax-exempt borrowings are externally restricted to finance the acquisition of specified qualifying assets or to service the related debt, the amount of interest cost to be capitalized is determined in accordance with paragraphs 8–12 of FASB ASC 835-20-25. If the NFP uses taxable debt or otherwise does not qualify for interest capitalization under those paragraphs, then the amount of interest cost to be capitalized is determined pursuant to paragraphs 2–7 of FASB ASC 835-20-35. Frequently, an NFP is required to capitalize interest under paragraphs 2–7 of FASB ASC 835-20-35 for some projects and paragraphs 8–12 of FASB ASC 835-20-35 for others.

9.15 Among the differences between the two sets of guidance are the interest cost to be capitalized and the capitalization period. For interest costs on qualifying assets acquired with proceeds of tax-exempt borrowings that are externally restricted, FASB ASC 835-20-30-11 requires that the amount of capitalized interest be all interest cost of the borrowing less any interest earned on related interest-bearing investments acquired with proceeds of the related tax-exempt borrowings from the date of the borrowing until the assets are ready for their intended use. For other borrowings, paragraphs 2–7 of FASB ASC 835-20-30 use a weighted average construction expenditures concept that is applied

during the period for which the three criteria in FASB ASC 835-20-25-3 are present. Those criteria are (a) expenditures for the asset have been made, (b) activities that are necessary to get the asset ready for its intended use are in progress, and (c) interest cost is being incurred.

- 9.16** In accordance with FASB ASC 835-20-30-12, the interest cost of a tax-exempt borrowing should be eligible for capitalization on other qualifying assets of the entity when the specified qualifying assets are no longer eligible for interest capitalization. The entire interest cost on that portion of the proceeds that is available for other uses, such as refunding an existing debt issue other than a construction loan related to those assets, also is eligible for capitalization on other qualifying assets. Example 1 in FASB ASC 835-20-55-4 illustrates this guidance.
- 9.17** In certain circumstances in which an NFP has an investment (equity, loans, and advances) accounted for by the equity method and the investee has not begun its planned principal operations, FASB ASC 835-20-35-2 requires capitalization of interest cost. As explained in FASB ASC 835-20-15-5(c), the investor's investment in the investee, not the individual assets or projects of the investee, is the qualifying asset for purposes of interest capitalization. Interest is capitalized while the investee has activities in progress necessary to commence its planned principal operations, provided that the investee's activities include the use of funds to acquire qualifying assets for operations.
- 9.18** FASB ASC 835-20-15 specifies the types of assets for which interest is not capitalized. Among the listed items are assets acquired with gifts and grants that are restricted by the donor or grantor to acquisition of those assets, to the extent that funds are available from such gifts and grants; interest earned from the temporary investment of those funds that is similarly restricted should be considered an addition to the gift or grant for this purpose. Other items include assets not included in the consolidated balance sheet of the parent company and consolidated subsidiaries and assets that are not being used in the earning activities of the entity and not undergoing the activities necessary to get them ready for use.
- 9.19** Some NFPs finance construction projects with municipal securities that have both taxable and tax-exempt components. The aggregate proceeds are to finance a specific construction project and are restricted by a common indenture or trust agreement to use only for construction of the project, repayment of the debt, or both. In such situations, the interest to be capitalized on the taxable portion of the issue is accounted for separate from the interest on the tax-exempt portion, based on paragraphs 2–7 of FASB ASC 835-20-30.

Depreciation and Amortization

- 9.20** FASB ASC 360-10-35-4 states that *depreciation* is a system of accounting that aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic

and rational manner. Depreciation should be recognized for contributed property, plant, and equipment, as well as for purchased property, plant, and equipment.

- 9.21** Paragraphs 1–6 of FASB ASC 958-360-35 require all NFPs to recognize depreciation for all property and equipment except land used as a building site, certain works of art or historical treasures with extraordinarily long lives, and similar assets.
- 9.22** Per FASB ASC 958-360-35-7, the terms of certain grants and reimbursements from other entities may specify whether depreciation or the entire cost of the asset in the year of acquisition should be included as a cost of activities associated with those grants or reimbursements for contractual purposes (sometimes referred to as *allowable costs*). Those terms should not affect the recognition and measurement of depreciation for financial reporting purposes.
- 9.23** FASB ASC 840-10-35-6 states that leasehold improvements that are placed in service significantly after and not contemplated at or near the beginning of the lease term should be amortized over the shorter of the following terms:
- a. The useful life of the assets, or
 - b. A term that includes required lease periods and renewals that are deemed to be reasonably assured (as used in the context of the definition of *lease term*) at the date the leasehold improvements are purchased

Expiration of Restrictions on Property, Plant, and Equipment

- 9.24** The expiration of restrictions on gifts of property, plant, and equipment or on gifts for their purchase is discussed in paragraphs 11.45–.48. The expiration of restrictions on a promise to give that is restricted to the purchase or construction of long-lived assets is discussed in paragraphs 11.37–.44.

Impairment or Disposal of Long-Lived Assets

- 9.25** The “Impairment or Disposal of Long-Lived Assets” subsections of FASB ASC 360-10 provide guidance whenever events or changes in circumstances indicate that the carrying amount of a long-lived asset (asset group)^{fn 3} may not be recoverable. This paragraph and

^{fn 3} The FASB ASC glossary defines an *asset group* as the unit of accounting for a long-lived asset or assets to be held and used, which represents the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities. The FASB ASC glossary states that a *disposal group* for a long-lived asset or assets to be disposed of by sale or otherwise represents assets to be disposed of together as a group in a single transaction and liabilities directly associated with those assets that will be transferred in the transaction. Per FASB ASC 360-10-15-4, examples of liabilities included in a disposal group are legal obligations that transfer with a long-lived asset, such as certain environmental obligations, and obligations that, for business reasons, a potential buyer would prefer to settle when assumed as part of a group, such as warranty obligations that relate to an acquired customer base. Per FASB ASC 360-10-35-24, in limited circumstances, a long-lived asset (for example, a corporate headquarters facility) may not have identifiable cash flows that are largely independent of the cash flows of other

the next three summarize that guidance but are not a substitute for reading those subsections. FASB ASC 360-10-35-17 states that an impairment loss shall be recognized only if the carrying amount of the long-lived asset (or asset group) is not recoverable and exceeds its fair value. The carrying amount of a long-lived asset (asset group) is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from use and eventual disposition of the asset (asset group). That assessment should be based on the carrying amount of the asset (asset group) at the date it is tested for recoverability, whether in use (see FASB ASC 360-10-35-33) or under development (see FASB ASC 360-10-35-34). An impairment loss should be measured as the amount by which the carrying amount of a long-lived asset (asset group) exceeds its fair value.

- 9.26** FASB ASC 958-360-35-8 states that when grouping assets for impairment testing, an NFP that relies in part on contributions to maintain its assets may need to consider those contributions in determining the appropriate cash flows to compare with the carrying amount of an asset. If future unrestricted contributions to the entity as a whole are not considered, the sum of the expected future cash flows may be negative, or positive but less than the carrying amount of the asset. For example, the costs of administering a museum may exceed the admission fees charged, but the museum may fund the cash flow deficit with unrestricted contributions.
- 9.27** A long-lived asset is classified as held and used until it is disposed of or it meets the criteria to be classified as held for sale. A long-lived asset that is disposed of by gift should be recognized in accordance with FASB ASC 720-25. The contribution of the long-lived asset should be measured at the fair value of the asset given, and if the fair value of the asset transferred differs from its carrying amount, a gain or loss shall be recognized on the disposition of the asset. An asset (disposal group) should be classified as held for sale in the period in which all of the criteria in FASB ASC 360-10-45-9 are met. If at any time afterwards the criteria are no longer met (except in certain limited circumstances beyond the entity's control, as discussed in FASB ASC 360-10-45-11), a long-lived asset (disposal group) classified as held for sale should be reclassified as held and used in accordance with FASB ASC 360-10-35-44. Further, if the criteria in FASB ASC 360-10-45-9 for classifying a long-lived asset (disposal group) as held for sale are met after the balance sheet date, but before the issuance of the financial statements, a long-lived asset (disposal group) should be classified as held and used in those financial statements when issued and certain disclosures are required.
- 9.28** A long-lived asset (disposal group) that is held for sale should be measured at the lower of its carrying amount or fair value less cost to sell. A long-lived asset should not be depreciated (amortized) while it is classified as held for sale. (Interest and other expenses attributable to the liabilities of a disposal group held for sale should continue to be

assets and liabilities and of other asset groups. In those circumstances, the asset group for that long-lived asset should include all assets and liabilities of the entity.

accrued.) FASB ASC 205-20 provides guidance on when the results of operations of a component of an entity that either has been disposed of or is classified as held for sale would be reported as a discontinued operation in the financial statements of the entity. FASB ASC 205-20-55 is intended to help an entity determine whether the two conditions described in FASB ASC 205-20-45-1 are met and, if so, result in reporting the results of operations of a component of an entity in discontinued operations.

- 9.29** FASB ASC 958-360-40-1 applies if contributed long-lived assets are disposed of before the end of their useful lives and those assets are subject to an accounting policy implying time restrictions on the use of contributed long-lived assets. In those situations, the gain or loss on the disposal of that asset should be reported as a change in unrestricted net assets and a reclassification should be reported for any remaining temporarily restricted net assets.

Asset Retirement Obligations

- 9.30** FASB ASC 410-20 establishes accounting standards for recognition and measurement of a liability for an asset retirement obligation and the associated asset retirement cost. It applies to legal obligations associated with the retirement of a tangible long-lived asset if those obligations result from the acquisition, construction, development, or normal operation of a long-lived asset. FASB ASC 410-20 also applies to any legal obligations that require disposal of a replaced part that is a component of a tangible long-lived asset, with exceptions for certain obligations. An NFP is required to recognize a liability if the obligation to perform the asset retirement activity is unconditional, even though the timing or method of settlement may be uncertain.
- 9.31** An NFP should recognize the fair value of a liability for an asset retirement obligation in the period in which it is incurred if a reasonable estimate of fair value can be made. (An expected present value technique will usually be the only appropriate technique with which to estimate the fair value of a liability for an asset retirement obligation.) The asset retirement cost should be capitalized by increasing the carrying amount of the related long-lived asset by the same amount as the liability.
- 9.32** For example, an NFP would have an asset retirement obligation if it accepted a gift of a building with the stipulation that in 10 years the building would be destroyed and the land converted to a garden that would be open to the public. Paragraphs 57–58 of FASB ASC 410-20-55 discuss an example of regulations that create a duty or responsibility for an entity to remove and dispose of asbestos in a special manner.

Gains and Losses

- 9.33** In accordance with FASB ASC 958-225-45-8, gains and losses recognized on property and equipment, including impairment losses, should be classified in a statement of activities as changes in unrestricted net assets unless explicit donor stipulations or law require their use to be restricted. In those situations, gains or losses should be classified

as increases or decreases in temporarily restricted or permanently restricted net assets, as appropriate.

Financial Statement Presentation

- 9.34** FASB ASC 958-225-45-11 describes limitations on an NFP's use of an intermediate measure of operations. It states that if that subtotal, such as income from operations, is presented, it should include the amount of an impairment loss recognized for a long-lived asset (asset group) to be held and used, pursuant to FASB ASC 360-10-45-4. It also should include the amount of a gain or loss recognized on the sale of a long-lived asset (disposal group) if that long-lived asset (disposal group) is not a component of the NFP, pursuant to FASB ASC 360-10-45-5.
- 9.35** FASB ASC 958-360-50 and FASB ASC 360-10-50 list most of the disclosures required for property, plant, and equipment. The following paragraphs list some of the more common of those disclosures, as well as references to other locations in FASB ASC that include required disclosures about property, plant, and equipment.
- 9.36** An NFP should disclose significant accounting policies concerning property and equipment, such as the following:
- The capitalization policy adopted
 - Whether time restrictions are implied on the use of contributed long-lived assets (and contributions of assets restricted to purchase them) received without donor stipulations regarding how long the contributed assets must be used
 - Whether donor-restricted contributions of long-lived assets are reported as unrestricted when restrictions are satisfied in the same reporting period in which the contributions are received, pursuant to FASB ASC 958-605-45-4
- 9.37** A statement of financial position or related notes should include the balances of each major class of property and equipment. The basis of valuation—for example, cost for purchased items and fair value for contributed items—should also be disclosed. Separate disclosure should also be made of the following items:
- Nondepreciable assets.
 - Property and equipment not held for use in operations, for example, items held for sale or for investment purposes or construction in process.
 - FASB ASC 958-210-50-3 requires disclosure of the nature and amount of limitations on the use of cash and cash equivalents and assets whose use is limited, including assets restricted by donors for the acquisition of property, plant, and equipment.

- Improvements to leased facilities and equipment.
 - FASB ASC 840-30-50 requires disclosures about assets (and related obligations) recognized under capital leases.
 - FASB ASC 835-20-50 requires disclosures about capitalized interest.
 - FASB ASC 205-20-50 requires disclosures about assets sold or held for sale.
 - FASB ASC 360-10-50 requires disclosure about impairment losses recognized on long-lived assets.
- 9.38** Accumulated depreciation, either for each major class of property and equipment or in total, should be disclosed (a) as a deduction or parenthetically in a statement of financial position, or (b) in the notes to the financial statements. The amount of depreciation expense for the period and the method or methods used to compute depreciation for the major classes of property and equipment should also be disclosed.
- 9.39** The notes to the financial statements should include disclosures concerning the liquidity of the NFP's property and equipment, including information about limitations on their use. For example, information should be provided about
- property and equipment pledged as collateral or otherwise subject to lien.
 - property and equipment acquired with restricted assets where title may revert to another party, such as a resource provider.
 - donor or legal limitations on the use of or proceeds from the disposal of property and equipment.
 - impaired long-lived assets reported at fair value, as required by FASB ASC 820-10-50-2.
- 9.40** Example 3 in paragraph 5.220 illustrates how an NFP might disclose alternative policies for implying time restrictions on the use of contributed long-lived assets (and contributions of assets restricted to purchase them) received without donor stipulations concerning how long the contributed assets must be used in notes to the financial statements. Paragraph 9.04 discusses those alternative accounting policies.

Chapter 10

Debt and Other Liabilities

Introduction

10.01 Many obligations of not-for-profit entities (NFPs) are similar to those of for-profit entities. This chapter considers debt and other liabilities that are not discussed elsewhere in this guide and that present accounting and auditing issues unique to NFPs.

Fair Value Measurement

10.02 The “Fair Value Option” subsections of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 825-10 permit an NFP to irrevocably elect fair value as the initial and subsequent measure for certain financial liabilities, with changes in fair value recognized in the statement of activities as those changes occur. The following liabilities that might exist for NFPs are outside the scope of the “Fair Value Option” subsections and thus cannot be reported at fair value: employers’ and plans’ obligations for pension benefits, other postretirement benefits (including health care and life insurance benefits), postemployment benefits, deferred compensation arrangements, financial liabilities recognized under lease contracts, current and deferred tax assets and liabilities, and liabilities that require the NFP to provide services, rather than cash or another financial asset, to the obligee.

10.03 Liabilities are rarely transferred in the marketplace because of contractual or other legal restrictions preventing their transfer. Paragraphs 16–18C of FASB ASC 820-10-35 provide guidance for determining the fair value of a liability. Even when there is no observable market to provide pricing information about the transfer of a liability (for example, because contractual or other legal restrictions prevent the transfer of the liability), there might be an observable market for the liability if it is held by other parties as an asset. When a quoted price for the transfer of an identical or a similar liability is not available and the identical item is held by another party as an asset, an NFP should measure the fair value of the liability from the perspective of a market participant that holds the identical item as an asset at the measurement date.

10.04 In such cases, an NFP should measure the fair value of the liability as follows:

- Using the quoted price in an active market for the identical liability held by another party as an asset, if that price is available
- If that price is not available, using other observable inputs, such as the quoted price in a market that is not active for the identical liability held by another party as an asset

- If observable prices are not available for an identical liability held as an asset, using another valuation technique such as the following:
 - An income approach (for example, a present value technique that takes into account the future cash flows that a market participant would expect to receive from holding the liability as an asset)
 - A market approach (for example, using quoted prices for similar liabilities held by other parties as assets)

- 10.05** An NFP should adjust the quoted price of the liability held by another party as an asset only if there are factors specific to the asset that are not applicable to the fair value measurement of the liability. An NFP should ensure that the price of the asset does not reflect the effect of a restriction preventing the sale of that asset. FASB ASC 820-10-35-16D includes some factors, including a third-party credit enhancement, that may indicate that the quoted price of the asset should be adjusted.
- 10.06** When a quoted price for the transfer of an identical or a similar liability is not available and the identical item is not held by another party as an asset, an NFP should measure the fair value of the liability using a valuation technique from the perspective of a market participant that owes the liability. Paragraphs 16I–16L of FASB ASC 820-10-35 provide guidance for using present value techniques to measure the fair value of a liability.
- 10.07** The fair value of a liability reflects the effect of *nonperformance risk* (the risk that the entity will not fulfill the obligation). Nonperformance risk includes, but may not be limited to, a reporting entity's own credit risk. Nonperformance risk is assumed to be the same before and after the transfer of the liability. When measuring the fair value of a liability, an NFP should take into account the effect of its credit risk (credit standing) and any other factors that might influence the likelihood that the obligation will or will not be fulfilled. FASB ASC 820-10-35-18A states that an issuer of a liability issued with an inseparable third-party credit enhancement that is accounted for separately from the liability should not include the effect of the credit enhancement (for example, a third-party guarantee of debt) in the fair value measurement of the liability. If the credit enhancement is accounted for separately from the liability, the issuer would take into account its own credit standing and not that of the third-party guarantor when measuring the fair value of the liability. Thus, if fair value is determined based on the prices at which the liabilities are trading in markets, an adjustment needs to be made for the difference between the credit standing of the guarantor (on which the market trades are based) and the credit standing of the NFP. In other words, the observed price for the debt traded as an asset is adjusted to exclude the effect of the third-party credit enhancement.
- 10.08** When measuring the fair value of a liability, an NFP should not include a separate input or an adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability. The effect of a restriction that prevents the transfer of a liability is either implicitly or explicitly included in the other inputs to the fair value measurement.

Municipal Bond Financing and Other Long-Term Debt

- 10.09** An NFP may finance part of its activities from the proceeds of tax-exempt bonds or other obligations issued through state and local financing authorities. FASB ASC 958-470-25-1 states that because the NFP is responsible for the repayment of those obligations, that financing should be recognized as a liability in its statement of financial position. The FASB ASC glossary defines *conduit debt obligation* as

Certain limited-obligation revenue bonds, certificates of participation, or similar debt instruments issued by a state or local governmental entity for the express purpose of providing financing for a specific third party (the conduit bond obligor) that is not a part of the state or local government's financial reporting entity. Although conduit debt securities bear the name of the governmental entity that issues them, the governmental entity often has no obligation for such debt beyond the resources provided by a lease or loan agreement with the third party on whose behalf the securities are issued. Further, the conduit bond obligor is responsible for any future financial reporting requirements.

- 10.10** Typically, a qualified governmental agency such as a financing authority (the issuer) issues the securities and then lends the proceeds to the NFP (the obligor). In these "conduit financings," although the securities bear the name of the issuing government, the issuer has no obligation for repayment of the debt; the bondholders' principal and interest will be paid solely from resources of the obligor.
- 10.11** Various types of collateral are offered for municipal bonds issued on behalf of NFPs. For revenue bond issues, the NFP pledges a specific revenue stream; typically revenue derived from the project or enterprise being funded. There may also be a mortgage on the property financed and other restrictive covenants. To obtain project financing, a financing authority may require an NFP to enter into a lease arrangement, a sublease arrangement, or both. The Audit and Accounting Guide *Health Care Entities* provides guidance if an NFP is part of an obligated group of affiliated entities, the assets and revenues of which serve as collateral for the bonds.
- 10.12** Municipal bonds are issued with either a variable or a fixed interest rate. A *fixed-rate bond* bears interest at a specified, constant rate. *Variable-rate* (or floating-rate) *bonds* bear interest at a rate that is reset from time to time. Some documents provide the ability to change the interest mode (for example, from auction-rate^{fn1} to variable-rate). In addition, financing strategies have emerged that convert a variable-rate obligation into a fixed-rate obligation (or vice versa) using derivative instruments. For example, a common financing structure involves creating fixed-rate debt by initially issuing lower-cost variable-rate debt coupled with a floating-to-fixed interest rate swap.

^{fn1} In a Dutch auction, investors bid for the bonds, which are sold at the lowest yield necessary to sell the entire issue.

10.13 The type of project or projects that are funded with municipal bond proceeds affects the taxability of income received by the bondholders and, thus, whether the bonds are characterized as "tax-exempt" or "taxable." Generally, tax-exempt bonds are issued to finance services or facilities that are for the public good. Interest paid to holders of tax-exempt bonds is often exempt from federal income taxes and sometimes from state or local taxes as well. Taxable bonds may be issued for uses not qualifying for tax-exempt financing (for example, rental real estate). Tax considerations are discussed in paragraphs 10.48–.52.

Conduit Bonds That Trade in Public Markets

10.14 Certain accounting standards require entities that have securities that trade in public markets to provide more extensive disclosures than is required for entities that do not have securities trading in public markets. Generally, the rationale behind these requirements is that the entity's financial statements are being utilized in public markets for making decisions about whether to buy, sell, or hold that entity's securities.

10.15 FASB ASC has multiple definitions for the term *public entity*. Generally, these are entities that have debt or equity securities that trade in public markets. When applying accounting standards that refer to public entities, careful attention should be paid to the requirements to determine which definition applies and whether the definition includes conduit bond obligors within its scope. If within its scope, it is also necessary to determine whether the obligor's securities trade in public markets (for example, over-the-counter markets). As discussed in paragraph 10.20, if conduit bonds have been issued on behalf of an NFP in a competitive or negotiated offering, they are deemed to trade in public markets; bonds issued in a private placement would not be deemed to trade in public markets for as long as the bonds are privately held.

10.16 The fact that an NFP with conduit bonds that trade in public markets is considered a public entity does not change that entity's status for purposes of applying accounting standards with requirements that are specific to NFPs, or that explicitly exclude NFPs. If the scope of an accounting standard that contains expanded disclosure requirements (or additional accounting requirements) for public entities explicitly excludes NFPs, NFPs would not apply that standard. Additionally, classification as a public entity under generally accepted accounting principles (GAAP) does not impose Securities and Exchange Commission (SEC) or other regulatory filing requirements (such as Regulation S-X or S-K) on NFPs that are conduit debt obligors, nor does it result in an NFP being required to comply with the portions of the Sarbanes-Oxley Act that apply only to issuers, as defined by the Securities and Exchange Act of 1934.

Credit Enhancement^{fn2}

^{fn2} Paragraph 10.07 discusses the fair value of bonds with third-party credit enhancements, whether measured for purposes of disclosure or reporting under the "Fair Value Option" subsections of FASB ASC 825-10.

- 10.17** NFPs may utilize credit enhancements to make their debt more attractive to lenders and investors or to allow them to access the market at more favorable rates. *Credit enhancement* involves the use of the credit standing of an entity other than the issuer or obligor to provide additional security in a bond or note financing. The term typically refers to bond insurance, bank letters of credit, and similar facilities, but also may refer more broadly to the use of any form of guaranty, secondary source of payment, or similar additional credit-improving instruments. For example, foundations may provide guarantees on bank borrowings of other NFPs or a governing board member may guarantee the debt of the NFP.
- 10.18** When credit enhancement is provided through a bank letter of credit, the debt bears the rating of the issuing bank that commits to pay the principal of and interest on the securities in the event the obligor is unable to do so. Letters of credit cover a specified time period. Bond insurance is an unconditional and irrevocable commitment from a municipal bond insurance company to make scheduled bond debt service payments in the event of nonpayment by the obligor. Bonds secured by a municipal bond insurance policy carry the rating of the municipal bond insurer. Once acquired, a bond insurance policy generally is in place for the life of the bonds.
- 10.19** Because credit-enhanced debt is rated based on the credit standing of another entity, downgrades of the other entity's ratings can have implications for the obligor's own credit ratings, as well as potentially triggering defaults under debt agreements and derivative contracts.

Issuance of Municipal Bonds

- 10.20** Municipal bonds are issued through negotiated sales, competitive bids, or private placements. In a *negotiated sale*, the issuer or obligor negotiates a price with one or more underwriters. In a *competitive bid sale*, the securities are sold to one or more underwriters who submitted the best acceptable bid(s). The underwriters then resell the securities to the general investing public. Municipal bonds issued in negotiated sales or competitive bids are deemed to be traded in public markets; thus, conduit borrowers under those arrangements are considered public entities for purposes of providing certain disclosures under accounting standards (see the discussion in paragraphs 10.14–.16). In addition, when underwriters sell municipal securities to the general investing public, the SEC imposes certain requirements on the underwriters, who in turn require the obligors to file certain disclosure documents. An overview of SEC considerations related to municipal bonds is provided in appendix A, “Municipal Securities Regulation,” of this chapter. In a *private placement*, the securities generally are sold directly to qualified investors (for example, an institutional investor), rather than through an offering to the general investing public. Municipal bonds issued in private placements are not deemed to trade in public markets because the investors typically are subject to restrictions on resale.
- 10.21** An NFP that is issuing municipal bonds through a financing authority prepares an official statement that offers the securities for sale and provides appropriate financial and other information about the offering, the NFP, and any guarantors or credit enhancement

providers. Financial advisers, bond counsel, and, frequently, engineers and appraisers assist the NFP in preparing information for the official statement. (Professional requirements related to auditor association with municipal securities offerings is discussed in paragraphs 10.108–.119.) The following are important stages in a municipal securities offering; the time periods between these stages may vary.

- The preliminary official statement is issued to all prospective buyers of the securities.
- The financing authority, NFP, and the underwriters execute the bond purchase agreement.
- The official statement is issued at the time of sale (sometimes referred to as the *effective date*) and identifies the actual debt service requirements of the securities.
- The closing date is the date the transaction is finalized and the proceeds are transferred from the buyers to the NFP.

Extinguishment and Modification Transactions

- 10.22** NFPs generally follow the same accounting and financial reporting standards for extinguishment and modification of debt as investor-owned entities. Those standards are found in FASB ASC 405-20 and FASB ASC 470-50.
- 10.23** FASB ASC 405-20-40 states that a liability is extinguished either when the debtor pays the creditor and is relieved of its obligation for the liability or when the debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor. FASB ASC 405-20-40-1(a)(4) states that paying the creditor includes reacquisition by the debtor of its outstanding debt securities whether the securities are cancelled or held as so-called treasury bonds.
- 10.24** Thus, a debt obligation is derecognized if an NFP reacquires its bonds through open market purchases, regardless of whether the reacquired securities are then held by the debtor as treasury bonds or retired. Treasury bonds held should never be reported as an asset of the NFP, even if the entity intends to remarket the bonds at a future date or hold and manage them as part of its investment portfolio.
- 10.25** Another way that an NFP may extinguish its debt is by issuing new debt whose proceeds are used to repay the previously-issued debt (a refunding transaction). If the new debt is held by the same creditor as the old debt, the refunding may be a modification of debt terms rather than an extinguishment, as discussed in paragraphs 6–12 of FASB ASC 470-50-40 (see paragraphs 10.35–.39). Current refunding, advance refunding, and crossover refunding are 3 types of refunding transactions. In a *current refunding*, the new debt proceeds may be used to repay the old debt within 90 days of the first call date or maturity of the debt to be refunded. In an *advance refunding*, the new debt proceeds are placed with an escrow agent and invested until they are used to pay principal and interest

of the old debt at a future time. In an *advance refunding*, outstanding securities are refinanced more than 90 days prior to their call or maturity date.^{fn3} In a crossover refunding, debt (referred to as *crossover bonds*) is issued for the purpose of paying off an existing debt issue (referred to as the *refunded bonds*). The crossover bonds are collateralized initially by an escrow of investments purchased with the crossover bond proceeds, and the refunded bonds continue to be secured by their original collateral or revenue stream. On a specified date, the investments held in escrow are sold and the refunded bonds are redeemed. Then, the crossover bonds become collateralized by the original collateral or payable from the original revenue stream. In refunding transactions, the entity must either call the bonds (if allowed) to redeem them early, or must irrevocably set aside the funds to pay them off (in a defeasance). These situations are discussed in the following paragraphs.

Calls and Mode Conversions

- 10.26** Some bond contracts allow an NFP to repay the bonds prior to their scheduled maturity date, which is referred to as a *call option*. Typically, new bonds are issued to pay off the outstanding bonds (a refunding).
- 10.27** Some bonds are structured as multimodal, which permits the NFP to exercise an interest mode conversion. A multimodal feature provides the NFP with a contractual right to change the interest feature of the bond from one form to another (for example, an auction-based interest rate to a fixed-rate or index-based variable interest rate). In most cases, a mode conversion involves a call (referred to as a *mandatory tender*) of the old bonds and marketing of new bonds to new investors as well as existing bondholders. Thus, the mode conversion is similar to a traditional refunding, and the same accounting considerations apply to mode conversions regarding refunding.

Defeasance

- 10.28** If the NFP would like to retire the debt early but does not have a call option, *defeasance* is a financing tool that allows it to obtain some or all of the benefits of repaying bondholders prior to actually retiring the debt. In a defeasance, the NFP purchases government securities for deposit into an escrow account, and irrevocably pledges the securities to the payment of the outstanding debt. The securities and their related earnings are sufficient to pay the principal and interest on the debt when it comes due. (In essence, the NFP is substituting collateral on the debt.) Often, some or all of the funds deposited into the escrow arise from an advance refunding. Generally, the revenues originally pledged as security on the outstanding securities switch over to become security for payment of the refunding debt (the new issue) on the date the advance refunding debt is issued.

^{fn3} Per the Tax Reform Act of 1986, new money bonds issued prior to January 1, 1986, can be advance refunded twice, whereas bonds issued on or after that date can only be advance refunded once.

- 10.29** Defeasances are categorized as legal or economic. The terms of some debt contracts allow for legal defeasance, which is the termination of the rights and interests of the debtholders and of their lien on the pledged revenues or other security. When the conditions specified in the debt contract for legal defeasance are met, the NFP's obligation for repayment of the debt is satisfied in full and the debt is extinguished.
- 10.30** In other situations, sometimes referred to as an *in-substance* or *economic defeasance*, establishing a defeasance escrow makes the revenues pledged as collateral available for other purposes without actually affecting a legal defeasance. This might be used if, for example, the debt contract does not provide a procedure for termination of the debtholders' rights and interests other than through redemption of the debt. In an economic defeasance, if for some reason the escrowed funds prove insufficient to make future payments on the old debt, the NFP is still legally obligated to make payment on such debt from the pledged revenues.
- 10.31** FASB ASC 405-20-55 provides implementation guidance on extinguishment of liabilities, including in-substance and legal defeasances.
- 10.32** When a defeasance occurs, the debtor has not paid the creditor. Therefore, liabilities are considered extinguished for accounting purposes only if the debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor. In a legal defeasance, generally the creditor legally releases the debtor from being the primary obligor under the liability; however, the question of whether the debtor has in fact been legally released is a matter of law, not an accounting determination. A legal opinion may be required. An in-substance defeasance transaction normally does not meet the derecognition criteria for either the liability or the escrowed assets unless a legal release is obtained.
- 10.33** Paragraphs 4-6 of FASB ASC 860-10-40 provide standards for determining whether financial assets should be derecognized.
- 10.34** Derecognition of the assets in the defeasance trust may need to be separately evaluated even if the defeased debt has met the criteria for derecognition. Because the obligor must surrender control over the assets transferred to the trust, and the transferred assets must be legally isolated from the obligor (for example, presumptively put beyond the reach of the obligor and its creditors even in bankruptcy or other receivership), if the obligor has any type of continuing involvement with the transferred assets (for example, if the obligor has the ability to direct the investment of trust assets or is entitled to residual assets upon termination of the trust), a separate legal isolation opinion may be required in order to conclude that the conditions for derecognition have been met.

Modifications

- 10.35** When one debt instrument is replaced with another (such as occurs in refundings or interest mode conversions), and the new debt instrument is held by the same creditor(s)

as the old, questions may arise regarding whether the transaction is considered a debt modification or a debt extinguishment.

- 10.36** Paragraphs 6–12 of FASB ASC 470-50-40 provide guidance for determining whether a replacement of one debt instrument with another is a modification of the original debt terms or the extinguishment of one obligation and the issuance of another. FASB ASC 470-50-40-6 states that an exchange of debt instruments with substantially different terms is a debt extinguishment and should be accounted for in accordance with FASB ASC 405-20-40-1 (by derecognizing the liability). FASB ASC 470-50-40-10 states that from the debtor's perspective, an exchange of debt instruments between a debtor and a creditor in a nontroubled debt situation is deemed to have been accomplished with debt instruments that are substantially different if the present value of the cash flows under the terms of the new debt instrument is at least 10 percent different from the present value of the remaining cash flows under the terms of the original instrument. However, if the debt modification is considered a troubled debt restructuring, the guidance in FASB ASC 470-60 would apply.
- 10.37** When evaluating whether a modification or an exchange has occurred with a public debt issuance, the debt instrument is the individual bond held by an investor, and the creditor is the bondholder. Thus, the unit of account is not for the bond issue in total, but on a bondholder-by-bondholder basis. As a practical matter, if the bonds are widely held, it may be reasonable to conclude that the issuance of new bonds to pay off old bonds is not a refinancing of debt with the same creditors and thus is an extinguishment, rather than a modification. If the bonds are not widely held and the transaction is in essence a refinancing of debt with the same creditor(s), it is necessary to determine whether the difference between the present value of the remaining cash flows associated with the original obligation and the present value of the cash flows associated with the new obligation is less than 10 percent. If the difference is less than 10 percent, the transaction is a modification.
- 10.38** For a conduit bond offering involving a governmental financing agency, an NFP should determine whether the financing agency is acting as a principal or as an agent of the obligor in order to determine whether the transaction is an extinguishment or a modification.
- 10.39** Paragraphs 19–20 of FASB ASC 470-50-40 and paragraphs 4–7 of FASB ASC 470-50-55 provide guidance and indicators to consider in making such a determination.

Gain or Loss on Debt Extinguishment

- 10.40** FASB ASC 470-50 addresses how a gain or loss on a debt extinguishment should be measured. It applies to all extinguishments of debt, whether early or not, except debt that is extinguished through a troubled debt restructuring (or convertible debt). Per FASB ASC 470-50-40-2, the difference between the reacquisition price and the net carrying amount of the extinguished debt should be recognized currently in income of the period of extinguishment as losses or gains and identified as a separate item. Gains and losses

should not be amortized to future periods. Classification of the gain or loss is discussed in FASB ASC 470-50-45 (see paragraph 10.74).

- 10.41** The *reacquisition price* of debt is the amount paid on extinguishment, including a call premium and miscellaneous costs of reacquisition. If extinguishment is achieved by a direct exchange of new securities, the reacquisition price is the fair value of the new securities. The net carrying amount of the extinguished debt is the amount due at maturity, adjusted for unamortized premium, discount, and cost of issuance.

Debt Issuance Costs

- 10.42** Paragraphs 17–18 of FASB ASC 470-50-40 provide guidance for reporting costs incurred by the debtor in connection with an exchange or modification of debt instruments. The accounting treatment depends on whether the fees are paid to the creditor or to other third-parties. The following paragraph summarizes that guidance but is not a substitute for reading the referenced paragraphs.
- 10.43** If the exchange or modification is to be accounted for in the same manner as a debt extinguishment and the new debt instrument is initially recorded at fair value, then (a) the fees between the debtor and creditor are included in determining the debt extinguishment gain or loss to be recognized, and (b) the third-party costs are amortized over the term of the new debt instrument using the interest method in a manner similar to debt issue costs. If the exchange or modification is not accounted for in the same manner as a debt extinguishment, then (a) the fees between the debtor and the creditor, along with any existing unamortized premium or discount, are amortized as an adjustment of interest expense over the remaining term of the replacement or modified debt instrument using the interest method, and (b) the third-party costs are expensed as incurred.
- 10.44** As discussed in FASB ASC 470-50-40, in the event of a mode conversion, modification, or extinguishment of debt, there may be effects on any related prepaid issuance costs or deferred issuance costs, such as impairment adjustments or revised amortization periods.

Puts/Tender Options

- 10.45** Some bond contracts allow the bonds to be repaid prior to their stated maturity at the option of the bondholder. The bondholder's right to request earlier payment is referred to as a *tender option* (or sometimes as a *put option*). Some NFPs utilize bank agreements such as letters of credit or standby bond purchase agreements (a liquidity facility) to provide liquidity for the put or tender feature. If a bondholder exercises its put option, the NFP (through its remarketing agent) generally will seek to sell the put bonds to another investor. If another investor is found who accepts the same terms as the original bondholder, the transaction occurs between the bondholders and does not affect the accounting by the NFP. The proceeds of the resale are used to pay the original bondholder. If another investor cannot be found (that is, a failed remarketing), the NFP is required to pay the bondholder. If the NFP has a liquidity facility, then the liquidity provider generally advances the funds needed to pay the bondholder. At that point,

ownership of the bonds transfers to the liquidity provider, and they become bank bonds. The interest rate payable on bank bonds converts to the rate stipulated in the liquidity facility agreement. Efforts continue to remarket the bank bonds for the period of time stipulated in the liquidity facility agreement. If another bondholder is found within that period, the proceeds generally are used to pay off the liquidity facility, the interest rate returns to the terms in the original bond agreement, and the bonds revert to their normal status, with the one exception discussed in paragraph 10.23.

- 10.46** If another buyer cannot be found after a certain period, the liquidity facility generally ceases to be interest-only and converts to a term loan. The NFP repays the debt over a relatively short period of time, rather than over the original stated maturity of the bonds. In effect, the bank (the liquidity facility) exchanges the term loan for the bond, and the bond is derecognized because its terms are substantially different from those of the term loan.
- 10.47** In some cases, an NFP may forego using an external liquidity facility. If a failed remarketing occurs, the NFP pays the holder of the put bonds using its own cash and liquid investments ("self-liquidity"). In these situations, the bonds are considered extinguished when the failed remarketing occurs, regardless of whether the put bonds are retained by the NFP as treasury bonds or retired.

IRS Considerations

- 10.48** As discussed in paragraph 10.13, interest paid to holders of tax-exempt bonds is often exempt from federal income taxes and sometimes from state or local taxes as well. In order to maintain the bonds' tax-exempt status, an NFP must comply with all applicable federal tax laws and Treasury regulations including (but not limited to) the use of bond-financed property and arbitrage requirements. The IRS encourages Section 501(c)(3) organizations to implement procedures that will enable them to adequately safeguard against postissuance violations that could result in loss of the tax-exempt status of the bonds. IRS Publication 4078, *Tax-Exempt Private Activity Bonds* (available for download at www.irs.gov), is a helpful source of information regarding the requirements. Other IRS information for the tax-exempt bond community is available at www.irs.gov/taxexemptbond/. Requirements related to arbitrage and the qualified use of proceeds are briefly summarized in the following paragraphs.
- 10.49** Tax-exempt bonds bear interest at lower rates than taxable bonds due to the inherent federal tax subsidy. Safeguards exist so that entities do not attempt to benefit inappropriately from this subsidy by issuing tax-exempt bonds and then investing the proceeds to earn *arbitrage* (the difference between the interest earned on the invested funds and the interest rate the NFP must pay to the bondholders). Specific IRS requirements control arbitrage, dictating which bond issues are subject to rebate (that is, remitting excess earnings to the federal government) and when the yield on investments must be restricted. Certain exceptions apply to these provisions based on the nature and timing of the expenditures paid by the bond proceeds.

- 10.50** FASB ASC 954-470-25-2, which applies to health care entities but is equally relevant to NFPs, states that IRS regulations concerning tax-exempt bonds prohibit the yield realized from the investment of the proceeds of tax-exempt bonds from exceeding the interest rate to be paid on such bonds. Whenever an NFP invests tax-exempt bond proceeds and the ultimate yield is higher than the interest rate on the bonds, the entity may be subject to an arbitrage rebate liability. The arbitrage determination is made as of the date of the issue; however, intentional acts undertaken after the date of the issue can disqualify the issue retroactively. The earnings in excess of interest expense represent a liability that must be paid to the U.S. Treasury in order for the bonds to maintain their tax-exempt status. The arbitrage rebate liability may be a substantial amount if the bond proceeds are not spent as quickly as planned. For example, this may occur if a provider encounters a delay in a major construction project.
- 10.51** The type of project or projects that are funded by a bond affects the taxability of income received by the bondholders. Conduit bonds issued for projects that only benefit private parties (private activity bonds) normally are taxable. Conduit bonds issued to finance facilities owned and utilized by Internal Revenue Code (IRC) Section 501(c)(3) nonprofit organizations are exempt from federal income tax if they are qualified Section 501(c)(3) bonds. To qualify for tax-exemption, at least 95 percent of the net bond proceeds must be used for exempt activities. Thus, no more than 5 percent of the net proceeds may be used in any private business use or by the NFP in an unrelated trade or business activity. Bond issuance costs are considered part of the 5 percent private use and reduce the net proceeds available for other types of private use. IRC Section 501(c)(3) borrowers must ensure that the IRS rules on private use are met both at the time that the bonds are issued and throughout the life of the bonds.
- 10.52** Treasury Regulations provide for certain remedial actions to cure uses of proceeds that would otherwise cause the qualified Section 501(c)(3) bonds to lose their exempt status. Those remedial actions can include redemption or defeasance of bonds, alternative qualified use of disposition proceeds, or alternative use of the bond-financed facilities. NFPs may also be eligible to enter into a closing agreement under the Tax Exempt Bonds Voluntary Closing Agreement Program (IRS Notice 2008-31).

Financial Statement Presentation and Disclosure

Statement of Financial Position

- 10.53** According to FASB ASC 958-470-25-1, if an NFP finances part of its activities using the proceeds of tax-exempt bonds or other obligations issued through state and local financing authorities and the NFP is responsible for the repayment of those obligations, that financing shall be recognized as a liability in the NFP's statement of financial position.
- 10.54** Although debt typically has a stated maturity of many years, careful consideration should be given to classification of the liability as current or noncurrent based on the features of the debt. Debt that appears to be long-term based on its legal maturity might not be

considered long-term for financial reporting purposes because of subjective acceleration clauses or due on demand (put) provisions. Careful consideration of the debt agreements and related documents (for example, the indenture, loan and trust agreement, liquidity facility, and so on) may be required in order to make a determination whether debt is properly classified.

- 10.55** The principal guidance for evaluating the appropriate classification of debt obligations in the statement of financial position is found in FASB ASC 210-10-45, FASB ASC 470-10-45, and FASB ASC 470-10-55.

Classification of Debt With Due on Demand or Put Provisions, Including Remarketing Agreements and Auction-Rate Securities

- 10.56** FASB ASC 470-10-45-10 states that the current liability classification should include obligations that, by their terms, are due on demand or will be due on demand within one year (or operating cycle, if longer) from the balance sheet date, even though liquidation may not be expected within that period.
- 10.57** For example, some variable-rate bonds have a demand feature (a put or tender option) whereby the bondholder may require the NFP or its remarketing agent to repurchase the bonds, often on short notice. Demand obligations normally are classified as current liabilities, despite the fact that the bond's stated maturities cover many years. However, such obligations often are supported by a liquidity facility (such as a standby bond purchase agreement or letter of credit from a financial institution) that provides the NFP with the ability to refinance, on a long-term basis, any obligation that may arise if tendered bonds cannot immediately be remarketed to another investor (see paragraphs 10.45–.47).
- 10.58** FASB ASC 470-10-55-8 states that debt agreements that allow a debt holder to redeem (or put) a debt instrument on demand (or within one year) should be classified as short-term liabilities despite the existence of a best-efforts remarketing agreement. That is, unless the issuer (the NFP) of the redeemable debt instrument has the ability and intent to refinance the debt on a long-term basis as provided for in FASB ASC 470-10-45-14, the debt should be classified as a current liability.
- 10.59** FASB ASC 470-10-45-14 requires that the intent to refinance a short-term obligation on a long-term basis be supported by an ability to consummate the refinancing that is demonstrated in either of the following ways: (a) post-balance-sheet-date issuance of a long-term obligation or equity securities, or (b) a financing agreement. If a financing agreement is used to justify noncurrent classification of the debt, FASB ASC 470-10-45-14(b) requires that before the statement of financial position is issued or is available to be issued, the entity must have entered into a financing agreement that clearly permits the entity to refinance the short-term obligation on a long-term basis on terms that are readily determinable, and all of the three conditions in FASB ASC 470-10-45-14(b) must be met.
- 10.60** In summary, those three conditions are the following:

1. The agreement does not expire within one year from the date of the entity's statement of financial position, and during that period the agreement is not cancelable by the lender except for violation of a provision with which compliance is objectively determinable or measurable. Further, any obligations incurred under the agreement are not callable during that period.
2. No violation of any provision in the financing agreement exists at the balance sheet date and no available information indicates that a violation has occurred thereafter or, if a violation has occurred thereafter, a waiver has been obtained.
3. The lender is expected to be financially capable of honoring the agreement.

However, the conditions are very complex, and the preceding summary is not intended as a substitute for reading paragraphs 14–20 of FASB ASC 470-10-45.

- 10.61** If the liquidity facility (which is the financing agreement) contains a subjective acceleration clause, the liquidity facility does not meet the first condition in the previous paragraph because compliance with that clause is not objectively determinable or measurable. The NFP is not deemed to have the ability and intent to finance on a long-term basis and thus, cannot classify the debt as noncurrent, even if the repayment terms of the liquidity facility would otherwise support such classification. (See paragraph 10.63 for the definition of a *subjective acceleration clause*). The probability of the subjective acceleration clause being exercised is irrelevant when attempting to demonstrate the ability to refinance a short-term obligation on a long-term basis. See the related discussion in paragraph 10.64.
- 10.62** Rather than utilizing a liquidity facility issued by an external third party, some NFPs choose to utilize their own funds for satisfying puts or tenders. NFPs that do so have no basis for excluding those put and tender obligations from current liabilities, because there is no third party providing liquidity that would effectively allow the entity to refinance the debt on a long-term basis.

Classification of Long-Term Debt With a Subjective Acceleration Clause

- 10.63** The FASB ASC glossary defines a *subjective acceleration clause* as a provision in a debt agreement that states that the creditor may accelerate the scheduled maturities of the obligation under conditions that are not objectively determinable (for example, if the debtor fails to maintain satisfactory operations or if a material adverse change occurs). For long-term obligations, the effect of a subjective acceleration clause on classification in the statement of financial position is determined by FASB ASC 470-10-45-2. That paragraph states that in some situations, the circumstances (for example, recurring losses or liquidity problems) would indicate that long-term debt subject to a subjective acceleration clause should be classified as a current liability. Other situations would indicate only disclosure of the existence of such clauses. Neither reclassification nor disclosure would be required if the likelihood of the acceleration of the due date were remote, such as if the lender historically has not accelerated due dates of loans containing

similar clauses and the financial condition of the borrower is strong and its prospects are bright.

- 10.64** In other words, a long-term obligation with a subjective acceleration clause could continue to be classified as noncurrent unless it was probable it would be called. For an obligation that by its terms is short term, FASB ASC 470-10-55-1 states that a higher standard is required for a financing agreement that permits an entity to refinance a short-term obligation on a long-term basis than is required for an existing long-term loan for which early repayment might be requested. As discussed in paragraph 10.61, if a financing agreement that permits an entity to refinance a short-term obligation on a long-term basis contains a subjective acceleration clause, the mere presence of that clause is enough to preclude long-term classification.

Classification of Long-Term Debt With a Covenant Violation

- 10.65** Violations of covenants could cause termination of the financing agreement or demand for immediate repayment. Thus, debt covenant violations can affect classification in the statement of financial position.
- 10.66** Paragraphs 11–12 of FASB ASC 470-10-45 discuss the classification of long-term obligations that (a) are callable by the creditor either because the debtor's violation of a provision of the debt agreement at the balance sheet date makes the obligation callable, or (b) may become callable because the violation, if not cured within a specified grace period, will make the obligation callable. Those paragraphs require that such callable obligations be classified as current liabilities unless either of the two conditions in FASB ASC 470-10-45-11 is met.
- 10.67** In summary, those two conditions are the following:
1. The creditor has waived or subsequently lost the right to demand repayment for more than one year from the balance sheet date, or
 2. The long-term obligation contains a grace period within which the debtor may cure the violation, and it is probable that the violation will be cured within that period.

However, the conditions are complex and the preceding summary is not a substitute for reading paragraphs 11–12 of FASB ASC 470-10-45.

- 10.68** If neither of those two conditions is met, the debt is classified as short term, regardless of the fact that the creditor has not demanded repayment and there is no indication that the creditor intends to do so within the next year. Further, no distinction between significant and insignificant violations should be drawn. That is the right of the creditor, and if the violation is considered insignificant by the creditor, the debtor should be able to obtain a waiver.
- 10.69** Paragraphs 2–6 of FASB ASC 470-10-55 provide examples of classification of long-term debt when a debt covenant violation at the balance sheet date is waived by a lender for a

period greater than a year, but the entity must meet the covenant on a quarterly or semiannual basis.

Cash and Cash Equivalents Restricted by Debt Agreements

- 10.70** Debt-financing instruments may require cash, investments, or both to be set aside in special accounts that can only be used for debt-related purposes, such as unexpended proceeds of debt issues and funds deposited with a trustee and limited to use in accordance with the requirements of a bond indenture or similar document (for example, sinking funds, debt reserve funds, or defeasance-related escrows). Such assets are usually reported in the statement of financial position as “cash and cash equivalents restricted by debt agreements” or “bond funds held by trustee” with a corresponding note disclosing the contractual restrictions. The portion of those assets that is required for liquidation of current liabilities is reported as current assets, with the remainder reported as noncurrent.
- 10.71** FASB ASC 860-30-50-1A requires disclosures if an entity pledges any of its assets as collateral. NFPs should disclose the carrying amount and classifications of both assets pledged as collateral (if those assets are not reclassified and separately reported in the statement of financial position) and associated liabilities. NFPs also should disclose qualitative information about the relationship(s) between collateral assets and associated liabilities. For example, if assets are restricted solely to satisfy a specific obligation, the nature of restrictions placed on the assets should be disclosed.

Subsequent Events

- 10.72** Events occurring subsequent to the date of the statement of financial position but before the financial statements are issued or available to be issued may need to be reflected in the financial statements, either by changing the classification of the debt or by disclosure. For example, debt restructuring transactions occurring after the balance sheet date may have an effect on the debtor's current or noncurrent classifications as of that balance sheet date, and extinguishing or modifying the terms of a debt issue may require disclosure. Chapter 3, “Financial Statements, Reporting Entity, and General Financial Reporting Matters,” includes additional information about subsequent events, including a discussion of whether an NFP evaluates subsequent events through the issuance date of the financial statements or the available to be issued date.

Statement of Activities

- 10.73** If the proceeds of tax-exempt borrowings are externally restricted to the acquisition of specified qualifying assets or to service the related debt, the amount of interest cost capitalized should be determined in accordance with paragraphs 10–12 of FASB ASC 835-20-30. Those considerations are discussed in chapter 9, “Plant, Property, and Equipment.”
- 10.74** Pursuant to FASB ASC 470-50-40-2, gains or losses on extinguishment of debt should be recognized currently in income of the period of extinguishment and identified as a

separate item. Paragraphs 2–7 of FASB ASC 225-20-45 provide the criteria that must be met for gains and losses from extinguishment of debt to be classified as extraordinary items.

Disclosures

- 10.75** General disclosure requirements for debt (such as description of the debt, collateral, interest rate, covenants, and guarantees) are set forth in FASB ASC 470-10-50. If debt was considered to be extinguished by in-substance defeasance under the provisions of FASB Statement No. 76, *Extinguishment of Debt*, before the effective date of FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (that is, before December 31, 1996), FASB ASC 470-40-50-1 requires disclosure of the amount of the debt and a description of the transaction as long as the debt remains outstanding. FASB ASC 860-30-50-2 provides disclosure requirements for assets that are set aside solely for the purpose of satisfying scheduled payments of a specific obligation.
- 10.76** If short-term obligations are classified in the statement of financial position as a long-term liability because the NFP has the ability and intent to refinance the debt on a long-term basis (see paragraph 10.59), those obligations need to be included in the disclosure of the combined aggregate amount of maturities and sinking fund requirements for all long-term borrowings that is required by FASB ASC 470-10-50-1. In those situations, the NFP must ensure that disclosure is made of both the debt repayment schedule of the liquidity facility and the stated maturity of the debt. This can be done by either (a) by providing two tabular schedules (one for the liquidity facility payment schedule and the other based on the stated maturity of the debt), or (b) including one repayment schedule in the table and providing narrative disclosure related to the other.
- 10.77** As discussed in paragraphs 10.14–16, additional disclosures are required for entities defined as public entities. Generally, *public entities* are those that have debt or equity securities that trade in public markets. Because FASB ASC has multiple definitions for the term *public entity*, careful attention should be paid to such disclosure requirements to determine if their scope includes conduit bond obligors whose bonds trade in public markets.
- 10.78** Paragraphs 10–19 of FASB ASC 825-10-50 require that public entities disclose the fair value of all financial instruments, whether recognized or not recognized in the statement of financial position, for which it is practicable to estimate that value. The disclosure is also required of nonpublic entities if its assets are \$100 million or more on the date of the financial statements or if it has derivative instruments. Determining the fair value of liabilities is discussed in paragraphs 10.02–.08.
- 10.79** FASB ASC 855-10-55-2 cites the sale of a bond after the balance sheet date but before financial statements are issued or are available to be issued as an example of an event that requires disclosure in the notes to the financial statements.

- 10.80** Other events occurring after the balance sheet date, such as failed auctions, potential or actual cancellation of a liquidity facility, defaults, or a mandatory tender of bonds, may also need to be disclosed in the financial statements as subsequent events.

Annual Filing Requirements

- 10.81** Some debt agreements require audited financial statements to be provided to the creditor, underwriters, and bond repositories on an annual ongoing basis. Some NFPs are required to annually submit audited financial statements to the Municipal Securities Rulemaking Board's (MSRB's) Electronic Municipal Market Access (EMMA) system, which is a system for disseminating the information to investors in municipal securities and other interested parties (see appendix A).

Tax Liabilities

- 10.82** Chapter 15, "Tax and Regulatory Considerations," discusses tax issues concerning NFPs, including recognition and measurement guidance for deferred tax assets and liabilities and tax positions taken or expected to be taken in a tax return.

Deferred Revenue

- 10.83** Resources received in exchange transactions from customers, patients, and other service beneficiaries for specific projects, programs, or activities that have not yet taken place should be recognized as liabilities to the extent that the earnings process has not been completed. For example, resources received from the advance sale of season theater tickets should be recognized as deferred revenue, representing the obligation to hold the performances. That revenue is earned as the theater performances are held.

Refunds Due to and Advances From Third Parties

- 10.84** Some NFPs receive (a) advances from third parties, such as government agencies, based on the estimated cost of providing services to constituents, (b) advances from donors with a conditional promise to contribute the transferred assets, and (c) resources from third parties to be used to make loans to the NFP's constituents. Advances from third parties for services not yet performed, as well as refunds due to third parties for amounts previously received under such agreements, should be included as liabilities on a statement of financial position.

Promises to Give

- 10.85** The FASB ASC glossary defines a *promise to give* as "a written or oral agreement to contribute cash or other assets to another entity. A promise carries rights and obligations—the recipient of a promise to give has a right to expect that the promised assets will be transferred in the future, and the maker has a social and moral obligation, and generally a legal obligation, to make the promised transfer. A promise to give may be

either conditional or unconditional.” Per FASB ASC 958-605-25-11, conditional promises to give should not be recognized until the conditions are substantially met.^{fn 4} FASB ASC 720-25-25 requires contributions made to be recognized as expenses in the period made and as decreases of assets or increases of liabilities depending on the form of the benefits given. In accordance with FASB ASC 958-720-25-2, unconditional promises to give should be recognized at the time the donor has an obligation to transfer the promised assets in the future, which generally occurs when the donor approves a specific grant or when the recipient of the promise is notified. If a donor explicitly reserves the right to rescind an intention to contribute, or if a solicitation explicitly allows a donor to rescind the intention, a promise to give should not be recognized by the donor. If payments of the unconditional promise to give are to be made to a recipient over several fiscal periods and the recipient is subject only to routine performance requirements, a liability and an expense for the entire amount payable should be recognized. FASB ASC 958-720-30-1 requires that the liability and expense be measured initially at fair value. Paragraphs 3.150–.153 of this guide discuss present value techniques for measuring fair value. Appendix A to chapter 5, “Contributions Received and Agency Transactions,” of this guide includes excerpts from the AICPA Financial Reporting white paper *Measurement of Fair Value for Certain Transactions of Not-for-Profit Entities*, which discusses fair value measurement of unconditional promises to give cash. Unconditional promises to give that are expected to be paid in less than one year may be measured at net settlement value.

- 10.86** Per FASB ASC 958-720-25-3, if an NFP makes contributions or awards grants to other NFPs upon specific requests of others, the NFP may be acting as an agent, trustee, or intermediary in a transfer between the donor and the beneficiary specified by the donor (agency transaction). The terms *agent*, *trustee*, and *intermediary* are defined in the FASB ASC glossary. Paragraph 10.91 describes liabilities for amounts held for others in agency transactions. Paragraphs 5.07–.31 provide further guidance about agency transactions.
- 10.87** Per FASB ASC 958-405-35-1, if the present value of the amounts to be paid is used to measure fair value^{fn 5} of an unconditional promise to give, the discount rate should be determined at the time the unconditional promise to give is initially recognized and should not be revised, unless the promise to give is subsequently remeasured at fair value pursuant to the “Fair Value Option” subsections of FASB ASC 825-10. The interest method, described in FASB ASC 835-30-35-2, should be used to amortize discounts. Per FASB ASC 958-405-45-1, the amortization of any discount related to unconditional

^{fn 4} Chapter 5, “Contributions Received and Agency Transactions,” provides additional guidance for recognizing conditional promises to give.

^{fn 5} Paragraphs 3.137–.167 discuss Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurement*, which defines *fair value* and establishes a framework for measuring fair value. Paragraphs 4–20 of FASB ASC 820-10-55 provide standards for using present value techniques when the measurement objective is fair value.

promises to give should be reported as a component of contribution expense, in the same functional classification in which the promise to give was reported.

- 10.88** If contributions payable are measured using present value techniques and the NFP has not elected to measure the payable at fair value as described in paragraph 10.02, methods of amortization other than the interest method may be used if the results are not materially different. The discount should be amortized between the date the promise to give is initially recognized and the date the cash or other contributed assets are paid.
- 10.89** In addition to disclosures required by FASB ASC 450-20-50, FASB ASC 958-405-50 requires that the notes to financial statements include a schedule of unconditional promises to give that shows the total amount separated into amounts payable in each of the next five years, the aggregate amount due in more than five years, and for unconditional promises to give that are reported using present value techniques, the unamortized discount.

Split-Interest Obligations

- 10.90** Some contributions received by NFPs, such as interests in charitable gift annuity contracts and charitable remainder and lead trusts, impose obligations on the NFP to make future payments to others. Guidance for reporting such contributions, often referred to as *split-interest agreements*, is included in chapter 6, "Split-Interest Agreements and Beneficial Interests in Trusts." Obligations arising from split-interest gifts should be recognized as liabilities. Paragraphs 6.32–.40 discuss periodic revaluations of the obligations under split-interest agreements, including whether the discount rate assumptions should be revised at each measurement date to reflect current market conditions. Periodic revaluations of these obligations result in changes in the value of split-interest agreements, which should be included as changes in the appropriate net asset classes in a statement of activities.

Amounts Held for Others Under Agency Transactions

- 10.91** Some NFPs receive assets in agency transactions. Paragraphs 23–24 of FASB ASC 958-605-25 discuss recognition of resources received by intermediaries and agents in agency transactions. If cash and other financial assets are held under agency transactions, the NFP should report a liability to the specified beneficiary concurrently with its recognition of those assets received from the donor. If the assets received from the donor are donated materials, supplies, or other nonfinancial assets, the intermediary or recipient entity may choose either to (a) report the receipt of the asset as a liability to the beneficiary concurrent with recognition of the assets received or (b) not to report the transaction at all. The choice is an accounting policy that should be applied consistently from period to period. FASB ASC 958-605-50-4 states that an intermediary or other recipient entity should disclose its accounting policy for recognizing nonfinancial assets that it accepts from a donor on behalf of a specified beneficiary. Paragraphs 5.07–.31 discuss agency transactions in more detail.

Revenue Sharing and Other Agreements

10.92 FASB ASC 958-810-25-7 notes that some NFPs enter into agreements with other entities, such as sharing revenue, resulting in liabilities to those other entities. In such circumstances, those liabilities should be reported. If NFPs agree to share revenue from fund-raising campaigns, the appropriate accounting depends on the relationship between the NFPs. FASB ASC 958-20 discusses agreements for which an NFP agrees to raise or hold contributions for a financially interrelated entity (see paragraph 5.27). FASB ASC 958-605-25-24 discusses agreements in which an NFP agrees to raise or hold contributions for another NFP as its agent (see paragraph 10.91).

Exit or Disposal Activities

10.93 FASB ASC 420, *Exit or Disposal Cost Obligations*, provides financial accounting and reporting standards for costs associated with exit or disposal activities, including restructurings. Per FASB ASC 420-10-15-4, an exit activity includes, but is not limited to, a restructuring, such as the sale or termination of a line of business, the closure of business activities in a particular location, the relocation of business activities from one location to another, changes in management structure, or a fundamental reorganization that affects the nature and focus of operations. FASB ASC 420 discusses recognition of liabilities for the costs of exit activities, including one-time termination benefits provided to current employees that are involuntarily terminated, costs to terminate a contract that is not a capital lease, costs to consolidate facilities or relocate employees, costs associated with a disposal activity covered by FASB ASC 205-20, and costs associated with an exit activity, including exit activities associated with an entity newly acquired in a merger or acquisition. FASB ASC 360-10 and FASB ASC 410-20 and paragraphs 9.25–.29 discuss exit and disposal obligations associated with the retirement (sale, abandonment, recycling, disposal, or other other-than-temporary idling) of tangible long-lived assets and the associated asset retirement costs.

Guarantees

10.94 An NFP that issues certain guarantees, including guarantees of the debt of others, should recognize a liability for those guarantees, even in circumstances in which it is not probable that payments will be required under the guarantee. Guarantees are not conditional promises to give because the guarantor has given something of value. For example, a community foundation may guarantee the debt of a local arts organization without charging a premium. The fact that the arts organization is able to obtain financing not otherwise available, or to be charged a lower interest rate on its borrowing as a result of the guarantee, is evidence that something of value has been given to the arts organization at the inception of the guarantee. When the community foundation enters into the guarantee agreement, it assumes a noncontingent obligation to stand ready to make payments in the event that the arts organization fails to pay.

10.95 FASB ASC 460, *Guarantees*, establishes the accounting and disclosure requirements to be met by a guarantor for certain guarantees issued and outstanding. FASB ASC 460-10-25-4 requires that at the inception of a guarantee, a guarantor shall recognize in its statement of financial position a liability for that guarantee. Per paragraphs 2–3 of FASB ASC 460-10-30, if a guarantee is issued as a contribution to an unrelated party, the liability recognized at the inception of the guarantee shall be measured at its fair value unless at the inception of the guarantee, the contingent liability amount required to be recognized at inception of the guarantee by FASB ASC 450-20-30 is greater. If a guarantee is issued in a standalone arm's-length transaction with an unrelated party, the liability recognized at the inception of the guarantee may be the premium received or receivable by the guarantor as a practical expedient. Per FASB ASC 460-10-35-1, the liability that the guarantor initially recognized would typically be reduced as the guarantor is released from risk under the guarantee. Disclosures about guarantees are required by FASB ASC 460-10-50.

Contingencies

10.96 In conformity with FASB ASC 450-20, notes to the financial statements may have to include information about, or a liability may have to be accrued for, loss contingencies. FASB ASC 958-450-25-1 provides the following examples of circumstances that may result in such contingencies:

- Noncompliance with donor-imposed restrictions on contributed assets
- A problem with the NFP's tax-exempt status, or that a determination letter regarding that status has not been received

Pension and Other Defined Benefit Postretirement Plan Obligations

Single-Employer Plans

10.97 An NFP that sponsors a single-employer defined benefit pension or postretirement plan should recognize the overfunded or underfunded status of that plan in its statement of financial position. The NFP should also recognize changes in that funded status in the year in which the changes occur as changes in unrestricted net assets. The underfunded status of a plan is a liability, and the overfunded status of a plan is an asset.

10.98 For a single-employer defined benefit pension plan, FASB ASC 715-30-25-1 states that if the projected benefit obligation exceeds the fair value of plan assets, the employer should recognize in its statement of financial position a liability that equals the unfunded projected benefit obligation. If the fair value of plan assets exceeds the projected benefit obligation, the employer shall recognize in its statement of financial position an asset that equals the overfunded projected benefit obligation. Per FASB ASC 715-30-35-62, the measurements of plan assets and benefit obligations required shall be as of the date of the employer's fiscal year-end statement of financial position, with limited exceptions.

10.99 For single-employer defined benefit postretirement plans other than pensions, FASB ASC 715-60-25-1 and FASB ASC 715-60-35-6 state that an employer that sponsors 1 or more plans should recognize in its statement of financial position the funded statuses of those plans, and should measure the funded status for each plan as the difference between the fair value of plan assets and the accumulated postretirement benefit obligation. Per FASB ASC 715-60-35-121, the measurements of plan assets and benefit obligations should be as of the date of the employer's fiscal year-end statement of financial position, with limited exceptions.

Multiemployer Plans

10.100 Some NFPs—often, those that have unionized employees—are local affiliates of a national organization or are religious organizations and participate in multiemployer pension plans. The following are characteristics of a multiemployer plan:

- The assets contributed by one employer may be used to provide benefits to employees of other participating employers because they are not specifically earmarked only for its employees.
- If a participating employer fails to make its required contributions, the unfunded obligations of the plan may be borne by the remaining participating employers.
- If an employer chooses to stop participating in a multiemployer plan, the withdrawing company may be required to pay to the plan a final payment (the withdrawal liability).

10.101 FASB ASC 715-80-35 states that the provisions of FASB ASC 450, *Contingencies*, apply if withdrawal from a multiemployer plan may result in an employer having an obligation to the plan for a portion of the unfunded benefit obligation of the pension or other postretirement benefit plans and that obligation is either probable or reasonably possible.

10.102 FASB ASC 715-80-50 requires disclosures to users of financial statements assess the potential future cash flow implications relating to an employer's participation in multiemployer pension plans. The disclosures also indicate the financial health of all of the significant plans in which the employer participates and assist a financial statement user in locating additional information that is available outside the financial statements. The disclosures of the employer's contributions made to the plan include all items recognized as net pension costs (see FASB ASC 715-80-35-1). The disclosures based on the most recently available information should include information available through the date at which the employer has evaluated subsequent events.

10.103 If an NFP participates in a multiemployer plan that provides postretirement benefits other than pensions for each annual period for which a statement of activities is presented. The disclosures should include a description of the nature of the benefits and the types of employees covered by these benefits, as well as a description of the nature and effect of any changes that affect comparability of total employer contributions from period to

period. Examples of events that affect comparability are provided in FASB ASC 715-80-50-11.

10.104

Appendix A — Municipal Securities Regulation

A-1 Currently, municipal securities are exempt from all of the provisions of the Securities Act of 1933 (1933 Act) and the Securities Exchange Act of 1934 (1934 Act) except the antifraud provisions of Section 17(a) of the 1933 Act and Section 10(b) of the 1934 Act (and the associated Rule 10b-5). Those antifraud provisions prohibit any person from misrepresenting or omitting material facts in the offering or sale of securities. Instances of application of the antifraud provisions in Securities and Exchange Commission (SEC) enforcement actions offer guidance within the context of actual transactions.

A-2 The SEC published its views with respect to the disclosure obligations of participants in the municipal securities markets under the antifraud provisions of the federal securities laws in its 1994 Interpretive Release, "Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others."^{fn15} In it, the SEC reviews numerous municipal disclosure practices needing improvement in light of the antifraud provisions.

A-3 SEC Rule 15c2-12 and associated SEC releases impose certain requirements on the underwriters of municipal securities.^{fn16} Because of Rule 15c2-12, obligors of most municipal securities offerings over set dollar amounts must provide certain disclosure documents when issuing securities (primary market disclosures) as well as at certain times thereafter (referred to as *continuing disclosures* or *secondary market disclosures*). Primary market disclosures are made by issuing an official statement. Secondary market disclosures consist of (a) annual continuing disclosures as contractually established and (b) material events notices. Both primary and secondary market disclosure documents are available through the nationally-recognized municipal securities information repository (the Electronic Municipal Market Access system, or EMMA) and to state information depositories, if one exists in the obligor's state.

SEC's Office of Municipal Securities

A-4 The Office of Municipal Securities (OMS), which is located in the Division of Trading and Markets, coordinates the SEC's municipal securities activities, advises the SEC on policy matters relating to the municipal bond market, and provides technical

^{fn15} Securities Act Release No. 33-7049, 59 FR 12748.

^{fn16} For the adopting release, see www.sec.gov/rules/final/adpt6.txt. For the text of Rule 15c2-12, see www.law.uc.edu/CCL/34ActRls/rule15c2-12.html.

assistance in the development and implementation of major SEC initiatives in the municipal securities area. In addition, OMS assists the Division of Enforcement and other SEC offices and divisions on a wide array municipal securities matters. OMS works closely with the municipal securities industry to educate state and local officials and conduit borrowers about risk management issues and foster a thorough understanding of the SEC's policies. OMS maintains a webpage of helpful information specifically directed to municipal securities issues and conduit obligors (www.sec.gov/info/municipal.shtml).

Secondary Market Disclosure Requirements

A-5 In 1994, the SEC issued rules requiring, as a condition of issuance of debt securities, that the obligor agree to implement a system of continuing disclosure that remains in effect as long as the bonds are outstanding. The core of this system is the continuing disclosure agreement (sometimes referred to as a "15c2-12 contract" or "15c2-12 agreement"). This is a covenant entered into by the obligor in which the obligor agrees to provide certain specified information to bondholders and beneficial owners throughout the life of the bond issue. The terms of the obligor's continuing disclosure agreement are spelled out in the indenture or bond resolution, and also are summarized in the official statement.

A-6 The system is much less prescriptive than the system of periodic reporting required of publicly traded companies. The primary elements are (1) annual reporting of financial and operating information, and (2) material events reporting. Quarterly reporting is encouraged but not required (unless agreed to in the continuing disclosure covenant for a particular issue).

A-7 There is no prescribed reporting format (similar to the 10-K) for submission of the annual financial and operating information. The specific list of items to be included in the annual report will be agreed upon by the parties to the financing transaction and enumerated in the continuing disclosure agreement and in an appendix to the official statement. Usually, it consists largely of audited financial statements and updates of specified categories of financial information and operating data or specific sections and charts in the final official statements, or both.

A-8 There is no statutory due date for the filing of annual financial information, as there is with 10-K filings. Instead, the filing deadline is contractually agreed to in the continuing disclosure agreement. If an obligor fails to file information by the agreed-upon deadline and subsequently issues an official statement for new bonds, it must disclose its failure to file in that official statement. Failure to disclose this information constitutes a material omission in the official statement.

A-9 The annual report does not have to be submitted all at once, in a single document; it may be submitted as a single document or as separate documents comprising a package.

A-10 The continuing disclosure agreement also requires the obligor to file disclosures related to significant events within 10 days of their occurrence. Events for which notice is to be provided (that is, that are not subject to a materiality determination) are as follows:

- Principal and interest payment delinquencies
- Unscheduled draws on debt-service reserves reflecting financial difficulties
- Unscheduled draws on credit enhancements reflecting financial difficulties
- Substitution of credit or liquidity providers, or their failure to perform
- Adverse tax opinions or events affecting the tax-exempt status of the security
- Defeasances
- Rating changes
- Tender offers
- Bankruptcy, insolvency, receivership, or a similar event
- Notices of failure to provide annual financial information on or before the date specified on the continuing disclosure agreement

Events that are subject to a materiality determination before triggering a requirement to provide notice are as follows:

- Appointment of successor additional trustees or the change of name of a trustee
- Nonpayment related defaults
- Modifications of rights to security holders
- Bond calls
- Matters affecting collateral (for example, release, substitution, or sale of property securing repayment of the securities)
- Consummation of a merger, consolidation, or acquisition involving an obligated person, or the sale of substantially all of the assets of an obligated person, other than in the ordinary course of business, the entry into definitive agreements to undertake such an action, or the termination of an agreement as it relates to any such sale, other than pursuant to its terms

Electronic Municipal Market Access System

A-11 Effective July 1, 2009, the Electronic Municipal Market Access System (EMMA) became the nationally recognized municipal securities information repository for filing annual reports, material event notices, and voluntarily-submitted information. EMMA is an Internet-based centralized database that provides free public access to disclosure and transaction information about municipal bonds to the municipal market. EMMA also provides access to official statements, advance refunding documents, real-time trade and historical trade information, daily market information, and other educational materials about municipal bonds. Essentially, EMMA makes municipal disclosure information available to the market in a manner similar to the SEC's Electronic Data-Gathering,

Analysis, and Retrieval System, or EDGAR, for the disclosures of publicly traded companies. Rule 15c2-12 requires all continuing disclosure information to be filed using EMMA. EMMA's web address is www.msrb.emma.org. The SEC release concerning this amendment to SEC Rule 15c2-12 is available at www.sec.gov/rules/sro/msrb/2008/34-59061.pdf.

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Chapter 11

Net Assets and Reclassifications of Net Assets

Introduction

11.01 The Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary defines *net assets* as “the excess or deficiency of assets over liabilities of a not-for-profit entity (NFP), which is classified into three mutually exclusive classes according to the existence or absence of donor-imposed restrictions.”^{fn 1} As a residual interest, net assets cannot be measured independently of an NFP’s assets and liabilities. Changes in net assets result from transactions and other events and circumstances in which total assets and total liabilities change by different amounts. In many NFPs, such changes include nonreciprocal transfers of assets received from donors who do not expect to receive either repayment or proportionate economic benefit in return. Display of and disclosures about net assets and changes in them are intended to assist donors and other users in assessing an NFP’s efforts to provide goods and services to its constituencies, its efficiency and effectiveness in providing such services, and its continuing ability to do so.

11.02 Changes in net assets result from revenues, expenses, gains, and losses; those changes are discussed in chapters 5–10 and 12–13 of this guide. This chapter describes principles for reporting total net assets in statements of financial position and changes in total net assets in statements of activities as well as related disclosures.

Fiduciary Responsibilities to Meet Donor Restrictions

11.03 As noted in paragraph 5.74, the receipt of contributed assets imposes a fiduciary responsibility on an NFP’s management to use the resources effectively and efficiently in pursuit of the NFP’s mission; a donor’s restriction on contributed resources focuses that fiduciary responsibility on a particular use for the contributed resources. As noted in FASB ASC 958-605-25-2, donors’ restrictions place limits on the use of contributed resources and may affect an NFP’s performance and its ability to provide services. The existence or absence of donors’ restrictions forms the basis for the classification of net assets.

11.04 The FASB ASC glossary defines a *donor-imposed restriction* as

^{fn 1} Though not-for-profit entities (NFPs) may use other terms, such as *equity*, this guide uses the term *net assets* to describe the residual interest.

a stipulation that specifies a use for a contributed asset that is more specific than the broad limits resulting from the following: (a) the nature of the NFP, (b) the environment in which it operates, and (c) the purposes specified in its articles of incorporation or bylaws or comparable documents for an unincorporated association. A donor-imposed restriction on an NFP's use of the asset contributed may be temporary or permanent. Some donor-imposed restrictions impose limits that are permanent, for example, stipulating that resources be invested in perpetuity (not used up). Others are temporary, for example, stipulating that resources may be used only after a specified date, for particular programs or services, or to acquire buildings and equipment.

- 11.05** When an NFP accepts a restricted contribution, it accepts a fiduciary responsibility to use the gift for the purposes for which it is given. An NFP needs a method of tracking restrictions on net assets and when those restrictions are satisfied. One way of tracking restricted net assets and their use is fund accounting, which facilitates tracking by segregating resources into funds that are consistent with the restricted use of the contribution. Chapter 16, "Fund Accounting," discusses fund accounting and the fund types typically used by NFPs. Other ways of tracking restricted net asset and their use are via a subsidiary ledger or a project accounting system.
- 11.06** No matter which system is used, an NFP needs to maintain documentation about the activities and other purposes for which the net assets in the fund, subsidiary ledger account, or project can be used. Documentation about any restrictions on periods in which the gift can be spent, restrictions on specific assets, limitations on investing, or other donor restrictions that limit the use of the resources also need to be included. For gifts that have complex restrictions, it is advisable to retain a copy of the gift agreement as part of the documentation. Some NFPs include donor names, donor contact information, and the amount(s) and date(s) of the contribution(s) in the documentation. For permanently restricted net assets, that documentation should be maintained in perpetuity.
- 11.07** The end result should be that the NFP is able to produce a listing of the amounts and purposes for which its net assets are restricted. That information supports the disclosure in the financial statement in accordance with FASB ASC 958-210-50-3, which requires that information about the nature and amounts of different types of permanent or temporary restrictions be provided either by reporting their amounts on the face of the statement of financial position or by including the relevant details in notes to financial statements.

Failure to Meet a Donor's Restriction

- 11.08** An event or change in circumstances occurring subsequent to a contribution may raise the possibility that the NFP may not satisfy a donor-imposed restriction. As noted in FASB ASC 958-450-25-1, noncompliance with donor-imposed restrictions on contributed assets, although rare, does occur, sometimes as a result of events occurring subsequent to receiving a contribution. Paragraphs 3.172–.174 provide guidance for noncompliance

with donor restrictions. FASB ASC 855, *Subsequent Events*, provides guidance if the noncompliance occurs after the balance sheet date but before the financial statements are issued. Paragraphs 3.176–.179 provide additional information about subsequent events.

Net Asset Classes

- 11.09** Paragraphs 9–11 of FASB ASC 958-210-45 provide guidance for the classification of net assets. The amounts for each of three classes of net assets—permanently restricted, temporarily restricted, and unrestricted—are based on the existence or absence of donor-imposed restrictions.
- 11.10** In addition to the three classes of net assets, further disaggregation of total net assets may also be reported. For example, unrestricted net assets may be subdivided into board-designated net assets and undesignated net assets. Donor-imposed restrictions limit an NFP's ability to use or dispose of specific contributed assets or the economic benefits embodied in those assets. Donor stipulations should not be considered restrictions unless they include limitations on the use of contributed assets that are more specific than the broad limits imposed by the NFP's purpose and nature.
- 11.11** FASB ASC 958-210-45-6 states that, generally, donor-imposed restrictions apply to net assets, not to specific assets. Donors may also restrict specific assets regarding their use (for example, land contributed for a park) or over time (for example, contributed securities that must be held in perpetuity). Paragraphs 3.09–.23 and 11.55 discuss reporting requirements for specific assets that have been received with donor-imposed restrictions.

Permanently Restricted Net Assets

- 11.12** The FASB ASC glossary defines *permanently restricted net assets* as the part of net assets of an NFP resulting from any of the following:
- a. Contributions and other inflows of assets whose use by the NFP is limited by donor-imposed stipulations that neither expire by passage of time nor can be fulfilled or otherwise removed by the actions of the NFP
 - b. Other asset enhancements and diminishments subject to the same kinds of stipulations
 - c. Reclassifications from or to other classes of net assets as a consequence of donor-imposed stipulations
- 11.13** Permanently restricted net assets must be maintained by the NFP in perpetuity. For example, contributions of cash or securities restricted by the donor with the stipulation that they be invested in perpetuity (donor-restricted endowment funds) and contributions

of collection items (if they are capitalized)^{fn 2} required by the donor to be maintained permanently in the NFP's collections should be recognized as increases in permanently restricted net assets.

11.14 Permanently restricted net assets may also change as a result of increases and decreases in existing assets that are subject to permanent restrictions. For example, FASB ASC 958-205-45-18 states that if a donor stipulates that net gains be added to the principal of its gift until that endowed gift plus accumulated gains increases to a specified dollar level, the gains are permanently restricted. Similarly, if a donor states that a specific investment security must be held in perpetuity, the gains and losses on that security are subject to that same permanent restriction unless the donor specifies otherwise. Increases in the carrying amounts of assets that are invested in perpetuity because of donor-imposed restrictions should be recognized as increases in permanently restricted net assets to the extent that donor stipulations or applicable law requires those increases to be retained permanently. Paragraphs 4.64–78 further discuss the permanently restricted net assets of donor-restricted endowment funds.

Temporarily Restricted Net Assets

11.15 The FASB ASC glossary defines *temporarily restricted net assets* as the part of the net assets of an NFP that result from any of the following:

- a. Contributions and other inflows of assets whose use by the NFP is limited by donor-imposed stipulations that either expire by passage of time or can be fulfilled and removed by actions of the NFP pursuant to those stipulations
- b. Other asset enhancements and diminishments subject to the same kinds of stipulations
- c. Reclassifications from or to other classes of net assets as a consequence of donor-imposed stipulations, their expiration by passage of time, or their fulfillment and removal by actions of the NFP pursuant to those stipulations

11.16 Temporarily restricted net assets are those net assets whose use by the NFP has been limited by donors (a) to later periods of time or after specified dates, or (b) to specified purposes.^{fn 3} For example, contributions restricted by the donor to use by the NFP over the next five years or to support a specific future program should be recognized as increases in temporarily restricted net assets. Contributions of assets (such as equipment

^{fn 2} Chapter 7, "Other Assets," discusses accounting policies concerning the capitalization of collection items.

^{fn 3} Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 958-605-45-4 states that donor-restricted contributions whose restrictions are met in the same reporting period may be reported as unrestricted support provided that an NFP has a similar policy for reporting investment gains and income (see FASB ASC 958-320-45-3), reports consistently from period to period and discloses its accounting policy. Paragraph 5.84 provides further guidance concerning that policy.

or buildings) that by their nature are used up over time and that the donor stipulates must be used by the NFP should also be recognized as increases in temporarily restricted net assets.^{fn 4} Paragraphs 4.64–.78 discuss the temporarily restricted net assets of donor-restricted endowment funds.

- 11.17** Temporarily restricted net assets may also change as a result of increases and decreases in existing assets or the economic benefits embodied in those assets that are subject to donor-imposed temporary restrictions. For example, if the donor has stipulated that income earned on temporarily restricted net assets must be added to principal until the principal is spent for a restricted purpose, the income should be reported as increases in temporarily restricted net assets.

Unrestricted Net Assets

- 11.18** The FASB ASC glossary defines *unrestricted net assets* as the part of net assets of an NFP that is neither permanently restricted nor temporarily restricted by donor-imposed stipulations.
- 11.19** Unrestricted net assets include those net assets whose use is not restricted by donors, even though their use may be limited in other respects, such as by contract or by board designation. Changes in net assets arising from exchange transactions (except income and gains on assets that are restricted by donors or by law) should be included in the unrestricted class. Paragraphs 4.64–.78 discuss the unrestricted net assets of endowment funds.
- 11.20** NFPs such as social and country clubs may issue membership interests, such as capital shares. As discussed in FASB ASC 958-405-25-3, if those interests are wholly or partially refundable when the member dies, moves away, resigns his or her membership, or at a fixed date, FASB ASC 480-10 provides guidance.
- 11.21** FASB ASC 480-10 is currently effective only for interests that are mandatorily redeemable at a fixed date whose amounts either are fixed or are determined by reference to an external index. This guide will be updated to discuss other mandatorily redeemable interests issued by NFPs when FASB ASC 480-10-65 indicates that guidance has become effective for those interests.
- 11.22** FASB ASC 480-10 states that an interest that is mandatorily redeemable at a fixed date for a fixed or indexed amount—that embodies an unconditional obligation requiring the issuer to redeem it by transferring its assets at a fixed date (or dates)—should be classified as a liability and initially measured at fair value. An interest that embodies a conditional obligation to redeem the instrument by transferring assets upon an event not

^{fn 4} Some NFPs may adopt an accounting policy of implying time restrictions on contributed long-lived assets in the absence of explicit donor-imposed restrictions. Paragraphs 5.85–.87 provide additional guidance on alternative policies.

certain to occur becomes mandatorily redeemable if that event occurs, the condition is resolved, or the event becomes certain to occur.

- 11.23** Thus, a membership interest that embodies a conditional obligation to redeem it upon an event not certain to occur (such as *only* upon moving from the community) is initially classified as unrestricted net assets. If the uncertain event occurs, the condition is resolved, or the event becomes certain to occur, and payment of a fixed or indexed amount is to be made at a fixed date (such as three months from the event's occurrence), the interest is reclassified as a liability.
- 11.24** Per FASB ASC 480-10-55-10, upon reclassification, the issuing NFP would measure the obligation at fair value and reduce net assets by the amount of that initial measure, recognizing no gain or loss. Subsequently, pursuant to FASB ASC 480-10-35-3, those mandatorily redeemable interests are measured at the present value of the amount to be paid at settlement using the rate implicit at inception if both the amount to be paid and the settlement date are fixed. If the amount to be paid varies by reference to an interest rate index, currency index, or another external index, those instruments are subsequently measured at the amount of cash that would be paid under the conditions specified in the contract if settlement occurred at the reporting date. The change in the liability amount from the prior period is reported as interest cost (reported as described in paragraph 13.72).
- 11.25** The Financial Reporting Executive Committee believes that the guidance in FASB ASC 460-10 that is not yet effective represents best practice for other mandatorily redeemable membership interests. Thus, a membership interest would also be classified as a liability if the obligation requiring the club to redeem it is unconditional, unless the redemption is required to occur only upon the liquidation or termination of the social or country club. An obligation to redeem a membership interest that is conditioned upon an event not certain to occur would be initially classified as unrestricted net assets. When the obligation becomes unconditional (that is, if the uncertain event occurs, the condition is resolved, or the event becomes certain to occur), the membership interest would be reclassified as a liability.

Noncontrolling Interests

- 11.26** FASB ASC 958-810-45-1 states that noncontrolling interests in the equity (net assets) of consolidated subsidiaries should be reported as a separate component of the appropriate class of net assets in the consolidated statement of financial position of an NFP. That amount shall be clearly identified and described (for example, as noncontrolling ownership interest in subsidiaries) to distinguish it from the components of net assets of the parent, which includes the parent's controlling financial interest in its subsidiaries. Paragraphs 17–25 of FASB ASC 958-810-55 illustrate the presentation of a noncontrolling interest in a consolidated statement of financial position and a consolidated statement of changes in unrestricted net assets.

- 11.27** The effects of donor-imposed restrictions, if any, on a partially owned subsidiary's net assets should be reported in accordance with FASB ASC 958-205 and 958-320. In other words, the noncontrolling interest would be displayed in unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets in accordance with the nature and existence of donor-imposed restrictions. For example, if a partially owned subsidiary had donor-restricted endowment funds, the net asset section of the statement of financial position of the consolidated entity might appear as follows:

Unrestricted net assets:

Charity A	\$ XX,XXX
Noncontrolling interest in NFP B	XX,XXX
Total unrestricted net assets	XX,XXX

Temporarily restricted net assets:

Charity A	XX,XXX
Noncontrolling interest in NFP B	XX,XXX
Total temporarily restricted net assets	XX,XXX

Permanently restricted net assets:

Charity A	XX,XXX
Noncontrolling interest in NFP B	XX,XXX
Total permanently restricted net assets	XX,XXX
Total net assets	\$XXX,XXX

- 11.28** FASB ASC 958-810-25-6 discusses an interest by an NFP in another NFP that is less than a complete interest. For example, an NFP may appoint 80 percent of the board of the other NFP. For NFPs other than health care entities (that is, within the scope of FASB ASC 954, *Health Care Entities*), if the conditions for consolidation in paragraphs 2–4 of FASB ASC 958-810-25 are met, the basis of that consolidation would not reflect a noncontrolling interest for the portion of the board that the reporting entity does not control because there is no ownership interest other than the interest of the reporting entity. Additional information about reporting of related entities, including consolidation, is provided by chapter 3, “Financial Statements, the Reporting Entity, and General Financial Reporting Matters.”

Reclassifications

11.29 Per FASB ASC 958-225-45-13, reclassifications of net assets—that is, simultaneous increases in one net asset class and decreases in another—should be made if any of the following events occur:

- a. The NFP fulfills the purposes for which the net assets were restricted.
- b. Donor-imposed restrictions expire with the passage of time or with the death of a split-interest agreement beneficiary (if the net assets are not otherwise restricted).
- c. A donor withdraws, or court action removes, previously imposed restrictions.
- d. A donor imposes restrictions on otherwise unrestricted net assets.^{fn 5}

Expiration of Donor-imposed Restrictions

11.30 Paragraphs 9–12 of FASB ASC 958-205-45 and FASB ASC 958-225-45-13 provide guidance for reporting reclassifications for the expiration of donor-imposed restrictions. An NFP should recognize the expiration of a donor-imposed restriction on a contribution in the period in which the restriction expires. A restriction expires when the stipulated time has elapsed, when the stipulated purpose for which the resource was restricted has been fulfilled, or both. If two or more temporary restrictions are imposed on a contribution, the effect of the expiration of those restrictions should be recognized in the period in which the last remaining restriction has expired. Expirations of donor-imposed restrictions should be reported in a statement of activities as reclassifications, decreasing temporarily restricted net assets and increasing unrestricted net assets. Paragraphs 11.33–.51 provide information about the expiration of donor restrictions in specific situations.

11.31 For example, the amount of a donor's contribution that must be used by the NFP for a specified program would be reclassified from temporarily restricted to unrestricted net assets in the period in which the NFP conducts the program. The restriction on a contribution to acquire supplies for a particular program activity expires when those supplies are acquired by the NFP. The restriction on a term endowment in which contributed cash is to be invested for 10 years expires at the end of the tenth year.

11.32 The reclassification from temporarily restricted net assets into unrestricted net assets reflects that relationship between a restricted contribution and an expense that it supports because the restriction generally expires (increasing unrestricted net assets) in the same period as the expense occurs (decreasing unrestricted net assets).

Using Restricted Contributions First

^{fn 5} Paragraph 5.77 discusses donors imposing restrictions on otherwise unrestricted net assets.

- 11.33** A purpose restriction is typically fulfilled when the NFP incurs an expense or recognizes a liability to a vendor to acquire goods or services that satisfies the restriction. When an expense is incurred or liability recognized, both unrestricted net assets and temporarily restricted net assets may be available for that purpose.
- 11.34** FASB ASC 958-205-45-11 states that if an expense is incurred for a purpose for which both unrestricted and temporarily restricted net assets are available, a donor-imposed restriction is fulfilled to the extent of the expense incurred unless the expense is for a purpose that is directly attributable to another specific external source of revenue. For example, an expense does not fulfill an existing donor restriction if that expense is incurred for a purpose that is directly attributable to and reimbursed by a sponsored exchange agreement or a conditional award from a government agency, private foundation, or others.
- 11.35** For example, an employee's salary may meet donor-imposed restrictions to support the program on which the employee is working. In that situation, the restriction is met to the extent of the salary expense incurred unless incurring the salary will lead to inflows of revenues from a specific external source, such as revenues from a cost reimbursement contract or a conditional promise to give that becomes unconditional when the NFP incurs the salary expense.
- 11.36** In accordance with FASB ASC 958-205-45-11, temporarily restricted net assets with time restrictions are not available to support expenses until the time restrictions have expired. For example, a donor might specify that a gift be invested for a period of five years, with the investment return being added to the original gift during that time. At the end of the five years, the donor specifies that the accumulated amount be spent for a lecture series on a particular environmental topic. Although the NFP may hold lectures on that topic prior to the end of the fifth year, the expenses of those lectures do not release the restriction. Only expenses for lectures on that topic held after the end of the fifth year will release the restriction because the temporarily restricted net assets were not available until the time restriction had expired. (Paragraphs 11.37–.44 provide additional information about the implied time restrictions on promises to give with payments due in future periods.)

Expiration of Restrictions on Promises to Give

- 11.37** Paragraphs 5.94–.97 explain that a time restriction is implied on unconditional promises to give that are due in future periods unless explicit donor stipulations or circumstances surrounding the receipt of the promise make clear that the donor intended it to be used to support activities of the current period. FASB ASC 958-605-45-5 states that it is reasonable to assume that by specifying future payment dates donors indicate that their gift is to support activities in each period in which a payment is scheduled.
- 11.38** Thus, in the absence of clarifying donor stipulations, it would be inappropriate to look backward at the date the time restriction is met to determine if the purpose restriction was met in a prior year. For example, if a donor promises to give \$5,000 a year for 5 years to

be used to fund scholarships for students that are accounting majors, it is reasonable to assume that the donor wanted a \$5,000 scholarship to be granted in each of the 5 years. In the absence of clarifying donor stipulations, it would be inappropriate to look backwards each year when the promised \$5,000 was paid and to conclude that the purpose restriction had been met by scholarships of \$25,000 granted in the year of the promise.

- 11.39** Technical Questions and Answers (TIS) section 6140.03, “Lapsing of Time Restrictions on Receivables That Are Uncollected at Their Due Date” (AICPA, *Technical Practice Aids*), explains that time restrictions on contributions receivable lapse when the receivable is due. In some cases, the due date may be explicitly stated. In other cases, circumstances surrounding receipt of the contribution may make clear the implicit due date. In yet other cases, the due date may be unclear. NFPs should consider the facts and circumstances surrounding the promise to give to determine the due date, if any. At the due date, the time restriction expires and the net assets become available for the purpose specified by the donor. If the donor did not specify a purpose or otherwise restrict the contribution, the temporarily restricted net assets are reclassified to unrestricted net assets at the due date.
- 11.40** An NFP implies time restrictions that expire in the periods that the payments are due unless another time period is inherent in the donor’s purpose restriction (that is, explicit donor stipulations or circumstances surrounding the receipt of a promise to give make clear that the donor intended the gift to be used to support activities of a period other than the one in which the payment is due). For example, a museum may receive an unconditional promise to give in year 1 that is restricted to supporting a traveling exhibit the museum will host in year 2. Although payments on that promise are due in installments in each of years 1, 2, and 3, a time restriction would not be implied because the donor restricted the gift to an event that will occur only in year 2.
- 11.41** TIS section 6140.04, “Lapsing of Restrictions on Receivables if Purpose Restrictions Pertaining to Long-Lived Assets Are Met Before the Receivables Are Due” (AICPA, *Technical Practice Aids*), provides guidance for situations in which a donor restricts a contribution to the purchase of particular long-lived assets, and those assets are acquired, placed in service, and the purpose restrictions met, prior to the due date of the contribution. For example, an NFP may have a capital campaign asking for commitments to contribute over the next 5 years so the NFP can build a new building. A donor may promise to give \$100,000 in 5 years in response to that request, but the building will be completed in 4 years. Because FASB ASC 958-205-45-11 states that temporarily restricted net assets with time restrictions are not available to support expenses until the time restrictions have expired, it can be unclear when the restrictions on the promise to give expire.
- 11.42** TIS section 6140.04 states that NFPs should consider the facts and circumstances surrounding the promise to give and whether those facts and circumstances indicate that the donor intended the contribution to be used to support activities of the current period (that is, the period in which the long-lived asset is constructed or placed in service). If circumstances indicate that the donor intended to support activities of the current period,

there is no time restriction and the guidance in paragraphs 9 and 11–12 of FASB ASC 958-205-45 would not be applicable, unless a restriction was placed on the contribution other than constructing the building (such as an additional donor restriction or a policy of implying time restrictions that expire over the useful life of the asset, as discussed in paragraph 11.46).

- 11.43** It is reasonable to assume that when a donor restricts a contribution to the construction or purchase of a specific long-lived asset, the donor intends to support activities of the period in which that long-lived asset is constructed or placed in service, even though the donor may specify payment dates that extend beyond that period. If circumstances indicate that the donor intended to support activities of the period in which the building is constructed or placed in service, a time restriction that expires when the payments are due should not be implied on the promise to give. If the only restriction on the unconditional promise to give is the construction or purchase of the specified long-lived asset (that is, the donor did not place additional restrictions on the contribution and the NFP does not imply a time restriction that expires over the useful life of the asset, as discussed in paragraph 11.46), the restriction is met as the asset is constructed or, if purchased, when it is placed in service.
- 11.44** If the donor does not stipulate a specific long-lived asset to be constructed or purchased, but merely states that the gift is to be used for capital acquisitions, it is reasonable to assume that by specifying future payment dates the donor indicates that the gift is to support capital acquisitions in each period in which a payment is scheduled (in accordance with FASB ASC 958-605-45-5). Both a purpose restriction and an implied time restriction exist, and in accordance with FASB ASC 958-205-45-11, the time restriction must expire first, and then the net assets are available for the purchase of capital assets. In accordance with TIS section 6140.03, the implied time restriction on the promise to give expires when the receivable is due, and the expiration of restrictions is recognized in the future period in which the last remaining purpose restriction expires.

Expiration of Restrictions on Gifts of Long-Lived Assets or Gifts for Their Purchase

- 11.45** Paragraphs 1–2 of FASB ASC 958-360-45 provide guidance for reclassification of net assets upon the expiration of donor restrictions related to property, plant, and equipment. If a donor specifies a time period over which a donated long-lived asset must be used, temporarily restricted net assets should, over time, be reclassified as unrestricted net assets in a statement of activities as those restrictions expire. The amount reclassified may or may not be equal to the amount of the related depreciation. The amount to be reclassified is based on the length of time indicated by the donor-imposed restrictions, and the amount of depreciation is based on the useful economic life of the asset. For example, a vehicle with an estimated useful economic life of five years may be contributed by a donor and restricted for a specific use by the NFP for three years. Although the vehicle is depreciated over five years, the restriction expires over three years.

- 11.46** If a donor does not specify a time period over which a donated long-lived asset must be used, FASB ASC 958-605-45-6 (which is discussed in paragraphs 5.85–.87) states that an NFP may elect a policy to imply a time restriction that expires over the useful life of the donated long-lived assets. An NFP that adopts a policy of implying time restrictions also should imply a time restriction on long-lived assets acquired with gifts of cash or other assets restricted for those acquisitions. FASB ASC 958-205-45-12 states that if time restrictions are implied on gifts of long-lived assets, those implied time restrictions expire as the economic benefits of the acquired assets are used up; that is, over their estimated useful lives. As discussed in paragraphs 9.20–.23, depreciation should be recorded over the asset's useful life, and net assets should be reclassified periodically from temporarily restricted to unrestricted as depreciation is recognized.
- 11.47** In the absence of donor stipulations specifying how long donated assets must be used or an NFP's policy of implying time restrictions, FASB ASC 958-205-45-12 states that restrictions on long-lived assets, if any, or cash to acquire long-lived assets expire when the assets are placed in service.
- 11.48** Paragraphs 11.41–.44 discuss the expiration of restrictions on a promise to give that is restricted to the purchase or construction of long-lived assets.

Expiration of Restrictions on Donor Restricted Endowment Funds

- 11.49** FASB ASC 958-205-45-10 provides the following example. A gift of a term endowment that is to be invested for five years should be recognized as restricted support (revenue or gain) in the period it is received. In year five, when that term endowment becomes unrestricted, a reclassification shall be reported to reflect the decrease in temporarily restricted net assets and the increase in unrestricted net assets. Thus, the related effects of that time-restricted gift should be reported in the period of receipt as well as the period in which the nature of the restriction changes.
- 11.50** The expiration of restrictions on donor-restricted endowment funds of permanent duration is discussed in paragraph 4.72.

Restrictions That Are Met in the Same Year as the Contribution Was Received

- 11.51** As noted in paragraph 5.68, an NFP may meet donor-imposed restrictions on all or a portion of an amount contributed in the same reporting period in which the contribution is received. In those cases, pursuant to FASB ASC 958-605-45-4, the contribution (to the extent that the restrictions have been met) may be reported as unrestricted support provided that the NFP has a similar policy for reporting investment gains and income (pursuant to FASB ASC 958-320-45-3, which is discussed in paragraph 4.83), reports consistently from period to period, and discloses its accounting policy in notes to financial statements. No reclassification is reported because the contribution was never included in temporarily restricted net assets.

Disclosures

- 11.52** FASB ASC 958-210-45-1 requires that a statement of financial position should report all of the following amounts: total assets, total liabilities, permanently restricted net assets, temporarily restricted net assets, unrestricted net assets, and total net assets. FASB ASC 958-225-45-1 requires that a statement of activities should report the following amounts for the period: the change in net assets, the change in permanently restricted net assets, the change in temporarily restricted net assets, and the change in unrestricted net assets. Per FASB ASC 958-225-45-2, the change in net assets should articulate to the net asset or equity reported in the statement of financial position.
- 11.53** FASB ASC 958-225-45-3 requires that reclassifications of amounts between net asset classes should be reported separately from other transactions in the statement of activities. FASB ASC 958-225-45-4 states that information about reclassifications generally is provided by aggregating items that possess similar characteristics into reasonably homogeneous groups. Consistent with illustrative note D of FASB ASC 958-205-55-21, NFPs are encouraged to disclose detailed information about the restrictions that have been met and that therefore resulted in reclassifications from temporarily restricted net assets to unrestricted net assets. The encouraged information illustrated in note D is more detailed than the requirement to aggregate items that possess similar characteristics into reasonably homogeneous groups. Examples of encouraged disclosures include the following:
- Different kinds of restrictions that expired during the reporting period, such as reclassifications pertaining to expiration of time restrictions, satisfaction of purpose restrictions, or other donor-directed releases of restrictions.
 - Information about the nature and extent of expenditures that satisfied purpose restrictions during the period (for example, capital expenditures, program service expenses, or supporting activity expenses)
- 11.54** FASB ASC 958-210-45-9 requires that information about the nature and amounts of different types of permanent restrictions or temporary restrictions be provided either by reporting their amounts on the face of the statement or by including relevant details in notes to financial statements.
- 11.55** For example, information about the following should be shown on the face of the financial statements or in the notes:
- Different kinds of permanent restrictions, such as those related to collection items and other specific assets to be held in perpetuity and to assets that have been contributed by donors with stipulations that they be invested in perpetuity
 - Different kinds of temporary restrictions, such as those concerning the support of specific operating activities, use in specific future periods, or the acquisition of long-term assets

- 11.56** FASB ASC 958-210-45-11 permits information about self-imposed limits, including voluntary resolutions by the governing board to designate a portion of unrestricted net assets (such as board-designated endowments), to be provided in the notes to or on the face of financial statements.
- 11.57** Separate disclosures of significant limitations other than those imposed by donors are permitted to be made on the face of the financial statements or in the notes to the financial statements. For example, paragraphs 6.49–.50 discuss disclosure of annuity reserves that are required by the laws of the state where the NFP is located or by the state where the donor resides and voluntary reserves set aside as a cushion against unexpected actuarial losses.
- 11.58** Paragraphs 4–5 of FASB ASC 958-810-50 describe the schedule of changes in consolidated net assets attributable to the parent and the noncontrolling interest that an NFP (parent) should provide if it has one or more consolidated subsidiaries with a noncontrolling interest. The schedule should be in notes to the consolidated financial statements or on the face of financial statements, if practicable. That schedule should reconcile beginning and ending balances of the parent’s controlling interest and the noncontrolling interests for each class of net assets for which a noncontrolling interest exists during the reporting period and should include, at a minimum, the items in FASB ASC 958-810-50-5. FASB ASC 958-810-55-25 illustrates the required disclosures.

Changing Net Asset Classifications Reported in a Prior Year

- 11.59** TIS section 6140.23, “Changing Net Asset Classifications Reported in a Prior Year” (AICPA, *Technical Practice Aids*), discusses circumstances in which NFPs correct net asset classifications previously reported in prior years’ financial statements. Consistent with the guidance in FASB ASC 958-205-45-2, as well as paragraph 2.31, information about the nature and amount of restrictions imposed by donors on the use of contributed assets, including their potential effects on specific assets and on liabilities or classes of net assets, is helpful in assessing the financial flexibility of an NFP. The classification of net assets as unrestricted, temporarily restricted, or permanently restricted provides information necessary to gain an understanding of an NFP’s financial position, including its financial flexibility and ability to continue to render services. Accordingly, individual net asset classes, rather than net assets in the aggregate (total net assets), are relevant in determining whether an NFP’s correction of net asset classifications previously reported in prior years’ financial statements is an error in previously issued financial statements.

Chapter 12

Revenues and Receivables From Exchange Transactions



Update 12-1 *Accounting and Reporting: Revenue Recognition*

On January 4, 2012, the Financial Accounting Standards Board (FASB) issued the proposed Accounting Standards Update (ASU) *Revenue from Contracts with Customers* to improve and align with International Financial Reporting Standards the financial reporting of revenue from contracts with customers and related costs. The core principle of the draft standard is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The proposed standards would replace most of the guidance in FASB *Accounting Standards Codification* (ASC) 605, *Revenue Recognition*, as well as revenue recognition guidance in other topics. Readers should be alert for the issuance of the final ASU.

Introduction

- 12.01** The FASB ASC glossary defines an *exchange transaction* as a reciprocal transfer between two entities that results in one of the entities acquiring assets or services or satisfying liabilities by surrendering other assets or services or incurring other obligations. The FASB ASC glossary's definition of *contribution* states that contributions differ from exchange transactions, which are reciprocal transfers in which each party receives and sacrifices something of approximately equal value. Chapter 5, "Contributions Received and Agency Transactions," includes guidance on distinguishing exchange transactions from contributions and agency transactions.
- 12.02** This chapter discusses recognition, measurement, and display issues for revenues and related receivables arising from exchange transactions. Because of the specialized nature of exchange transactions from investment activities, they are discussed separately in chapter 4, "Cash, Cash Equivalents, and Investments." The following transactions, which are generally in part contributions and in part exchange transactions, are discussed elsewhere in the guide, as follows:
- Naming opportunities (paragraphs 5.52–.55)
 - Donor status (paragraph 5.56)
 - Split-interest gifts (chapter 6, "Split-Interest Agreements and Beneficial Interests in Trusts")
 - Special events (paragraphs 5.117–.121)

Difference Between Revenues and Gains

- 12.03** Paragraph 78 of FASB Concept No. 6, *Elements of Financial Statements—a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2)*, defines *revenues* as "inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations." Exchange transactions that give rise to revenues for not-for-profit entities (NFPs) typically involve their efforts to provide goods or services to members, clients, students, customers, and other beneficiaries for a fee.
- 12.04** FASB ASC 605-10-25-1 states that an entity's revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues. Gains commonly result from transactions and other events that involve no earning process, and for recognizing gains, being earned is generally less significant than being realized or realizable.
- 12.05** In some situations, judgment is required to determine whether an increase in net assets should be reported as revenue or as gain. Consistent with paragraphs 14–16 of FASB ASC 958-225-45, that determination should be based on the relationship of the transaction to the NFP's activities. Transactions and other events that would properly be considered part of one NFP's ongoing major or central activities (and hence give rise to revenues) may be considered peripheral for other NFP's (and hence give rise to gains). For example, sales of computer equipment by a college store should be reported as revenues if such sales are considered part of the college's ongoing major or central activities. Sales of old computer equipment used in a museum's administrative offices would, however, be reported as gains if such sales are peripheral and if the equipment were sold above book value. Chapter 13, "Expenses, Gains, and Losses," discusses reporting gains from exchange transactions.

Recognition, Measurement, and Display of Revenue

- 12.06** The recognition, measurement, and display of revenues arising from exchange transactions are similar for both NFPs and for-profit entities. Revenues from exchange transactions should be recognized when earned based on accrual accounting principles and should be measured by the increase in cash, receivables, or other assets or by the decrease in liabilities resulting from the transaction. The following subtopics within FASB ASC provide relevant standards for revenues earned by NFPs:

^{fn1}Paragraphs 3.168–.170 discuss the option for entities to report certain assets and liabilities at fair value in conformity with Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 815-15 or the "Fair Value Option" subsections of FASB ASC 825-10.

- FASB ASC 605-25, which discusses revenue recognition if an entity will perform multiple revenue-generating activities under a single arrangement, such as provide multiple products, services, rights to use assets, or any combination thereof
- FASB ASC 605-28, which discusses revenue recognition for research or development contracts if a portion or all of the consideration is contingent upon achievement of a milestone
- FASB ASC 605-45, which discusses the following:
 - Whether an entity that sells products or services that will be delivered by a third party should report revenue gross or net of certain amounts paid to others
 - Presentation for shipping and handling fees and out-of-pocket expenses billed to customers
 - Presentation of taxes collected from customers and remitted to governmental authorities
- FASB ASC 835-30, which discusses imputation of interest on notes issued in exchange transactions if the stated interest rate varies from prevailing interest rates
- FASB ASC 912-605, which discusses revenue recognition by government contractors

In addition, as discussed in paragraph 1.15, some NFPs conduct activities similar to industries within the scope of FASB ASC 905–999 and should apply the guidance concerning the recognition and measurement of revenues to the transactions unique to those industries. An example of such guidance is FASB ASC 920, *Entertainment—Broadcasters*.

12.07 Paragraphs 83–84 of FASB Concept No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, provides nonauthoritative guidance for recognition of revenues and gains. In addition, FASB ASC 605-10-S99-1 also provides useful guidance, although it applies only to public registrants. In general, based upon the guidance in those two sources, revenue is not recognized until it is both realized or realizable and earned, which generally occurs when the following four criteria have been met:

- Persuasive evidence of an arrangement exists
- Delivery has occurred or services have been rendered
- The seller's price to the buyer is fixed or determinable

- Collectibility is reasonably assured

- 12.08** If payment is received from a buyer before revenue is able to be recognized, the obligation to the buyer to either perform under the agreement or to return the payment is recognized (generally referred to as *deferred revenue*). Recognition of that revenue is deferred until the obligation underlying the liability is satisfied and all other revenue recognition criteria have been met.
- 12.09** As described in FASB ASC 845-10-05-2, most business transactions involve exchanges of cash or other monetary assets or liabilities for goods or services. The amount of monetary assets or liabilities exchanged generally provides an objective basis for measuring the cost of nonmonetary assets or services received by an entity, as well as for measuring gain or loss on nonmonetary assets transferred from an entity. However, some exchanges involve primarily nonmonetary assets or liabilities. FASB ASC 845-10-30-1 states that, in general, the accounting for nonmonetary transactions should be based on the fair values of the assets (or services) involved, which is the same basis as that used in monetary transactions. Thus, the cost of a nonmonetary asset acquired in exchange for another nonmonetary asset is the fair value of the asset surrendered to obtain it, and a gain or loss should be recognized on the exchange. The fair value of the asset received should be used to measure the cost if it is more clearly evident than the fair value of the asset surrendered.
- 12.10** In accordance with FASB ASC 958-225-45-5, revenues from exchange transactions should be reported as increases in unrestricted net assets in a statement of activities even when there are legal limitations on the uses of the revenue arising from contracts or other agreements. For example, dormitory fees paid by students to a college that must, under terms of a bond indenture, be immediately deposited in a sinking fund to retire the bonds issued to build the dormitory are unrestricted revenues, as are assessments or fees to cover the cost of a new swimming pool that are received by a country club from its members. Those revenues are not contributions, and restricted revenues arise only from donor's restrictions on contributions or investment return earned on contributed resources. As discussed in chapter 3, "Financial Statements, the Reporting Entity, and General Financial Reporting Matters," further classifications (for example, between operating and nonoperating) may be incorporated within a statement of activities beyond the required net asset classes.
- 12.11** Revenues from exchange transactions should generally be reported gross of any related expenses. Expenses that are directly related to specific gross revenues may, however, be displayed sequentially with those revenues. For example, gross revenues from special events less the direct costs related to those events, followed by a subtotal, may be reported in a statement of activities. Chapter 13 discusses reporting of special events.

Discounts

- 12.12** Per FASB ASC 958-605-45-2, if the NFP regularly provides discounts (such as financial aid for students that is not reported as an expense, reduced fees for services, or free

services) to certain recipients of its goods or services, revenues should be reported net of those discounts. Net revenue may be reported as a single line item in a statement of activities, or the gross revenue is permitted to be reported less the related discount, provided that the discount is displayed immediately beneath the revenue. Paragraphs 7–8 of FASB ASC 958-720-25 (paragraph 13.15) provide guidance concerning whether reductions in amounts charged for goods or services should be reported as discounts or expenses.

Membership Dues

- 12.13** As discussed in Technical Questions and Answers (TIS) section 6140.02, “Income Recognition of Membership Dues by Not-for-Profit Entity” (AICPA, *Technical Practice Aids*), if a member receives benefits from those dues, dues revenue would be recognized over the period of membership in accordance with FASB ASC 958-605-25-1.
- 12.14** Nonrefundable initiation and life membership fees received in exchange transactions should be recognized as revenues in the period in which the fees become receivable if future fees are expected to cover the costs of future services to be provided to members. If nonrefundable initiation and life membership fees, rather than future fees, are expected to cover those costs, nonrefundable initiation and life member fees received in exchange transactions should be recognized as revenue over the average duration of membership, the life expectancy of members, or other appropriate time periods. Dues would be recognized as contributions revenue when received if members receive no benefits from the dues, as discussed further in paragraphs 5.46–.49.

Receivables From Exchange Transactions

- 12.15** Unless measured at fair value in conformity with the “Fair Value Option” subsections of FASB ASC 825-10,^{fn 1} FASB ASC 958-310-35-3 requires that receivables arising from exchange transactions should be reported at net realizable value if the amounts are due within one year. Longer-term receivables should be reported in conformity with FASB ASC 310-10-35. Pursuant to FASB ASC 310-10-45-4, a valuation allowance for credit losses (also referred to as an allowance for uncollectible receivables or an allowance for doubtful accounts) should be deducted from the receivables to which the allowance relates and should be disclosed. TIS section 6140.09, “Reporting Bad Debt Losses” (AICPA, *Technical Practice Aids*), states that under FASB ASC 958-225-45-15, bad debt losses are not permitted to be netted against revenues.
- 12.16** FASB ASC 310-10-50 requires an NFP to provide information about its significant accounting policies for receivables, the credit quality of its financing receivables, and the

^{fn 1} Paragraphs 3.168–.170 discuss the option for entities to report certain assets and liabilities at fair value in conformity with Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 815-15 or the “Fair Value Option” subsections of FASB ASC 825-10.

allowance for credit losses. Examples of financing receivables of NFPs include church mortgages held by church development funds, student loans issued by college and universities, loans receivable in housing associations, microfinance loans, certain program-related investments issued by foundations, and officer and employee notes receivable.^{fn2} The relative significance of the financing receivables to an NFP's operations and financial position and the quantitative and qualitative risks arising from the credit quality of the receivables is considered when determining the extent of the disclosures.

- 12.17** FASB ASC 310-10-55 provides examples of disclosures about financing receivables that are useful to NFPs that hold financing receivables as a major program activity. The following examples of disclosures are useful to NFPs that hold financing receivables, but not as a major program activity. Each example indicates the loan portfolio's size as compared to total assets. That disclosure is not required, but provides users with an understanding of the relative significance of the loan portfolio.

Example 1—Student Loans

The University makes uncollateralized loans to students based on financial need under the Perkins federal loan program (federal funding) and the University student loan program (institutional funding). At August 31, 20X1, and 20X0, student loans were \$3,654,126 and \$3,238,878, respectively, which is about 3 percent of total assets. Of these amounts, as of August 31, 20X1, and 20X0, \$2,257,200 and \$1,973,900, respectively, were not in repayment status (that is, the borrowers were not yet required to make payments). Most loans that are in repayment status are collected over a period of 10 years.

Allowances for doubtful accounts are established based on prior collection experience and current economic factors that, in management's judgment, could influence the ability of loan recipients to repay the amounts per the loan terms. Amounts due under the federal loan programs are guaranteed by the government and, therefore, no allowances are placed on any past due balances under the program. The allowance for doubtful accounts for the University student loan program was approximately \$173,000 for each of the years ended August 31, 20X1, and 20X0. Institutional loan balances are written off only when they are deemed to be permanently uncollectible.

At August 31, 20X1, and 20X0, the following amounts were past due under the student loan programs.

^{fn2} Chapter 8, "Programmatic Investments," provides additional information on loans if their primary purpose is to further the mission-related objectives of the not-for-profit entity, and the production of income is not a significant purpose.

In Default					
<u>August 31,</u>	<u>Less than 240 days (8 monthly installments)</u>	<u>More than 240 days and less than 2 years</u>	<u>More than 2 years, up to 5 years</u>	<u>More than 5 years</u>	<u>Total past due</u>
20X1	\$224,325	\$112,659	\$121,925	\$70,325	\$529,234
20X0	246,436	173,308	129,168	70,575	619,487

The availability of funds for loans under the Perkins federal loan program is dependent on reimbursement to the pool from repayments on outstanding loans. Funds advanced by the federal government of \$2,811,563 and \$2,663,531 at August 31, 20X1, and 2010, respectively, are ultimately refundable to the government and are classified as liabilities in the statement of financial position. Outstanding loans cancelled under the program result in a reduction of the funds available for loan and a decrease in the liability to the government.

Example 2—Notes Receivable from Staff

As part of a program to attract and retain excellent staff, the Organization provides home purchase down payment assistance. Notes receivable amounting to \$208,100 and \$222,500 were outstanding at June 30, 20X1, and 20X0, respectively, and are less than ½ percent of total assets. The notes are collateralized by second trust deeds on single family residences located in the towns surrounding the Organization. The second trust deeds are subordinated to the first trust deeds on the residences. Interest rates on the notes are determined by market rates for second trust deeds at the origination of the note, and range from X percent to Y percent. The loans have a term of 10 years with due-on-sale and due-on-separation-of-service clauses. Note payments are withheld from staff members' salaries; thus, there are no amounts past due. No allowance for doubtful accounts has been recorded against these notes based on their collateralization and prior collection history.

Example 3—Loan Receivable from Officer

As part of the compensation package, the Charity made a \$10,000 loan to an officer, which is less than ¼ percent of the Charity's total assets. The loan is due on demand and bears simple interest at the rate of X percent.

Collection is not intended to be pursued in the next year; accordingly, the loan is presented as long term. The loan is unsecured. Collection is fully expected and accordingly, no allowance has been provided.

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Chapter 13

Expenses, Gains, and Losses

Introduction

- 13.01** Generally, expenses, gains, and losses of not-for-profit entities (NFPs) are similar to those of for-profit entities and are recognized, measured, and displayed similarly. This chapter discusses certain expense, gain, and loss recognition, measurement, and display issues that are unique to NFPs and that are not covered elsewhere in this guide.

Expenses

- 13.02** Paragraph 80 of Financial Accounting Standards Board (FASB) Concept No. 6, *Elements of Financial Statements—a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2)*, defines *expenses* as "outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations." Expenses are distinguished from losses, which are decreases in an NFP's net assets from peripheral or incidental transactions and from all other transactions and other events and circumstances affecting the NFP except those that result from expenses.
- 13.03** Per FASB *Accounting Standards Codification* (ASC) 958-225-45-7, a statement of activities should report expenses as decreases in unrestricted net assets. As discussed in paragraphs 3.35–.37, further classifications (such as between operating and nonoperating) may be incorporated within a statement of activities beyond the required net asset classes. As explained in chapter 11, "Net Assets and Reclassifications of Net Assets," the relationship between a restricted contribution and an expense that it supports is reported via a reclassification from temporarily restricted net assets into unrestricted net assets; the restriction generally expires (increasing unrestricted net assets) in the same period as the expense occurs (decreasing unrestricted net assets).
- 13.04** FASB ASC 958-720-45-2 specifies that to help donors, creditors, and others in assessing an NFP's service efforts, including the costs of services and how it uses resources, a statement of activities or notes to financial statements should provide information about expenses reported by their functional classification, such as major classes of program services and supporting activities. FASB ASC 958-205-45-6 requires voluntary health and welfare entities^{fn 1} to report information about expenses by their functional classes,

^{fn 1} *Voluntary health and welfare entities* are defined in the Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary and in the glossary of this guide.

such as major classes of program services and supporting activities, as well as information about expenses by their natural classifications (such as salaries, rent, electricity, interest expense, depreciation, awards and grants to others, and professional fees), in a matrix format in a separate financial statement called a *statement of functional expenses*.^{fn 2} FASB ASC 958-720-45-16 states that other NFPs are encouraged, but not required, to provide information about expenses by their natural classification.

13.05 Reporting information about the functional classification of expenses may require the allocation of costs that benefit two or more functions. All references in this guide to the allocation of costs of informational materials and activities that include a fund-raising appeal among functions are subject to the provisions of the “Accounting for Costs of Activities that Include Fundraising” subsections of FASB ASC 958-720, which are discussed in paragraphs 13.74–.113.

13.06 There is no requirement to report losses by functional category.^{fn 3}

Expense Recognition Issues

13.07 Expenses are recognized when an NFP's economic benefits are used up in delivering or producing goods, rendering services, or other activities or when previously recognized assets are expected to provide reduced or no future benefits. Some expenses, such as cost of goods sold, are recognized simultaneously with revenues that result directly and jointly from the same transactions or other events as the expenses. Some expenses, such as salaries, are recognized when cash is spent or liabilities are incurred for goods and services that are used up either simultaneously with acquisition or soon after. Some expenses, such as depreciation, are allocated by systematic and rational procedures to the periods during which the related assets are expected to provide services. An expense or loss is also recognized if it becomes evident that the previously recognized future economic benefits of an asset have been reduced or eliminated, or that a liability has been incurred or increased, without associated economic benefits.

Fund-raising Costs

13.08 Fund-raising costs are the costs of *fund-raising activities*, which are defined in the FASB ASC glossary as activities undertaken to induce potential donors to contribute money, securities, services, materials, facilities, other assets, or time. (Paragraphs 13.62–.64

^{fn 2} Not-for-profit entities may have various kinds of functions. The discussion in this guide focuses on program, management and general, and fund-raising for illustrative purposes, because those functional classifications are the predominant practice. Other functional classifications are possible. Accordingly, the classifications used in the matrix may include program, management and general, and fund-raising or other classifications, such as cost of sales or investing.

^{fn 3} Paragraphs 13.02 and 13.30–.36 discuss the differences between expenses and losses.

provide additional discussion of fund-raising activities.) As discussed in paragraphs 5.38–.56, in some circumstances, classifying asset transfers as exchange transactions or as contributions may require the exercise of judgment concerning whether a nonreciprocal transfer has occurred. To the extent such transactions are contributions, the costs of soliciting them are fund-raising costs.

- 13.09** Per FASB ASC 958-720-25-4, costs of fund-raising, including the cost of special fund-raising events, should be expensed as incurred. Costs are incurred when the item or service has been received. Fund-raising costs incurred in one period, such as those made to obtain bequests, compile a mailing list of prospective contributors, or solicit contributions in a direct-response activity, may result in contributions that will be received in future periods. These costs also should be expensed as incurred. Accounting for the costs of premiums, such as address labels, calendars, greeting cards, coffee mugs, and other items of nominal value that are provided to donors and potential donors, is discussed in paragraphs 5.40–.41.
- 13.10** The Financial Reporting Executive Committee (FinREC) believes that the costs of tangible fund-raising assets, such as brochures and promotional items, may be recorded as an asset upon purchase and expensed when used because the cost is incurred upon use, rather than upon purchase. This is similar to the guidance for advertising materials in FASB ASC 720-35-25-3, which states, “Sales materials, such as brochures and catalogues, may be accounted for as prepaid supplies until they no longer are owned or expected to be used, in which case their cost would be a cost of advertising.” Thus, until tangible fund-raising assets are no longer owned or expected to be used, they may be accounted for as an asset. As discussed in paragraph 7.06, the NFP should assess whether the value of that inventory is impaired.
- 13.11** In some circumstances, fund-raising activities are conducted by professional fund-raisers or federated fund-raising entities (or other such fund-raising NFPs) on behalf of a reporting entity. Often, the professional fund-raiser, federated fund-raising entity, or other such fund-raising NFP charges a fee for its services, and sometimes that fee is deducted from the contributions raised before they are remitted to the reporting entity.
- 13.12** If the fund-raising activities are conducted by a professional fund-raiser, guidance is provided by Technical Questions and Answers (TIS) section 6140.21, “Should an NPE Report Amounts Charged to the NPE by a Professional Fund-raiser Gross, as Fund-Raising Expenses, or Net, as a Reduction of Contributions?” (AICPA, *Technical Practice Aids*). In circumstances in which a professional fund-raiser charges an NFP for soliciting contributions on the NFP’s behalf, the NFP should report the amounts charged by the professional fund-raiser gross, as fund-raising expense, rather than net, as a reduction of the contributions received. As discussed in paragraphs 14–15 of FASB ASC 958-225-45, revenues and expenses should be reported gross (except for investment revenues and related expenses, which are permitted to be reported net of related expenses), whereas gains and losses may be reported net. TIS section 6140.21 provides the following example:

NFP A enters into an agreement with Professional Fund-raiser B, whereby Professional Fund-raiser B solicits contributions on behalf of NFP A, for a fee of 20 percent of contributions raised. Professional Fund-raiser B raises \$100,000 and remits \$80,000 to NFP A after retaining its fee of \$20,000. NFP A should report \$100,000 contribution revenue and \$20,000 fund-raising expense.

- 13.13** If the fund-raiser is a federated fund-raising entity or other such fund-raising NFP, guidance is provided by FASB ASC 958-605-55-86 and TIS section 6140.22, “In Circumstances in Which the Reporting NPE Undertakes a Transaction in Which Another NPE (Fund-Raising NPE) Raises Contributions on Behalf of the Reporting NPE, and the Reporting NPE Compensates the Fund-Raising NPE for Raising Those Contributions (Compensation Including, But Not Limited to, an Administrative Fee), Should the Reporting NPE Report the Fund-Raising NPE’s Compensation Gross, as Fund-Raising Expenses, or Net, as a Reduction of Contributions?” (AICPA, *Technical Practice Aids*). Example 4 of FASB ASC 958-605-55 is an example of a federated fund-raising entity that allows donors to specify that their gifts be transferred to an NFP beneficiary of the donor’s choice. FASB ASC 958-605-55-86 states that the beneficiaries specified by the donors would report the gross amounts of the gifts as contribution revenue and the administrative fees withheld by the federated fund-raising entity as expenses; the net amount would be recognized as a receivable from the federated fund-raising entity. TIS section 6140.22 contains a similar conclusion and states that if a fund-raising NFP acts as an agent or intermediary for a reporting entity, and the reporting entity compensates the fund-raising NFP for acting as an agent or intermediary, the reporting entity should report fund-raising expenses for that compensation. The reporting entity should report the amount retained as compensation by the fund-raising NFP (that is, the administrative fees) as fund-raising expenses and report contributions for the gross amount contributed from the donor. In functionalizing the administrative fees reported as fund-raising expenses, the reporting entity would classify those expenses as fund-raising activities. (Paragraphs 5.07–.31 of this guide provide further guidance about identifying transactions in which an NFP acts as an agent or intermediary.)
- 13.14** In other circumstances, an NFP might be the beneficiary of fund-raising activities conducted by another entity, such as a corporation or an individual. The NFP beneficiary has not contracted with the entity conducting the fund-raising and may not have a role in planning or running the campaign or event. In those cases, the NFP should determine whether they have incurred fund-raising expenses by considering the guidance in paragraphs 5.151–.161. In addition to the proceeds forwarded by the entity conducting the fund-raising, the NFP may have also received a contribution of fund-raising material, informational material, advertising, and media time or space. As described in paragraphs 5.151–.161, if the NFP has an active involvement in determining and managing the message and the use of the materials prepared by the entity, a contribution of fund-raising material, informational material, advertising, or media time or space would be recognized as contribution revenue and fund-raising expense.

Financial Aid and Other Reductions in Amounts Charged for Goods and Services

13.15 Some NFPs provide reductions in amounts charged for goods or services, such as financial aid provided by colleges and universities. Per FASB ASC 958-720-25-7, reductions in amounts charged for goods or services provided by an NFP should be reported as expenses if such reductions are given in exchange for goods or services provided to the NFP, such as part of a compensation package. Per FASB ASC 958-720-45-23, amounts reported as expenses for such reductions should be reported in the same functional classification in which the cost of the goods or services provided to the NFP are reported. Per FASB ASC 958-720-25-8, if reductions in amounts charged for goods or services provided by an NFP are given other than in exchange for services provided to the NFP, those amounts should be reported as follows:

- As expenses to the extent that the NFP incurs incremental expense in providing such goods or services
- As discounts^{fn 4} if the NFP incurs no incremental expense in providing such goods or services

Advertising Costs

13.16 FASB ASC 720-35 provides recognition, measurement, and disclosure guidance for the advertising activities of all entities, including NFPs. (FASB ASC 720-35-15-3 specifically notes, however, that fund-raising by NFPs is not within the scope of the subtopic.) FASB ASC 720-35-50 requires certain disclosures about advertising activities, including disclosure of total amount charged to advertising expense for each statement of activities presented.

13.17 FASB ASC 720-35-05-4 defines *advertising* as "the promotion of an industry, an entity, a brand, a product name, or specific products or services so as to create or stimulate a positive entity image or to create or stimulate a desire to buy the entity's products or services." Per FASB ASC 958-720-25-6, advertising by an NFP includes activities to create or stimulate a desire to use the NFP's products or services that are provided without charge.

13.18 Per FASB ASC 720-35-25-1 and FASB ASC 340-20-25-4, the costs of advertising should be expensed either as incurred or the first time the advertising takes place, subject to the following exception. The costs of direct-response advertising should be capitalized if both of the following conditions are met: (a) the primary purpose of the advertising is to elicit sales to customers who could be shown to have responded specifically to the advertising and (b) the direct-response advertising is expected to result in probable future benefits. Per FASB ASC 340-20-25-8, the probable future benefits of direct-response advertising activities are probable future revenues arising from that advertising in excess

^{fn 4} Chapter 12, "Revenues and Receivables From Exchange Transactions," of this guide provides guidance concerning display of discounts.

of future costs to be incurred in realizing those revenues. Per FASB ASC 958-720-25-6, if no future revenues are anticipated because the products or services advertised are being provided by the NFP without charge, there is no basis for capitalizing the costs of direct-response advertising after the first time the advertising takes place.

Start-Up Costs

- 13.19** FASB ASC 720-15 provides guidance on the financial reporting of start-up costs and organization costs. It requires costs of start-up activities, including organization costs to be expensed as incurred.
- 13.20** The FASB ASC glossary broadly defines *start-up activities* as those one-time activities related to any of the following: (a) opening a new facility, (b) introducing a new product or service, (c) conducting business in a new territory, (d) conducting business with an entirely new class of customer or beneficiary, (e) initiating a new process in an existing facility, or (f) commencing some new operations. Start-up activities include activities related to organizing a new entity (commonly referred to as organization costs).
- 13.21** FASB ASC 720-15-15 describes certain costs that may be incurred in conjunction with start-up activities that are outside the scope of FASB ASC 720-15. FASB ASC 720-15-55 provides examples to help entities determine what costs are and are not within its scope. Example 3 (paragraphs 8–10) of FASB ASC 720-15-55 describes an NFP that provides meals to the homeless and is opening a shelter to house the homeless. The example shows the costs that might be incurred in conjunction with start-up activities and clarifies which costs are and are not within the scope of the subtopic.

Internal Use Computer Software Costs

- 13.22** FASB ASC 350-40 provides guidance on accounting for the costs of computer software developed or obtained for internal use. It identifies the characteristics of internal-use software and provides examples to assist in determining when computer software is for internal use. The determination of which costs are capitalized as intangible assets and which costs are expensed depends on the nature of the cost and the stage of the software development project.^{fn 5}

Contributions Made

- 13.23** As part of their program services, some NFPs make contributions to other NFPs. FASB ASC 720-25 provides standards for contributions made. Contributions made should be recognized as expenses in the period made and as decreases of assets or increases of liabilities depending on the form of the benefits given.

^{fn 5} Related literature includes FASB ASC 720-45, which provides guidance on costs associated with business process reengineering and IT transformation projects.

- 13.24** Unconditional promises to give cash are recognized as payables and contribution expenses. The recognition rules for contributions made in the form of unconditional promises to give are discussed in paragraphs 10.85–.89. As discussed in paragraphs 11–15 of FASB ASC 958-605-25, conditional promises to give should be recognized when the conditions on which they depend are substantially met; that is, when the conditional promise becomes unconditional. However, a conditional promise to give is considered unconditional if the possibility that the condition will not be met is remote. FASB ASC 958-605-55-16 provides an example and states that a stipulation that an annual report must be provided by the donee to receive subsequent annual payments on a multiyear promise is not a condition if the possibility of not meeting that administrative requirement is remote. FASB ASC 450-20-50 should be considered when determining whether disclosures about conditional promises to give are required.
- 13.25** Contributions made should be measured at the fair values of the assets given or, if made in the form of a settlement or cancellation of a donee's liabilities, at the fair value of the liabilities cancelled. If the fair value of an asset transferred differs from its carrying amount, a gain or loss should be recognized on the disposition of the asset.
- 13.26** FASB ASC 958-720-25-3 states that if an NFP makes contributions or awards grants to other NFPs upon specific requests of others, the NFP may be acting as an agent, trustee, or intermediary in a transfer between the donor and the beneficiary specified by the donor (an agency transaction). Paragraph 10.91 describes liabilities for amounts held for others in agency transactions. Paragraphs 5.07–.31 provide further guidance about identifying agency transactions.
- 13.27** Some transfers may appear to be contributions made but are actually reciprocal in nature. Paragraphs 5.32–.37 provide further guidance about a transfer made by an NFP for its own benefit or for the benefit of its affiliate.
- 13.28** If NFPs make contributions to other NFPs, FinREC believes best practice is to separately identify such contributions to other NFPs (both affiliated and other than affiliated NFPs), either in the statement of activities or notes to the financial statements. (Though separately identified from other types of expenses, such contributions are nevertheless reported as expenses within the functional classifications.) FinREC believes contributions to other NFPs, including grants that are contributions, are different in concept from expenses incurred in running an organization's own activities, and that distinction may be meaningful to financial statement users.

Contributed Use of Facilities

- 13.29** Some NFPs provide the free use of facilities to other NFPs. Example 5 (paragraphs 41–48 of FASB ASC 958-605-55) provides an example of an entity providing free use of facilities to an NFP. It states that if the entity explicitly and unconditionally promises the use of the facility for a specified period of time (for example, five years), the donor would recognize that unconditional promise when made as a payable and an expense at its fair value. Although the example does not discuss the accounting in subsequent

periods as the space is occupied, the use of real estate for a five-year period without a transfer of ownership is an operating lease, and the donor should report a reduction of the payable and rent income. Paragraphs 5.162–.164 discuss the donee's reporting of the receipt of an unconditional contribution of the use of long-lived assets (such as a building or the use of facilities) in which the donor retains legal title to the long-lived asset.

Gains and Losses

- 13.30** *Revenues* are inflows of assets that result from an NFP's ongoing major or central operations and activities. *Gains* are increases in net assets resulting from an NFP's peripheral or incidental transactions and other events and circumstances affecting the NFP other than those that result from revenues. *Expenses* are outflows of assets or incurrences of liabilities that result from an NFP's ongoing major or central operations and activities. *Losses* are decreases in net assets from an NFP's peripheral or incidental transactions and other events and circumstances affecting the NFP other than those that result from expenses.
- 13.31** Gains and losses result both from an NFP's peripheral or incidental activities and from events and circumstances that stem from the environment and that are largely beyond the control of a particular organization and its management. Some gains and losses result from holding assets or liabilities while their values change, such as from changes in the fair value of securities or changes in foreign exchange rates. Other gains and losses result from natural catastrophes, such as fires, floods, and earthquakes. Still others result from transactions (such as an NFP's sale of buildings and equipment that are no longer needed for its ongoing operations or from its winning or losing a lawsuit) that are only peripheral or incidental to the NFP.
- 13.32** Transactions resulting in revenues for one NFP may result in gains for another, which, in turn, determines how the related costs should be classified and displayed.
- 13.33** Per FASB ASC 958-225-45-14, a statement of activities should report the gross amounts of revenues and expenses (except for investment revenues and related expenses, which are permitted to be reported net of related expenses, as discussed in paragraphs 4.44–.52). FASB ASC 958-225-45-15 states that a statement of activities may report gains and losses as net amounts if they result from peripheral or incidental transactions or from other events and circumstances that may be largely beyond the control of the NFP and its management.
- 13.34** Per FASB ASC 958-225-45-16, the frequency of the events and the significance of the gross revenues and expenses distinguish major or central events from peripheral or incidental events. Events are ongoing major and central activities if (a) they are normally part of an NFP's strategy and it normally carries on such activities or if (b) the event's gross revenues or expenses are significant in relation to the NFP's annual budget. Events are peripheral or incidental if they are not an integral part of an NFP's usual activities or if their gross revenues or expenses are not significant in relation to the NFP's annual

budget. Accordingly, similar events may be reported differently by different NFPs based on the NFP's overall activities.

- 13.35** Per FASB ASC 958-225-45-8, gains and losses should be recognized as increases or decreases in unrestricted net assets unless their use is temporarily or permanently restricted by explicit donor stipulations or by law. As discussed in paragraph 3.36, certain gains and losses are required to be presented as part of income from operations if that subtotal is presented in the statement of activities.
- 13.36** Losses need not be reported by their functional classification or in the matrix that presents information about expenses according to both their functional and natural classifications.

Reporting Costs Related to Sales of Goods and Services

- 13.37** Per FASB ASC 958-720-45-20, the way that costs related to sales of goods and services are displayed depends on whether the sales constitute a major or central activity of the NFP or a peripheral or incidental activity. For example, a not-for-profit museum that has a store that is a major or central activity should report and display separately the revenues from the store's sales and the related cost of sales. Cost of sales is permitted to be reported immediately after revenues from sale of merchandise, and may be followed by a descriptive subtotal, or cost of sales may be reported with other expenses. If the store sells merchandise that is related to the museum's program, the store would be a program service and the cost of the store's sales would be reported as a program expense. In other circumstances, cost of sales could be reported as a separate supporting service. For example, if operating a cafeteria is a major or central activity but is not related to the NFP's programs, the cafeteria's cost of sales would be reported as supporting services. Similarly, TIS section 6140.06, "Functional Category of Cost of Sales of Contributed Inventory" (AICPA, *Technical Practice Aids*), states that cost of sales of contributed inventory would be reported as the cost of a separate supporting service, unless the item sold is related to a program activity, in which case, cost of sales is reported as a cost of a program activity. Cost of sales of contributed inventory would not be reported as fund-raising expenses.
- 13.38** FASB ASC 958-720-45-22 states that, in contrast, a not-for-profit church that occasionally produces and sells a cookbook (considered to be a peripheral or incidental activity) has gains (or losses) from those sales, and the receipts and related costs are permitted to be offset and only the net gains (or losses) are reported.
- 13.39** Losses from the church cookbook (a peripheral or incidental activity) described in the previous paragraph are not classified as an expense, so they should not be reported by their functional classification.

Reporting the Cost of Special Events and Other Fund-raising Activities

- 13.40** Some NFPs conduct fund-raising or joint activities, including special social and educational events (such as symposia, dinners, dances, and theater parties) in which the attendee receives a direct benefit (for example, a meal or theater ticket). As discussed in TIS section 6140.07, “Functional Category of Costs of Special Events” (AICPA, *Technical Practice Aids*), some, but not necessarily all, costs of special fund-raising events should be reported as fund-raising. Certain costs of special fund-raising events, such as costs of direct donor benefits that are provided in exchange transactions, should be reported in categories other than fund-raising. As discussed in TIS section 6140.08, “Functional Category of the Costs of Direct Donor Benefits” (AICPA, *Technical Practice Aids*), the costs of donor benefits that are not program related should be reported as a separate supporting category, such as cost of sales, if the benefits are provided in exchange transactions; they should not be reported as fund-raising. If the donor benefits are provided in transactions that are not exchange transactions, such as a fund-raising dinner for which there is no charge to attend, the costs of donor benefits should be reported as fund-raising unless they are program related. Some special events are joint activities; if so, the guidance in the “Accounting for Costs of Activities that Include Fundraising” subsections of FASB ASC 958-720 should be considered in classifying the expenses of the special event. Those standards are discussed in paragraphs 13.74–.113.
- 13.41** FASB ASC 958-225-45-17 states that an NFP may report net amounts in its statement of activities for its special events if they result from peripheral or incidental transactions. However, so-called “special events” often are ongoing and major activities; if so, an NFP shall report the gross revenues and expenses of those activities. Costs netted against receipts from peripheral or incidental special events shall be limited to direct costs.
- 13.42** NFPs may report the gross revenues of special events and other fund-raising activities with the cost of direct benefits to donors (for example, meals and facilities rental) displayed either (1) as a line item deducted from the special event revenues or (2) in the same section of the statement of activities as are other programs or supporting services and allocated, if necessary, among those various functions. Alternatively, the NFP could consider revenue from special events and other fund-raising activities as part exchange (for the fair value the participant received) and part contribution (for the excess of the payment over that fair value) and report the two parts separately.
- 13.43** Paragraphs 11–15 of FASB ASC 958-225-55 (example 4) illustrate the guidance in FASB ASC 958-225-45-17. NFP B has a special event that is an ongoing and major activity with a ticket price of \$100. The activity does not meet the audience criterion in paragraphs 13.95–.101 and, therefore, all costs of the activity, other than the direct donor benefits, should be reported as fund-raising. The event includes a dinner that costs NFP B \$25 and that has a fair value of \$30. (Chapter 5, “Contributions Received and Agency Transactions,” discusses the appropriate reporting if the meal or other items of value are donated to the NFP for resale.) In addition, NFP B incurs other direct costs of the event of \$15 in connection with promoting and conducting the event, including incremental direct costs incurred in transactions with independent third parties and the payroll and payroll-related costs for the activities of employees who are directly associated with, and devote time to, the event. The other direct costs are unrelated to the direct benefits to

donors and, accordingly, should not be included as costs of benefits to donors. The other direct costs include (a) \$5 that otherwise might be considered management and general costs if they had been incurred in a different activity, and (b) fund-raising costs of \$10. In addition, NFP B has the following transactions, which are unrelated to the special event: unrestricted contributions of \$200, program expenses of \$60, management and general expenses of \$20, and fund-raising expenses of \$20.

13.44 Paragraphs 13–15 of FASB ASC 958-225-55 illustrate three ways in which the NFP could display the results of the special event as part of its statement of activities, as follows:

Case A

Changes in unrestricted net assets:

Contributions	\$200
Special event revenue	100
Less: Costs of direct benefits to donors	<u>(25)</u>
Net revenues from special events	<u>75</u>
Contributions and net revenues from special events	275
Other expenses:	
Program	60
Management and general	20
Fund-raising	<u>35</u>
Total other expenses	<u>115</u>
Increase in unrestricted net assets	<u><u>\$160</u></u>

Case B

Changes in unrestricted net assets:

Revenues:

Contributions	\$200
Special event revenue	<u>100</u>
Total revenues	<u>300</u>

Expenses:

Program	60
Costs of direct benefits to donors	25
Management and general	20
Fund-raising	<u>35</u>
Total other expenses	<u>140</u>
Increase in unrestricted net assets	<u><u>\$160</u></u>

Case C

Changes in unrestricted net assets:

Contributions	\$270
Dinner sales	30
Less: Costs of direct benefits to donors	<u>(25)</u>
Gross profit on special events	<u>5</u>
Contributions and net revenues from special events	275
Other expenses:	
Program	60
Management and general	20
Fund-raising	<u>35</u>
Total other expenses	<u>115</u>
Increase in unrestricted net assets	<u><u>\$160</u></u>

Investment Revenues, Expenses, Gains, and Losses

13.45 If the objective is to invest in the entity for total return (including an objective to realize investment income, gains upon sale, or both), investment revenues, expenses, gains, and losses are discussed in chapter 4, “Cash, Cash Equivalents, and Investments.” If the primary purpose of the investment is to further the mission-related objectives of the NFP, and the production of income is not a significant purpose, revenues, expenses, gains, and losses are discussed in chapter 8, “Programmatic Investments.”

Functional Reporting of Expenses

- 13.46** FASB ASC 958-720-45-2 requires the presentation, in either a statement of activities or the notes to the financial statements, of information about expenses reported by their functional classification, such as major classes of program services and supporting activities. *Program services* are defined in the FASB ASC glossary as "the activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the NFP exists. Those services are the major purpose for and the major output of the NFP and often relate to several major programs." *Supporting services* are defined in the FASB ASC glossary as "all activities of a not-for-profit entity (NFP) other than program services. Generally, they include management and general activities, fundraising activities, and membership-development activities." FASB ASC 958-720-45 provides examples of the kinds of activities that fall into each of those categories.
- 13.47** Program services may include cost of sales and costs of other revenue-generating activities that are program related. Supporting services may include, as one or more separate categories, cost of sales and costs of other revenue-generating activities that are not program related. Further elaboration of the kinds of activities that fall into each of the functional categories is provided in the following sections.

Program Services

- 13.48** FASB ASC 958-720-45-2 requires that a statement of activities or notes to financial statements provide information about expenses reported by their functional classification, including major classes of program services. The number of functional reporting classifications for program services varies according to the nature of the NFP and the services it renders. Most NFPs incur costs and provide services for several separate and identifiable programs, and the expenses for those programs should be disaggregated and reported either on the face of the statement of activities or in the notes to financial statements by the kind of program or group of related programs. The goal is to report meaningful information about the cost of the NFP's service efforts. For example, assume an NFP has as its mission helping the homeless. It has two programs: one whose function is to operate a soup kitchen to feed the homeless, and another whose function is to help the homeless get into appropriate housing. The NFP typically would disaggregate and report separately information about the two programs. As another example, assume that a large religious organization has, as part of its ministries, similar programs to help the homeless. In addition, it also has programs for worship services, youth instruction, adult instruction, family counseling, and fellowship. That religious organization typically would aggregate the expenses of the two programs for the homeless, and report them as a single line item, such as "support services for the homeless."
- 13.49** FASB ASC 958-720-45-3 provides the following additional examples. A large university may have programs for student instruction, research, and patient care, among others. A federated fund-raising entity's programs may include making contributions to NFPs supported by the federated fund-raising organization. A health and welfare entity may have programs for health or family services, research, disaster relief, and public education, among others.

- 13.50** Further, FASB ASC 958-720-45-3 notes that paragraphs 1–19 of FASB ASC 280-10-50 (which address how to determine reportable operating segments) may be helpful in determining what constitutes major classes of programs and supporting activities, even though segment reporting is not required of NFPs. The guidance pertaining to segment reporting considers, among other factors, quantitative thresholds to determine discrete segment data, such as size of revenues, expenses, profits, geographic areas, internal measurements, and availability of discrete financial information.
- 13.51** Though uncommon, a single functional reporting classification may be adequate to report the program service that an NFP provides. For example, for Housing and Urban Development organizations, private foundations, and Section 509(a)(3) supporting organizations, a single functional reporting classification may be adequate. Additionally, smaller NFPs or younger NFPs may focus their efforts on a single program.
- 13.52** NFPs have latitude in defining their major programs so that the information provided is meaningful in understanding the expenses of the NFP’s service efforts. Factors to consider in determining the programs to present include the following (some factors may be more or less significant than others, depending on the facts and circumstances, and therefore, more or less heavily weighted in identifying major programs):
- Program objectives
 - Nature of services
 - Constituents served, including as disaggregated by geographic or other demographics
 - Magnitude of the program to the NFP’s overall activities
 - Budgetary categories
 - Oversight, regulatory, grant, or other compliance requirements that separate the program from others
 - Other factors that may be relevant to financial statement users
- 13.53** In addition, FinREC believes that program information in the financial statements is most meaningful when it correlates with descriptions of the NFP’s mission and the NFP’s programs that are used by the NFP in its fund-raising materials, its programmatic promotional materials, website descriptions, tax filings, annual reports, and other public information.
- 13.54** Paragraphs 13.55–.58 provide four examples that may be helpful in applying the guidance in paragraphs 13.48–.53.

Example A

13.55 NFP A provides training for homeless individuals in order to enable them to enter the workforce. As part of its mission, it conducts outreach (providing food and shelter) to locate homeless individuals who would be best served by the training. It is also an advocate for the rights of the homeless, and runs a small job placement service for the graduates of its program. NFP A budgets and fundraises separately for these four functions. The major classes of programs it uses in its financial statements are training, outreach services, advocacy, and job placement services.

Example B

13.56 NFP B is similar in all aspects to the NFP in example A, except that its advocacy efforts are minimal, and the job placement services happen more by word of mouth than by formal procedures. The major classes of programs that NFP B uses in its financial statements are training services and outreach services; for financial reporting purposes the other activities typically would be incorporated into one of these two programs or into an “other programs” line item. If in the future, these other activities become a significant part of NFP B’s mission and budget, NFP B would then consider them major classes of programs, similar to NFP A in example A.

Example C

13.57 NFP C provides the same services as the NFP in example A, except that NFP C serves distinct geographic areas, which each have their own funding sources (both governmental and private). It is important to NFP C and its funding sources to identify both of these geographic areas and major funding sources separately, and accordingly the major classes of programs that NFP C uses in its financial statements are segregated by geographic region and funding source.

Example D

13.58 NFP D is a Section 509(a)(3) entity created to provide support to NFP E. NFP D conducts fund-raising activities and grants funds to its supported organization. NFP D only engages in grant-making to its supported organization, and accordingly NFP D uses in its financial statements only one program activity classification, which it titles “grants made to NFP E.”

Required Disclosures About Program Services

13.59 Per FASB ASC 958-205-50-1, the financial statements should provide a description of the nature of the NFP’s activities, including a description of each of its major classes of programs. If not provided in the notes to financial statements, the description can be presented on the statement of activities (for example, using column headings). Per FASB ASC 958-720-45-5, the components of total program expenses should be evident from the details provided on the face of the statement of activities. If the components of total program expenses are not evident, then FASB ASC 958-720-50-1(b) requires that the notes disclose total program expenses and provide information about why total program

expenses disclosed in the notes do not articulate with the statement of activities. As an example, FASB ASC 958-720-50-1 notes that total program expenses are not evident from the details provided on the face of the statement of activities if cost of sales is not identified as either program or supporting services.

Supporting Services

13.60 NFPs may have various kinds of supporting activities, such as management and general, fund-raising, and membership development. Some industries have functional categories of supporting activities that are prevalent in that industry. For example, colleges and universities typically have institutional support and institutional development activities. A single functional reporting classification is ordinarily adequate to portray each kind of supporting service. NFPs may, however, present more detailed disaggregated information for each kind of supporting service. For example, fund-raising expenses and the corresponding resources that are obtained may be reported separately for each kind of fund-raising activity undertaken, either on the face of a statement of activities or in the notes to the financial statements.

Management and General Activities

13.61 Per the FASB ASC glossary, *management and general activities* are activities that are not identifiable with a single program, fund-raising activity, or membership-development activity but that are indispensable to the conduct of those activities and to an entity's existence. Paragraphs 7–8 of FASB ASC 958-720-45 provide additional description of management and general activities. They include oversight; business management; general record keeping; budgeting; financing; soliciting funds other than contributions, including exchange transactions (whether program-related or not), such as government contracts, and related administrative activities; disseminating information to inform the public of the NFP's stewardship of contributed funds; announcements concerning appointments; the annual report; related administrative activities; and all management and administration except for direct conduct of program services or fund-raising activities. The costs of oversight and management usually include the salaries and expenses of the governing board, the CEO of the NFP, and the supporting staff. However, if such staff spends a portion of their time directly supervising program services or categories of other supporting services, their salaries and expenses should be allocated among those functions.

Fund-raising Activities

13.62 Per the FASB ASC glossary, *fundraising activities* are activities undertaken to induce potential donors to contribute money, securities, services, materials, facilities, other assets, or time. Paragraphs 9–10 of FASB ASC 958-720-45 provide additional description of fund-raising activities. They include publicizing and conducting fund-raising campaigns; maintaining donor mailing lists; conducting special fund-raising events; preparing and distributing fund-raising manuals, instructions, and other materials; and conducting other activities involved with soliciting contributions from individuals,

foundations, government agencies, and others. Fund-raising activities include soliciting contributions of services from individuals, regardless of whether those services meet the recognition criteria for contributions in the “Contributions Received” subsection of FASB ASC 958-605-25. TIS section 6140.11, “Costs of Soliciting Contributed Services and Time That Do Not Meet the Recognition Criteria in FASB ASC 958” (AICPA, *Technical Practice Aids*), states that certain contributed services are prohibited from being recognized for practical, rather than conceptual, reasons. Those services are nevertheless contributions, regardless of whether or not they are recognized. Therefore, soliciting those contributions meets the definition of fund-raising in the FASB ASC glossary. For example, costs of soliciting contributed services to be used in program functions should be accounted for as fund-raising expenses, even if the contributed services do not meet the recognition criteria. Similarly, costs of soliciting management and general services should be reported as fund-raising, even if the management and general services do not meet the recognition criteria. (Paragraph 13.119 discusses how fund-raising activities of federated fund-raising organizations should be reported.) Per FASB ASC 958-720-50-1, the financial statements should disclose total fund-raising expenses.

13.63 As discussed in TIS section 6140.20, “NPEs Reporting No Fund-raising Expenses” (AICPA, *Technical Practice Aids*), it would be unusual for an NFP to have contributions but have minimal or no fund-raising expense. Examples of circumstances in which an NFP could have contributions but minimal or no fund-raising expense typically include those in which (a) because of name recognition or custom, donors contribute to the NFP without the NFP undertaking fund-raising activities, (b) fund-raising activities are conducted entirely or almost entirely by volunteers whose contributed services do not meet the recognition criteria for contributed services in FASB ASC 958-605-25-16, or (c) other entities that the NFP does not control contribute to the NFP with the NFP undertaking minimal or no fund-raising activity or other participation in relation to those contributions. The NFP should consider whether it is required to make financial statement disclosures required by FASB ASC 850, *Related Party Disclosures*, and FASB ASC 275, *Risks and Uncertainties*.

13.64 TIS section 6140.20 provides the following examples of circumstances in which an NFP with contributions may have no fund-raising expense or minimal fund-raising expense in relation to contributions:

- A religious entity obtains most or all of its contributions from member tithing.
- An entity has no paid staff and most or all contributions arise from uncompensated board members soliciting contributions (and this board member activity does not meet the recognition criteria for contributed services in FASB ASC 958-605-25-16).
- The reporting entity is a private foundation or is supported by a private foundation, and the reporting entity expends no or minimal resources in soliciting those contributions.

- The reporting entity obtains most or all of its contributions from one or more entities that it does not control (fund-raising NFP), expends minimal resources, and has minimal participation in soliciting those contributions.

TIS section 6140.20 provides the following examples:

- NPE Relief and Development Entity is one of many entities devoted to cause ABC. NPE Relief and Development Entity receives most or all of its contributions from Relief and Development Entities in the USA, Canada, and the United Kingdom that raise support for cause ABC throughout the world.
- NPE Religious Entity Denomination International Mission Board receives a substantial portion of its support from the NPE Religious Entity Denomination, which supports various entities and causes, including but not limited to NPE Religious Entity Denomination International Mission Board. NPE Religious Entity Denomination allocates, at its discretion, X percent of its contributions from supporting churches and individuals to NPE Religious Entity Denomination International Mission Board.

Membership Development Activities

13.65 Per the FASB ASC glossary, *membership-development activities* include soliciting for prospective members and membership dues, membership relations, and similar activities. FASB ASC 958-720-45-12 states that if no significant benefits or duties are connected with membership, the substance of membership-development activities may, in fact, be fund-raising. Paragraphs 11–14 of FASB ASC 958-720-45 provide additional description of membership-development activities. The related costs should be reported as fund-raising costs when the substance of membership development is, in fact, fund-raising. (See paragraphs 9–12 of FASB ASC 958-605-55 for indicators useful in determining the contribution and exchange portions of membership dues.)^{fn 6} Membership development activities may be conducted in conjunction with other activities. In circumstances in which membership development is conducted in conjunction with other activities but does not include soliciting contributions (for example, the NFP's membership dues are entirely exchange transactions and the activity is in part soliciting new members and in part program activities for existing members), the activity is not a joint activity, and the costs should be allocated to membership development and one or more other functions. For example, membership may entitle the members to group life and other insurance at reduced costs because of the NFP's negotiated rates and to a subscription to the NFP's magazine or newsletter. Under these circumstances, an appropriate part of the costs of soliciting members should be allocated to the membership-development function and a

^{fn 6} Chapter 5, “Contributions Received and Agency Transactions,” and table 5-2 of this guide provide the guidance in paragraphs 9–12 of FASB ASC 958-605-55.

part to program services. In circumstances in which membership development is in part soliciting revenues from exchange transactions and in part soliciting contributions, the activity is a joint activity, as discussed in the “Accounting for Costs of Activities that Include Fundraising” subsections of FASB ASC 958-720. Those subsections are discussed in paragraphs 13.74–.113 but are not intended as a substitute for reading them.

Classification of Expenses Related to More Than One Function

13.66 Some expenses are directly related to, and can be assigned to, a single major program or service or a single supporting activity. Other expenses relate to more than one program or supporting activity, or to a combination of programs and supporting services. These expenses should be allocated among the appropriate functions. Examples include a direct mail solicitation that combines fund-raising with program activities (subject to the provisions of paragraphs 13.74–.113), salaries of persons who perform more than one kind of service, and the rental of a building used for various programs and supporting activities.

Direct Identification Versus Allocation Methods^{fn 7}

13.67 Direct identification of specific expense (also referred to as assigning expenses) is the preferable method of charging expenses to various functions. If an expense can be specifically identified with a program or supporting service, it should be assigned to that function. For example, travel costs incurred in connection with a program activity should be assigned to that program.

13.68 If direct identification (that is, assignment) is impossible or impracticable, an allocation is appropriate. The techniques used to allocate are common to all entities, for-profit and NFP alike. A reasonable allocation of expenses among an NFP's functions may be made on a variety of bases. Objective methods of allocating expenses are preferable to subjective methods. The allocation may be based on related financial or nonfinancial data. The paragraphs that follow provide guidance (in addition to that presented throughout this chapter) on allocating or presenting certain costs that may be incurred by NFPs. The guidance found in U.S. Office of Management and Budget Circular A-122, *Cost Principles for Non-Profit Organizations*, may also be helpful in allocating costs.

13.69 Per FASB ASC 958-720-45-25, occupying and maintaining a building is not a separate supporting service.

^{fn 7} This section provides general information about assigning and allocating costs among functional classifications. For costs incurred in joint activities, the guidance in this section is subject to the provisions of paragraphs 13.74–.113.

^{fn 1} Some not-for-profit entities (NFPs) may meet the definition of an NFP as discussed in paragraphs 1.01–.02 but may nevertheless not be tax-exempt under the Internal Revenue Code (IRC). For example, an NFP that may otherwise qualify for tax-exempt status under the IRC may lose its tax exemption because it has violated the private inurement rules applicable to tax-exempt entities. Examples of potential threats to an NFP's federal tax-exempt status are discussed in paragraphs 15.06–.22.

- 13.70** The expenses associated with occupying and maintaining a building, such as depreciation, utilities, maintenance, and insurance, may be allocated among the NFP's functions based on the square footage of space occupied by each program and supporting service. If floor plans are not available and the measurement of the occupied space is impractical, an estimate of the relative portion of the building occupied by each function may be made.
- 13.71** TIS section 6960.12, "Allocation of Overhead" (AICPA, *Technical Practice Aids*), states that allocation of overhead is an interprogram transaction that should not be reported as revenue of the program providing the services, but rather as a reduction of expense of such program.
- 13.72** Per FASB ASC 958-720-45-24, interest costs, including interest on a building's mortgage, should be allocated to specific programs or supporting services to the extent possible. Interest costs that cannot be allocated should be reported as part of the management and general function. (FASB ASC 835-20-50-1 requires disclosure of total interest costs incurred and the amount thereof that has been capitalized, if any.)
- 13.73** An NFP should evaluate its expense allocation methods periodically. The evaluation may include, for example, a review of the time records or activity reports of key personnel, the use of space, and the consumption of supplies and postage. The expense allocation methods should be reviewed by management and revised when necessary to reflect significant changes in the nature or level of the NFP's current activities, so that the financial statements appropriately reflect the amounts for program services and supporting activities.

Expenses of Materials and Activities That Combine Fund-raising Activities With Activities That Have Elements of Another Function (Joint Activities)

- 13.74** FASB ASC 958-720-05-5 states that some NFPs solicit support through a variety of fund-raising activities, including the following: direct mail, telephone solicitation, door-to-door canvassing, telethons, special events, and others. Sometimes fund-raising activities are conducted with activities related to other functions, such as program activities or supporting services and management and general activities. Sometimes fund-raising activities include components that would otherwise be associated with program or supporting services, but in fact support fund-raising. The "Accounting for Costs of Activities that Include Fundraising" subsections of FASB ASC 958-720 establish financial accounting standards for accounting for costs of those joint activities and require financial statement disclosures about the nature of the activities for which joint costs have been allocated and the amounts of joint costs. The following paragraphs summarize those subsections but are not intended as a substitute for reading them.
- 13.75** The functional classifications of fund-raising, program, and management and general are discussed throughout the "Accounting for Costs of Activities that Include Fundraising" subsections of FASB ASC 958-720 for purposes of illustrating how the guidance in these paragraphs would be applied by entities that use those functional classifications. Some

entities have a functional structure that does not include fund-raising, program, or management and general, or that includes other functional classifications, such as membership development. Use of those functional classifications is not intended to require reporting the functional classifications of fund-raising, program, and management and general.

- 13.76** For example, some NFPs may conduct membership development activities. As discussed in paragraph 13.65, the substance of membership development activities may, in fact, be fund-raising. To the extent that member benefits are received, however, membership is an exchange transaction. In circumstances in which membership development is in part soliciting revenues from exchange transactions and in part soliciting contributions and the purpose, audience, and content of the activity are appropriate for achieving membership development, joint costs should be allocated between fund-raising and the exchange transaction. Accounting for the costs of a joint activity is discussed in paragraphs 13.74–.113.

Accounting for Joint Activities

- 13.77** Per FASB ASC 958-720-45-29, if the criteria of purpose, audience, and content are met, the costs of a joint activity should be classified as follows: (a) the costs that are identifiable with a particular function should be charged to that function and (b) joint costs should be allocated between fund-raising and the appropriate program or management and general function. If any of the criteria are not met, all costs of the joint activity should be reported as fund-raising costs, including costs that might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund-raising. Paragraphs 5.117–.121 and paragraphs 13.40–.44 provide additional guidance for the recognition and presentation in financial statements of special events.
- 13.78** FASB ASC 958-720-55-34 provides guidance for classifying costs of a joint activity that are identifiable with a particular functional classification. That paragraph provides the following example. The purpose for which costs other than joint costs are incurred may be fund-raising, program, or management and general, depending on the context in which they are used in the activity undertaken. For example, a program-related pamphlet may be sent to an audience in need of the program. In that context, the pamphlet is used for program purposes. However, in order to demonstrate to potential donors that the NFP's programs are worthwhile, that same pamphlet may be sent to an audience that is likely to contribute but that has no need or reasonable potential for use of the program. In that context, the pamphlet is used for fund-raising. The classification of the cost of the pamphlets depends upon the use of the pamphlets and the application of the criteria in FASB ASC 958-720-45-29. Thus, if some program-related pamphlets are used in program activities that include no fund-raising, the cost of the pamphlets used in those separate program activities that include no fund-raising should be charged to program. If some pamphlets are used in a joint activity and the criteria in FASB ASC 958-720-45-29

(paragraph 13.77) are met, the costs of materials that accomplish program goals and that are unrelated to fund-raising, such as the costs of a program-related pamphlet included in a joint activity, should be charged to program, whereas joint costs, such as postage, should be allocated between fund-raising and program. However, if the program-related pamphlet is used in fund-raising packets and the criteria are not met, the costs of the pamphlets used in the fund-raising packets, as well as the joint costs, should be charged to fund-raising.

- 13.79** In circumstances in which entities that have a functional structure that includes other functional classifications conduct joint activities, all costs of those joint activities should be charged to fund-raising (or the category in which fund-raising is reported), unless the purpose, audience, and content of those joint activities are appropriate for achieving those other functions.

Purpose

- 13.80** The purpose criterion is met if the purpose of the joint activity includes accomplishing program or management and general functions. Paragraphs 33–47 of FASB ASC 958-720-45 (reproduced in part in paragraphs 13.81–.94) provide guidance that should be considered in determining whether the purpose criterion is met. Paragraphs 35–39 of FASB ASC 958-720-45 (paragraphs 13.81–.85) provide guidance pertaining to program functions only. FASB ASC 958-720-45-38 (paragraph 13.86) provides guidance pertaining to both program and management and general functions.

- 13.81** *Program functions.* To accomplish program functions, the activity should call for specific action by the audience that will help accomplish the NFP's mission. Actions that help accomplish the NFP's mission are actions that do either of the following: (a) benefit the recipient (such as by improving the recipient's physical, mental, emotional, or spiritual health and well-being) or (b) benefit society (such as by addressing societal problems). If the activity calls for specific action by the audience that will help accomplish the NFP's mission, the guidance in FASB ASC 958-720-45-38 (paragraphs 13.86–.94) should also be considered in determining whether the purpose criterion is met.

- 13.82** FASB ASC 958-720-55-4 provides the following examples of activities that call for specific action by the audience that will help accomplish the NFP's mission:

- An NFP's mission includes improving individuals' physical health. For that NFP, motivating the audience to take specific action that will improve their physical health is a call for specific action by the audience that will help accomplish the NFP's mission. An example of an activity that motivates the audience to take specific action that will improve their physical health is sending the audience a brochure that urges them to stop smoking and suggests specific methods, instructions, references, and resources that may be used to stop smoking.
- An NFP's mission includes educating individuals in areas other than the causes, conditions, needs, or concerns that the NFP's programs are designed to address

(referred to as *causes*). For that NFP, educating the audience in areas other than causes or motivating the audience to otherwise engage in specific activities that will educate them in areas other than causes is a call for specific action by the audience that will help accomplish the NFP's mission. Examples of NFPs whose mission includes educating individuals in areas other than causes are universities and possibly other NFPs. An example of an activity motivating individuals to engage in education in areas other than causes is a university inviting individuals to attend a lecture or class in which the individuals will learn about the solar system. (Paragraphs 13.84–.85 provide further discussion of NFPs with educational missions.)

- Some educational activities that might otherwise be considered as educating the audience about causes may implicitly call for specific action by the audience that will help accomplish the NFP's mission. For example, activities that educate the audience about environmental problems caused by not recycling implicitly call for that audience to increase recycling. If the need for and benefits of the specific action are clearly evident from the educational message, the message is considered to include an implicit call for specific action by the audience that will help accomplish the NFP's mission.

13.83 FASB ASC 958-720-55-5 provides the following examples of activities that fail to call for a specific action by the audience that will help accomplish the NFP's mission:

- Educating the audience about causes or motivating the audience to otherwise engage in specific activities that will educate them about causes is not a call for specific action by the audience that will help accomplish the NFP's mission. Such activities are considered in support of fund-raising.
- Asking the audience to make contributions is not a call for specific action by the audience that will help accomplish the NFP's mission.

13.84 Paragraphs 22–24 of FASB ASC 958-720-55 provide additional guidance for NFPs with educational missions, which is reproduced in this paragraph and the next. Most transactions in which a student attends a lecture or class are exchange transactions and are not joint activities. Such transactions are joint activities only if the activity includes fund-raising. Some organizations have missions that include educating the public (students) in areas other than causes. FASB ASC 958-720-55-4 states that, for those entities, educating the audience in areas other than causes or motivating the audience to engage in specific activities, such as attending a lecture or class, that will educate them in areas other than causes is considered a call for specific action by the recipients that will help accomplish the NFP's mission. Educating the audience about causes or motivating the audience to engage in specific activities that will educate them about causes without educating them in other subjects is not considered a call for specific action by the audience that will help accomplish the NFP's mission.

- 13.85** An example of a lecture or class that will educate students in an area other than causes is a lecture on the nesting habits of the bald eagle, given by the Save the Bald Eagle Society, an NFP whose mission is to save the bald eagle from extinction and educate the public about the bald eagle. An example of a lecture or class that will address particular causes is a lecture by the Bald Eagle Society on the potential extinction of bald eagles and the need to raise contributions to prevent their extinction. For purposes of applying this guidance, motivating the audience to attend a lecture on the nesting habits of the bald eagle is a call for specific action that will help accomplish the NFP's mission. If the lecture merely addresses the potential extinction of bald eagles and the need to raise contributions to prevent their extinction without addressing the nesting habits of the bald eagle, motivating the audience to attend the lecture is not considered a call for specific action by the recipient that will help accomplish the NFP's mission.
- 13.86** *Program and management and general functions.* Per FASB ASC 958-720-45-38, the following factors should be considered, in the order in which they are listed, to determine whether the purpose criterion is met:
- a. The compensation or fees test (paragraphs 13.87–.90)
 - b. The separate and similar activities test (paragraphs 13.91–.92)
 - c. The other evidence test (paragraphs 13.93–.94)
- 13.87** *The compensations or fees test.* Paragraphs 40–44 of FASB ASC 958-720-45 provide guidance for the compensation or fees test. The purpose criterion is not met if a majority of compensation or fees for any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity.
- 13.88** Some compensation contracts provide that compensation for performing the activity is based on a factor other than contributions raised, but not to exceed a specified portion of contributions raised. For example, a contract may provide that compensation for performing the activity is \$10 per contact hour, but not to exceed 60 percent of contributions raised. In such circumstances, compensation is not considered based on amounts raised unless the stated maximum percentage is met. In circumstances in which it is not yet known whether the stated maximum percentage is met, compensation is not considered based on amounts raised unless it is probable that the stated maximum percentage will be met.
- 13.89** The compensation or fees test is a negative test in that it either (a) results in failing the purpose criterion or (b) is not determinative of whether the purpose criterion is met.
- 13.90** In considering the guidance in FASB ASC 958-720-45-38 (paragraph 13.86), the compensation or fees test is the preeminent guidance. Therefore, if the activity fails the compensation or fees test, the activity fails the purpose criterion and the separate and similar activities test should not be considered. If the purpose criterion is not failed based on the compensation or fees test, this factor (the compensation or fees test) is not

determinative of whether the purpose criterion is met, and the factor in paragraphs 45–46 of FASB ASC 958-720-45 (paragraphs 13.91–.92) (separate and similar activities test) should be considered.

13.91 *The separate and similar activities test.* The purpose criterion is met if a similar program or management and general activity is conducted separately and on a similar or greater scale. That is, the purpose criterion is met if either of the following two conditions is met:

- a. The first condition is met if both of the following are true:
 - i. The program component of the joint activity calls for specific action by the recipient that will help accomplish the NFP's mission (see paragraphs 35–37 of FASB ASC 958-720-45, which are reproduced in part in paragraphs 13.81–.85).
 - ii. A similar program component is conducted without the fund-raising component using the same medium and on a scale that is similar to or greater than the scale on which it is conducted with the fund-raising. Determining the scale on which an activity is conducted may be subjective. Factors to consider in determining the scale on which an activity is conducted may include dollars spent, the size of the audience reached, and the degree to which the characteristics of the audience are similar to the characteristics of the audience of the activity being evaluated.
- b. The second condition is met if
 - i. a management and general activity that is similar to the management and general component of the joint activity being accounted for is conducted without the fund-raising component using the same medium and on a scale that is similar to or greater than the scale on which it is conducted with the fund-raising.

13.92 If the purpose criterion is met based on the separate and similar activities test, the other evidence test (paragraphs 13.93–.94) should not be considered. If the separate and similar activities test is not determinative, the other evidence test should be considered.

13.93 *The other evidence test.* The compensation or fees test and the separate and similar activities test may not always be determinative because the attributes they consider may not be present. If the factors in paragraphs 40–44 of FASB ASC 958-720-45 (the compensation or fees test in paragraphs 13.87–.90) or paragraphs 44–45 of FASB ASC 958-720-45 (the separate and similar activities test in paragraphs 13.91–.92) do not determine whether the purpose criterion is met, other evidence may determine whether the criterion is met. All available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, the purpose criterion is met.

13.94 The following are examples of indicators that provide evidence for determining whether the purpose criterion is met:

- a. FASB ASC 958-720-55-7 provides the following examples of indicators that provide evidence that the purpose criterion may be met:
 - i. *Measuring program results and accomplishments of the activity.* The facts may indicate that the purpose criterion is met if the NFP measures program results and accomplishments of the activity (other than measuring the extent to which the public was educated about causes).
 - ii. *Medium.* The facts may indicate that the purpose criterion is met if the program component of the joint activity calls for specific action by the recipient that will help accomplish the NFP's mission and if the NFP conducts the program component without a significant fund-raising component in a different medium. Also, the facts may indicate that the purpose criterion is met if the NFP conducts the management and general component of the joint activity without a significant fund-raising component in a different medium.
- b. FASB ASC 958-720-55-8 provides the following examples of indicators that provide evidence that the purpose criterion may not be met:
 - i. *Evaluation.* The facts may indicate that the purpose criterion is not met if the evaluation of any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity.
 - ii. *Compensation.* The facts may indicate that the purpose criterion is not met if some, but less than a majority, of compensation or fees for any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity.
- c. FASB ASC 958-720-55-9 provides the following examples of indicators that provide evidence that the purpose criterion may be either met or not met:
 - i. *Evaluation of measured results of the activity.* The NFP may have a process to evaluate measured program results and accomplishments of the activity (other than measuring the extent to which the public was educated about causes). If the NFP has such a process, in evaluating the effectiveness of the joint activity, the NFP may place significantly greater weight on the activity's effectiveness in accomplishing program goals or may place significantly greater weight on the activity's effectiveness in raising contributions. The former may indicate that the purpose criterion is met. The latter may indicate that the purpose criterion is not met.

- ii. *Qualifications.* The qualifications and duties of those performing the joint activity should be considered. If a third party, such as a consultant or contractor, performs part or all of the joint activity, such as producing brochures or making telephone calls, the third party's experience and the range of services provided to the NFP should be considered in determining whether the third party is performing fund-raising, program (other than educating the public about causes), or management and general activities on behalf of the NFP. If the NFP's employees perform part or all of the joint activity, the full range of their job duties should be considered in determining whether those employees are performing fund-raising, program (other than educating the public about causes), or management and general activities on behalf of the NFP. For example, employees who are not members of the fund-raising department and employees who are members of the fund-raising department but who perform nonfund-raising activities are more likely to perform activities that include program or management and general functions than are employees who otherwise devote significant time to fund-raising.
- iii. *Tangible evidence of intent.* Tangible evidence indicating the intended purpose of the joint activity should be considered. Examples of such tangible evidence include the following:
 - (1) The NFP's written mission statement, as stated in its fund-raising activities, bylaws, or annual report;
 - (2) Minutes of board of directors', committees', or other meetings;
 - (3) Restrictions imposed by donors (who are not related parties) on gifts intended to fund the joint activity;
 - (4) Long-range plans or operating policies;
 - (5) Written instructions to other entities, such as script writers, consultants, or list brokers, concerning the purpose of the joint activity, audience to be targeted, or method of conducting the joint activity; and
 - (6) Internal management memoranda.

Audience

13.95 A rebuttable presumption exists that the audience criterion is not met if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute to the NFP. That presumption can be overcome if the audience is also selected for one or more of the reasons in FASB ASC 958-720-45-49 (paragraph 13.96a–c). In determining whether that presumption is overcome, NFPs should consider the extent to

which the audience is selected based on its ability or likelihood to contribute to the NFP and contrast that with the extent to which it is selected for one or more of the reasons in FASB ASC 958-720-45-49 (paragraph 13.96a–c). For example, if the audience's ability or likelihood to contribute is a significant factor in its selection and it has a need for the action related to the program component of the joint activity, but having that need is an insignificant factor in its selection, the presumption would not be overcome.

13.96 FASB ASC 958-720-45-49 states that in circumstances in which the audience includes no prior donors and is not otherwise selected based on its ability or likelihood to contribute to the NFP, the audience criterion is met if the audience is selected for any of the following reasons:

- a. The audience's need to use or reasonable potential for use of the specific action called for by the program component of the joint activity.
- b. The audience's ability to take specific action to assist the NFP in meeting the goals of the program component of the joint activity.
- c. The NFP is required to direct the management and general component of the joint activity to the particular audience or the audience has reasonable potential for use of the management and general component.

13.97 Paragraphs 11–15 of FASB ASC 958-720-55 provide additional guidance for the audience criterion, which is reproduced in this paragraph and the following 4 paragraphs. Some NFPs conduct joint activities that are special events, such as symposia, dinners, dances, and theater parties, in which the attendee receives a direct benefit (for example, a meal or theater ticket) and for which the admission price includes a contribution. For example, it may cost \$500 to attend a dinner with a fair value of \$50. In that case, the audience is required to make a \$450 contribution in order to attend.

13.98 In circumstances in which the audience is required to make a contribution to participate in a joint activity, such as attending a special event, the audience's ability or likelihood to contribute is a significant factor in its selection. Therefore, in circumstances in which the audience is required to make a contribution to participate in a joint activity, the extent to which the audience is selected for the program or management and general reasons in FASB ASC 958-720-45-49 (paragraph 13.96) must be overwhelmingly significant in order to rebut the presumption that the audience criterion is not met.

13.99 The source of the names and the characteristics of the audience should be considered in determining the reason for selecting the audience. Some NFPs use lists compiled by others to reach new audiences. The source of such lists may indicate the purpose or purposes for which they were selected. For example, lists acquired from entities with similar or related programs are more likely to meet the audience criterion than are lists acquired from entities with dissimilar or unrelated programs. Also, the characteristics of those on the lists may indicate the purpose or purposes for which they were selected. For example, a list based on a consumer profile of those who buy environmentally friendly

products may be useful to an NFP whose mission addresses environmental concerns and could therefore indicate that the audience was selected for its ability to take action to assist the NFP in meeting program goals. However, a list based on net worth would indicate that the audience was selected based on its ability or likelihood to contribute, unless there was a correlation between net worth and the program or management and general components of the activity.

13.100 Some audiences may be selected because they have an interest in or affinity to the program. For example, homeowners may have an interest in the homeless because they are sympathetic to the plight of the homeless. Nevertheless, including homeowners in the audience of a program activity to provide services to the homeless would not meet the audience criterion because they do not have a need or reasonable potential for use of services to the homeless.

13.101 An example of a joint activity in which the audience is selected because the NFP is required to direct the management and general component of the joint activity to the particular audience is an activity in which the NFP sends a written acknowledgment or other information to comply with requirements of the IRS to prior donors and includes a request for contributions. An example of a joint activity in which the audience is selected because the audience has reasonable potential for use of the management and general component is an activity in which the NFP sends its annual report to prior donors and includes a request for contributions.

Content

13.102 FASB ASC 958-720-45-50 states that the content criterion is met if the joint activity supports program or management and general functions, as follows:

- a. Program.* The joint activity calls for specific action by the recipient that will help accomplish the NFP's mission (see paragraphs 35–37 of FASB ASC 958-720-45, which are reproduced in part in paragraphs 13.81–.85). If the need for and benefits of the action are not clearly evident, information describing the action and explaining the need for and benefits of the action is provided.
- b. Management and general.* The joint activity fulfills one or more of the NFP's management and general responsibilities through a component of the joint activity.

13.103 Per FASB ASC 958-720-45-35, actions that help accomplish the NFP's mission are actions that either benefit the recipient or benefit society. FASB ASC 958-720-55-17 provides the following examples of actions that benefit the recipient (such as by improving the recipient's physical, mental, emotional, or spiritual health and well-being) or society (such as by addressing societal problems):

- a.* Actions that benefit the recipient include the following:

- i. *Stop smoking.* Specific methods, instructions, references, and resources should be suggested.
- ii. *Do not use alcohol or drugs.* Specific methods, instructions, references, and resources should be suggested.

b. Actions that benefit society include the following:

- i. *Write or call.* The party to communicate with and the subject matter to be communicated should be specified.
- ii. *Complete and return the enclosed questionnaire.* The results of the questionnaire should help the NFP achieve its mission. For example, if the NFP discards the questionnaire, it does not help the NFP achieve its mission.
- iii. *Boycott.* The particular product or company to be boycotted should be specified.

13.104 Information identifying and describing the NFP, its causes, or how the contributions provided will be used is considered in support of fund-raising.

13.105 Per FASB ASC 958-720-45-53, activities that are undertaken in order to solicit contributions are fund-raising activities. For example, activities conducted to comply with requirements of regulatory bodies concerning soliciting contributions, such as the requirement by some states or other regulatory bodies that certain disclosures be included when soliciting contributions, are fund-raising activities. For purposes of applying this guidance, communications that include such required disclosures are considered fund-raising activities and are not considered management and general activities.

13.106 FASB ASC 958-720-55-18 provides the following examples of required disclosures that are considered fund-raising activities:

- Information filed with the attorney general concerning this charitable solicitation may be obtained from the attorney general of [*the state*] by calling 123-4567. Registration with the attorney general does not imply endorsement.
- A copy of the registration and financial information may be obtained from the Division of Consumer Services by calling toll-free, within [*the state*], 1 (800) 123-4567. Registration does not imply endorsement, approval, or recommendation by [*the state*].
- Information about the cost of postage and copying, and other information required to be filed under [*the state*] law, can be obtained by calling 123-4567.
- The entity's latest annual report can be obtained by calling 123-4567.

Allocation Methods

- 13.107** The cost allocation methodology used should be rational and systematic, it should result in an allocation of joint costs that is reasonable, and it should be applied consistently given similar facts and circumstances. Paragraphs 25–31 of FASB ASC 958-720-55 (reproduced in appendix C, “Allocation Methods,” of this chapter) provide explanations and examples of some acceptable allocation methods. The allocation of joint costs should be based on the degree to which costs were incurred for the functions to which the costs are allocated (that is, program, management and general, or fund-raising). For purposes of determining whether the allocation methodology for a particular joint activity should be consistent with methodologies used for other particular joint activities, facts and circumstances that may be considered include factors related to the content and relative costs of the components of the activity. The audience should not be considered in determining whether the facts and circumstances are similar for purposes of determining whether the allocation methodology for a particular joint activity should be consistent with methodologies used for other particular joint activities. A change in cost allocation methodology should be evaluated in accordance with FASB ASC 250, *Accounting Changes and Error Corrections*, to determine if it is a change in accounting principle.
- 13.108** Paragraphs 32–33 of FASB ASC 958-720-55 provide the following information about which joint costs should be measured and allocated. Some costs, such as utilities, rent, and insurance (commonly referred to as *indirect costs*), may be joint costs. For example, the telephone bill for a department that, among other things, prepares materials that include both fund-raising and program components may commonly be referred to as an indirect cost. Such telephone bills may also be joint costs. However, for some NFPs, it is impracticable to measure and allocate the portion of the costs that are joint costs. Considerations about which joint costs should be measured and allocated, such as considerations about materiality and the costs and benefits of developing and providing the information, are the same as considerations about cost allocations in other circumstances.

Incidental Activities

- 13.109** Some fund-raising activities conducted in conjunction with program or management and general activities are incidental to such program or management and general activities. In circumstances in which a fund-raising, program, or management and general activity is conducted in conjunction with another activity and is incidental to that other activity, and the criteria in FASB ASC 958-720-45-29 (paragraph 13.77) for allocation are met, joint costs are permitted but not required to be allocated and may therefore be charged to the functional classification related to the activity that is not the incidental activity. However, in circumstances in which the program or management and general activities are incidental to the fund-raising activities, it is unlikely that the criteria in that paragraph to permit allocation of joint costs would be met.
- 13.110** Paragraphs 160–165 of FASB ASC 958-720-55 provide the following three examples of incidental activities. NFP Q conducts a fund-raising activity by including a generic

message, "Contributions to NFP Q may be sent to [address]" on a small area of a message that would otherwise be considered a program or management and general activity based on its purpose, audience, and content. That fund-raising activity likely would be considered incidental to the program or management and general activity being conducted. NFP R conducts a program activity by including a generic program message such as "Continue to pray for [a particular cause]" on a small area of a message that would otherwise be considered fund-raising based on its purpose, audience, and content. That program activity would likely be considered incidental to the fund-raising activity being conducted. NFP S conducts a management and general activity by including the brief management and general message "We recently changed our phone number. Our new number is 123-4567" on a small area of a message that would otherwise be considered a program or fund-raising activity based on its purpose, audience, and content. That management and general activity would likely be considered incidental to the program or fund-raising activity being conducted.

Disclosures

13.111 FASB ASC 958-720-50-2 requires that an NFP that allocates joint costs should disclose all of the following in the notes to its financial statements:

- a. The types of activities for which joint costs have been incurred
- b. A statement that such costs have been allocated
- c. The total amount allocated during the period and the portion allocated to each functional expense category

13.112 An NFP is also encouraged, but not required, to disclose the amount of joint costs for each kind of joint activity, if practical.

Additional Guidance

13.113 FASB ASC 958-720-55-2 (reproduced in appendix A, "Accounting for Joint Activities," of this chapter) includes a flowchart useful in accounting for joint activities. Paragraphs 35–159 of FASB ASC 958-720-55 (reproduced in appendix B, "Examples of Applying the Criteria of Purpose, Audience, and Content to Determine Whether a Program or Management and General Activity Has Been Conducted," of this chapter) illustrate the application of the purpose, audience, and content criteria to determine whether a program or management and general activity has been conducted along with the fund-raising activity. Paragraph 25–31 of FASB ASC 958-720-55 (reproduced in appendix C of this chapter) illustrate allocation methods. Paragraphs 166–170 of FASB ASC 958-720-55 (reproduced in appendix D, "Examples of Disclosures," of this chapter) illustrate disclosures required when joint activities are conducted.

Support to Related Local and National NFPs

13.114 Some NFPs make payments or provide other support to local or national entities. The specific purposes and benefits of those payments may be for use of the national entity's name; for permission to raise funds in a specified geographical area; for the ability to participate in joint purchasing arrangements; for technical and fund-raising assistance; or for similar functions. Alternatively, the purposes and benefits of those payments may be indeterminable. Payments in the form of grants and dues may also be made to related local and national entities.

13.115 Per FASB ASC 958-720-45-26, payments to related local and national NFPs should be reported by their functional classification to the extent that it is practicable and reasonable to do so and the necessary information is available, even if it is impossible to allocate the entire amount of such payments to functions. Payments to those entities that cannot be allocated to functions should be treated as a separate supporting service, reported on a statement of activities as a separate line item, and labeled "unallocated payments to local (or national) organizations."

Distributions from Financially Interrelated Fund-raising Foundations to Specified Beneficiaries

13.116 FASB ASC 958-20-25-1 states that a foundation that exists to raise, hold, and invest assets for a specified beneficiary or for a group of affiliates of which the specified beneficiary is a member generally is financially interrelated with the NFP or NFPs it supports. (Paragraphs 5.27–.31 describe the standards for determining when NFPs are financially interrelated.) The foundation recognizes contribution revenue when it receives assets from the donor. When it later distributes the contributed assets to the beneficiary (and assuming that the distributions are neither [a] loans or repayments of loans, or [b] reciprocal transactions, including those discussed in paragraphs 4–7 of FASB ASC 958-20-25), a financially interrelated foundation reduces assets and recognizes an expense when it distributes assets to its financially interrelated beneficiary, as illustrated in examples 1 and 3 in FASB ASC 958-20-55.

13.117 Because they are expenses, distributions to financially interrelated NFPs should be reported by their functional classifications, as required by FASB ASC 958-720-45-2. If the foundation has only a single major program, as discussed at paragraph 13.51, the distributions might be reported on the statement of activities as "distributions to {name of beneficiary}." If the foundation has several programs, analogous to the guidance in FASB ASC 958-720-45-26, the payments to the beneficiary would be functionally classified to the extent that it is practicable and reasonable to do so and the necessary information is available, even if it is impossible to allocate the entire amount of such payments. Payments to financially interrelated beneficiaries that cannot be allocated to functions would be treated as a separate supporting service, reported on a statement of activities as a separate line item, and labeled "unallocated payments to financially interrelated entities." The foundation should consider whether the disclosures for related party transactions, as discussed in FASB ASC 850, are necessary.

13.118 Some fund-raising foundations (recipients) raise, hold, and invest assets for health care entities (beneficiaries). As discussed in TIS section 6140.19, “Application of FASB ASC 958—Classification of Distributions From a Financially Interrelated Fund-raising Foundation (Recipient Entity) to a Health Care Beneficiary” (AICPA, *Technical Practice Aids*), those foundations are not health care entities as described in FASB ASC 954-10-15, and therefore would not follow the guidance in FASB ASC 954, *Health Care Entities*. Instead, those foundations should report in conformity with the guidance in FASB ASC 958, *Not-for-Profit Entities*, including consideration of its guidance for financially interrelated entities in FASB ASC 958-20. That guidance applies regardless of whether the recipient entity and the beneficiary are under common control or whether one controls the other in a parent-subsidary relationship. (Paragraphs 1.04–.05 of this guide discuss further the scope of this guide as it pertains to health care entities.)

Expenses of Federated Fund-raising Entities

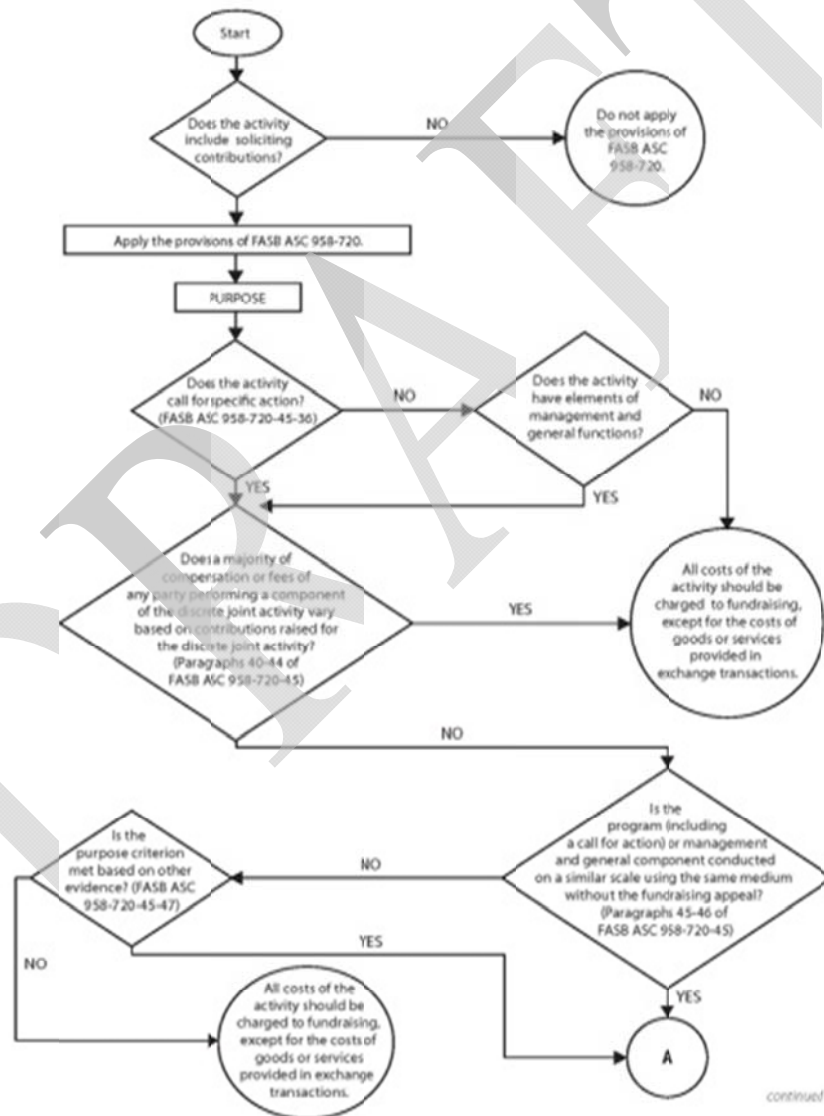
13.119 Per FASB ASB 958-720-45-27, federated fund-raising entities solicit and receive designated and undesignated contributions and make grants and awards to other NFPs. The fund-raising activities of federated fund-raising entities, including activities related to fund-raising on behalf of others, should be reported as fund-raising expenses.

Income Taxes

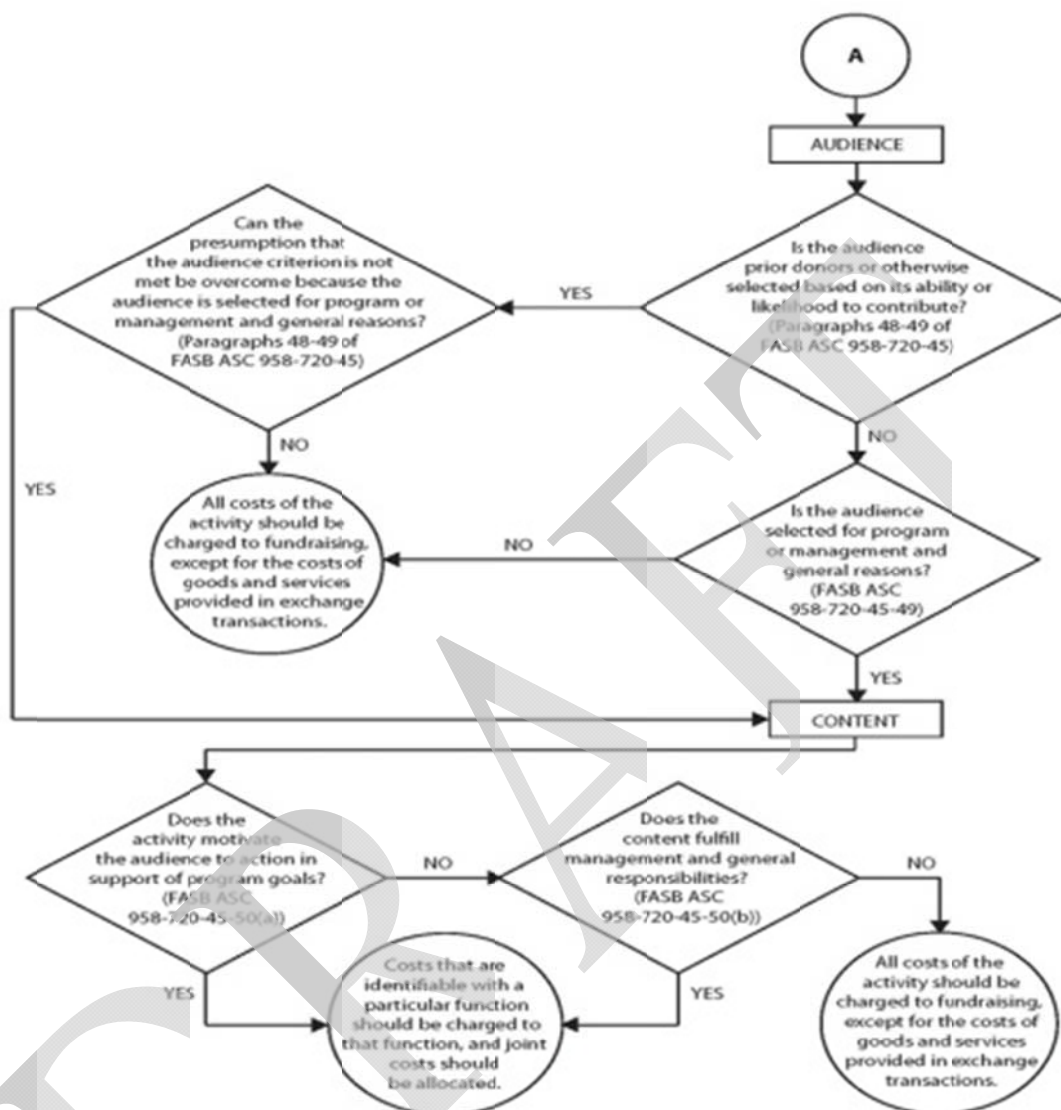
13.120 Per FASB ASC 958-720-50-1, if an NFP incurs income tax expense, the financial statements of the NFP should disclose the amount of income tax expense and describe the nature of the activities that generated the taxes.

Appendix A — Accounting for Joint Activities

A-1 The following flowchart from Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 958-720-55-2 summarizes the guidance in paragraphs 29–53 of FASB ASC 958-720-45 (see paragraphs 13.74–.113) and is not intended as a substitute for the guidance therein.



continued



Appendix B — Examples of Applying the Criteria of Purpose, Audience, and Content to Determine Whether a Program or Management and General Activity Has Been Conducted

B-1 Paragraphs 35–159 of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 958-720-55 illustrate the application of the purpose, audience, and content criteria to determine whether a program or management and general activity has been conducted along with a fund-raising activity. Those examples are reproduced in the following paragraphs.

Example 1: Mailing of Informational Materials

Facts

B-2 Not-for-profit entity (NFP) A's mission is to prevent drug abuse. NFP A's annual report states that one of its objectives in fulfilling that mission is to assist parents in preventing their children from abusing drugs.

B-3 NFP A mails informational materials to the parents of all junior high school students explaining the prevalence and dangers of drug abuse. The materials encourage parents to counsel children about the dangers of drug abuse and inform them about how to detect drug abuse. The mailing includes a request for contributions. NFP A conducts other activities informing the public about the dangers of drug abuse and encouraging parents to counsel their children about drug abuse that do not include requests for contributions and that are conducted in different media. NFP A's executive director is involved in the development of the informational materials as well as the request for contributions. The executive director's annual compensation includes a significant bonus if total annual contributions exceed a predetermined amount.

Conclusion

B-4 The purpose, audience, and content criteria are met, and the joint costs should be allocated.

B-5 The activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse and informing them about how to detect drug abuse) that will help accomplish the NFP's mission. Therefore, the guidance in FASB ASC 958-720-45-38 (see paragraph 13.86) should be considered. Neither of the factors in paragraphs 40–44 of FASB ASC 958-720-45 (see the compensation or fees test in paragraphs 13.87–.90) or paragraphs 45–46 of FASB ASC 958-720-45 (see the separate and similar activities test in paragraphs 13.91–.92) is determinative of whether the purpose criterion is met. (Although NFP A's executive director's annual compensation varies based on annual contributions, the executive director's compensation does not vary

based on contributions raised for this discrete joint activity.) Therefore, other evidence, such as the indicators in paragraphs 6–9 of FASB ASC 958-720-55 (see paragraph 13.94), should be considered. The purpose criterion is met based on the other evidence because (a) the program component of this activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse) that will help accomplish the NFP's mission, and it otherwise conducts the program activity in this example without a request for contributions, and (b) performing such programs helps accomplish NFP A's mission. Note that had NFP A conducted the activity using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions, the purpose criterion would have been met under paragraphs 45–46 of FASB ASC 958-720-45 (see paragraphs 13.91–.92).

B-6 The audience criterion is met because the audience (parents of junior high school students) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

B-7 The content criterion is met because the activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse and informing them about how to detect drug abuse) that will help accomplish the NFP's mission (assisting parents in preventing their children from abusing drugs), and it explains the need for and benefits of the action (the prevalence and dangers of drug abuse).

Example 2: Mailing to Prior Donors

Facts

B-8 NFP B's mission is to reduce the incidence of illness from ABC disease, which afflicts a broad segment of the population. One of NFP B's objectives in fulfilling that mission is to inform the public about the effects and early warning signs of the disease and specific action that should be taken to prevent the disease.

B-9 NFP B maintains a list of its prior donors and sends them donor renewal mailings. The mailings include messages about the effects and early warning signs of the disease and specific action that should be taken to prevent it. That information is also sent to a similar-sized audience but without the request for contributions. Also, NFP B believes that recent donors are more likely to contribute than nondonors or donors who have not contributed recently. Prior donors are deleted from the mailing list if they have not contributed to NFP B recently, and new donors are added to the list. There is no evidence of a correlation between recent contributions and participation in the program component of the activity. Also, the prior donors' need to use or reasonable potential for use of the messages about the effects and early warning signs of the disease and specific action that should be taken to prevent it is an insignificant factor in their selection.

Conclusion

B-10 The purpose and content criteria are met. The audience criterion is not met. All costs, including those that might otherwise be considered program or management and general costs if they had been incurred in a different activity, should be charged to fund-raising.

B-11 The activity calls for specific action by the recipient (action that should be taken to prevent ABC disease) that will help accomplish the entity's mission. Therefore, the guidance in FASB ASC 958-720-45-38 (see paragraph 13.86) should be considered. The purpose criterion is met because (a) the program component of the activity calls for specific action by the recipient that will help accomplish the NFP's mission (to reduce the incidence of illness from the disease), and (b) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (a similar mailing is done without the request for contributions, to a similar-sized audience).

B-12 The audience criterion is not met. The rebuttable presumption that the audience criterion is not met because the audience includes prior donors is not overcome in this example. Although the audience has a need to use or reasonable potential for use of the program component, that was an insignificant factor in its selection.

B-13 The content criterion is met because the activity calls for specific action by the recipient (actions to prevent ABC disease) that will help accomplish the entity's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

Example 3: Telephone Solicitation of Prior Donors

Facts

B-14 NFP C's mission is to reduce the incidence of illness from ABC disease, which afflicts a broad segment of the population. One of NFP C's objectives in fulfilling that mission is to increase governmental funding for research about ABC disease.

B-15 NFP C maintains a list of its prior donors and its employees call them on the telephone reminding them of the effects of ABC disease, asking for contributions, and encouraging them to contact their elected officials to urge increased governmental funding for research about ABC disease. The callers are educated about ABC, do not otherwise perform fund-raising functions, and are not compensated or evaluated based on contributions raised. NFP C's research indicates that recent donors are likely to contact their elected officials about such funding whereas nonrecent donors are not. Prior donors are deleted from the calling list if they have not contributed to NFP C recently, and new donors are added to the list.

Conclusion

B-16 The purpose, audience, and content criteria are met, and the joint costs should be allocated.

B-17 The activity calls for specific action by the recipient (contacting elected officials concerning funding for research about ABC disease) that will help accomplish the NFP's mission. Therefore, the guidance in FASB ASC 958-720-45-38 (see paragraph 13.86) should be considered. Neither of the factors in paragraphs 40–44 of FASB ASC 958-720-45 (see the compensation or fees test in paragraphs 13.87–90) or paragraphs 45–46 of FASB ASC 958-720-45 (see the separate and similar activities test in paragraphs 13.91–92) is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraphs 6–9 of FASB ASC 958-720-55 (see paragraph 13.94), should be considered. The purpose criterion is met based on the other evidence, because (a) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the callers are educated about ABC and do not otherwise perform fund-raising functions), (b) the method of compensation for performing the activity does not indicate that it is a fund-raising activity (the employees are not compensated or evaluated based on contributions raised), and (c) performing such programs helps accomplish NFP C's mission.

B-18 The audience criterion is met because the audience (recent donors) is selected based on its ability to assist NFP C in meeting the goals of the program component of the activity (recent donors are likely to contact their elected officials about such funding whereas nonrecent donors are not).

B-19 The content criterion is met because the activity calls for specific action by the recipient (contacting elected officials concerning funding for research about ABC disease) that will help accomplish the NFP's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

Example 4: Mailing Targeted Based on Program-Related Criteria

Facts: Case A

B-20 NFP D's mission is to improve the quality of life for senior citizens. One of NFP D's objectives included in that mission is to increase the physical activity of senior citizens. One of NFP D's programs to attain that objective is to send representatives to speak to groups about the importance of exercise and to conduct exercise classes.

B-21 NFP D mails a brochure on the importance of exercise that encourages exercise in later years to residents over the age of 65 in 3 zip code areas. The last 2 pages of the 4-page brochure include a perforated contribution remittance form on which NFP D explains its program and makes an appeal for contributions. The content of the first 2 pages of the brochure is primarily educational; it explains how seniors can undertake a self-supervised exercise program and encourages them to undertake such a program. In addition, NFP D includes a second brochure on various exercise techniques that can be used by those undertaking an exercise program.

B-22 The brochures are distributed to educate people in this age group about the importance of exercising, to help them exercise properly, and to raise contributions for NFP D. These objectives are documented in a letter to the public relations firm that developed the brochures. The audience is selected based on age, without regard to ability to contribute. NFP D believes that most of the recipients would benefit from the information about exercise.

Conclusion: Case A

B-23 The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that the costs of the second brochure should be charged to program because all the costs of the brochure are identifiable with the program function.)

B-24 The activity calls for specific action by the recipient (exercising) that will help accomplish the NFP's mission. Therefore, the guidance in FASB ASC 958-720-45-38 (see paragraph 13.86) should be considered. Neither of the factors in paragraphs 40–44 of FASB ASC 958-720-45 (see the compensation or fees test in paragraphs 13.87–.90) or paragraphs 45–46 of FASB ASC 958-720-45 (see the separate and similar activities test in paragraphs 13.91–.92) is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraphs 6–9 of FASB ASC 958-720-55 (see paragraph 13.94), should be considered. The purpose criterion is met based on the other evidence, because (a) performing such programs helps accomplish NFP D's mission, and (b) the objectives of the program are documented in a letter to the public relations firm that developed the brochure.

B-25 The audience criterion is met because the audience (residents over 65 in certain zip codes) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

B-26 The content criterion is met because the activity calls for specific action by the recipient (exercising) that will help accomplish the NFP's mission (increasing the physical activity of senior citizens), and the need for and benefits of the action are clearly evident (explains the importance of exercising).

Facts: Case B

B-27 In this case, NFP D employs a fund-raising consultant to develop the first brochure and pays that consultant 30 percent of contributions raised.

Conclusion: Case B

B-28 The content and audience criteria are met. The purpose criterion is not met, however, because a majority of compensation or fees for the fund-raising consultant varies based on contributions raised for this discrete joint activity (the fund-raising consultant is paid 30 percent of contributions raised). All costs should be charged to fund-raising, including the costs of the second brochure and any other costs that

otherwise might be considered program or management and general costs if they had been incurred in a different activity.

Example 5: Door-to-Door Canvass

Facts

B-29 NFP E's mission is to protect the environment. One of NFP E's objectives included in that mission is to take action that will increase the portion of waste recycled by the public.

B-30 NFP E conducts a door-to-door canvass of a community that recycles a low portion of its waste. The purpose of the activity is to help increase recycling by educating the community about environmental problems created by not recycling, and to raise contributions. Based on the information communicated by the canvassers, the need for and benefits of the action are clearly evident. The ability or likelihood of the residents to contribute is not a basis for communities selected, and all neighborhoods in the geographic area are covered if their recycling falls below a predetermined rate. The canvassers are selected from individuals who are well-informed about NFP E's environmental concerns and programs and who previously participated as volunteers in program activities such as answering environmental questions directed to NFP E and developing program activities designed to influence legislators to take actions addressing those concerns. The canvassers have not previously participated in fund-raising activities.

Conclusion

B-31 The purpose, audience, and content criteria are met, and the joint costs should be allocated.

B-32 The activity calls for specific action by the recipient (implicitly—to help increase recycling) that will help accomplish the entity's mission. Therefore, the guidance in FASB ASC 958-720-45-38 (see paragraph 13.86) should be considered. Neither of the factors in paragraphs 40–44 of FASB ASC 958-720-45 (see the compensation or fees test in paragraphs 13.87–.90) or paragraphs 45–46 of FASB ASC 958-720-45 (see the separate and similar activities test in paragraphs 13.91–.92) is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraphs 6–9 of FASB ASC 958-720-55 (see paragraph 13.94), should be considered. The purpose criterion is met based on the other evidence, because (a) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the canvassers are selected from individuals who are well-informed about NFP E's environmental concerns and programs and who previously participated as volunteers in program activities such as answering environmental questions directed to NFP E and developing program activities designed to influence legislators to take actions addressing those concerns), and (b) performing such programs helps accomplish NFP E's mission (to protect the environment).

B-33 The audience criterion is met because the audience (neighborhoods whose recycling falls below a predetermined rate) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

B-34 The content criterion is met because the activity calls for specific action by the recipient (implicitly—to help increase recycling) that will help accomplish NFP E's mission (to protect the environment), and the need for and benefits of the action are clearly evident (increased recycling will help alleviate environmental problems).

Example 6: Door-to-Door Solicitation Campaign

Facts

B-35 NFP F's mission is to provide summer camps for economically disadvantaged youths. Educating the families of ineligible youths about the camps is not one of the program objectives included in that mission.

B-36 NFP F conducts a door-to-door solicitation campaign for its camp programs. In the campaign, volunteers with canisters visit homes in middle class neighborhoods to collect contributions. NFP F believes that people in those neighborhoods would not need the camp's programs but may contribute. The volunteers explain the camp's programs, including why the disadvantaged children benefit from the program, and distribute leaflets to the residents regardless of whether they contribute to the camp. The leaflets describe the camp, its activities, who can attend, and the benefits to attendees. Requests for contributions are not included in the leaflets.

Conclusion

B-37 The purpose, audience, and content criteria are not met. All costs should be charged to fund-raising.

B-38 The activity does not include a call for specific action because it only educates the audience about causes (describing the camp, its activities, who can attend, and the benefits to attendees). Therefore, the purpose criterion is not met.

B-39 The audience criterion is not met, because the audience is selected based on its ability or likelihood to contribute, rather than based on its need to use or reasonable potential for use of the action called for by the program component or its ability to take action to assist the NFP in meeting the goals of the program component of the activity. (NFP F believes that people in those neighborhoods would not need the camp's programs but may contribute.)

B-40 The content criterion is not met because the activity does not call for specific action by the recipient. (The content educates the audience about causes that the program is designed to address without calling for specific action.)

Example 7: Annual National Telethon

Facts

B-41 NFP G's mission is to educate the public about lifesaving techniques in order to increase the number of lives saved. One of NFP G's objectives in fulfilling that mission, as stated in the minutes of the board's meetings, is to produce and show television broadcasts including information about lifesaving techniques.

B-42 NFP G conducts an annual national telethon to raise contributions and to reach the American public with lifesaving educational messages, such as summary instructions concerning dealing with certain life-threatening situations. Based on the information communicated by the messages, the need for and benefits of the action are clearly evident. The broadcast includes segments describing NFP G's services. NFP G broadcasts the telethon to the entire country, not merely to areas selected on the basis of giving potential or prior fund-raising results. Also, NFP G uses national television broadcasts devoted entirely to lifesaving educational messages to conduct program activities without fund-raising.

Conclusion

B-43 The purpose, audience, and content criteria are met, and the joint costs should be allocated.

B-44 The activity calls for specific action by the recipient (implicitly, to save lives) that will help accomplish the NFP's mission. Therefore, the guidance in FASB ASC 958-720-45-38 (see paragraph 13.86) should be considered. The purpose criterion is met because (a) the program component of the activity calls for specific action by the recipient that will help accomplish NFP G's mission (to save lives by educating the public), and (b) a similar program activity is conducted without the fund-raising using the same medium and on a scale that is similar to or greater than the scale on which it is conducted with the appeal (NFP G uses national television broadcasts devoted entirely to lifesaving educational messages to conduct program activities without fund-raising).

B-45 The audience criterion is met because the audience (a broad segment of the population) is selected based on its need to use or reasonable potential for use of the action called for by the program activity.

B-46 The content criterion is met because the activity calls for specific action by the recipient (implicitly—to save lives) that will help accomplish the NFP's mission (to save lives by educating the public), and the need for and benefits of the action are clearly evident (saving lives is desirable).

Example 8: Television Broadcast Educating the Public

Facts

B-47 NFP H's mission is to provide food, clothing, and medical care to children in developing countries.

B-48 NFP H conducts television broadcasts in the United States that describe its programs, show the needy children, and end with appeals for contributions. NFP H's operating policies and internal management memoranda state that these programs are designed to educate the public about the needs of children in developing countries and to raise contributions. The employees producing the programs are trained in audiovisual production and are familiar with NFP H's programs. Also, the executive producer is paid \$25,000 for this activity, with a \$5,000 bonus if the activity raises more than \$1,000,000.

Conclusion

B-49 The purpose, audience, and content criteria are not met. All costs should be charged to fund-raising.

B-50 The activity does not include a call for specific action because it only educates the audience about causes (describing its programs and showing the needy children). Therefore, the purpose criterion is not met. Also, note that if the factor in paragraphs 40–44 of FASB ASC 958-720-45 (the compensation or fees test; see paragraphs 13.87–.90) were considered, it would not be determinative of whether the purpose criterion is met. Although the executive producer will be paid \$5,000 if the activity raises more than \$1,000,000, that amount would not be a majority of the executive producer's total compensation for this activity, because \$5,000 would not be a majority of the executive producer's total compensation of \$30,000 for this activity. Also, note that if other evidence, such as the indicators in paragraphs 6–9 of FASB ASC 958-720-55 (see paragraph 13.94), were considered, the purpose criterion would not be met based on the other evidence. Although the qualifications and duties of the personnel performing the activity indicate that the employees producing the program are familiar with NFP H's programs, the facts that some, but less than a majority, of the executive producer's compensation varies based on contributions raised, and that the operating policies and internal management memoranda state that these programs are designed to educate the public about the needs of children in developing countries with no call for specific action by recipients and to raise contributions, indicate that the purpose is fund-raising.)

B-51 The audience criterion is not met because the audience is selected based on its ability or likelihood to contribute, rather than based on its need to use or reasonable potential for use of the action called for by the program component or its ability to take action to assist the NFP in meeting the goals of the program component of the activity. (The audience is a broad segment of the population of a country that is not in need of or has no reasonable potential for use of the program activity.)

B-52 The content criterion is not met because the activity does not call for specific action by the recipient that will help accomplish the NFP's mission. (The content educates the audience about the causes without calling for specific action.)

Example 9: Distribution of the Annual Report

Facts

B-53 NFP I is a university that distributes its annual report, which includes reports on mission accomplishments, to those who have made significant contributions over the previous year, its board of trustees, and its employees. The annual report is primarily prepared by management and general personnel, such as the accounting department and executive staff. The activity is coordinated by the public relations department. Internal management memoranda indicate that the purpose of the annual report is to report on how management discharged its stewardship responsibilities, including the university's overall performance, goals, financial position, cash flows, and results of operations. Included in the package containing the annual report are requests for contributions and donor reply cards.

Conclusion

B-54 The purpose, audience, and content criteria are met, and the joint costs should be allocated.

B-55 The activity has elements of management and general functions. Therefore, no call for specific action is required. Neither of the factors in paragraphs 40–44 of FASB ASC 958-720-45 (see the compensation or fees test in paragraphs 13.87–.90) or paragraphs 45–46 of FASB ASC 958-720-45 (see the separate and similar activities test in paragraphs 13.91–.92) is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraphs 6–9 of FASB ASC 958-720-55 (see paragraph 13.94), should be considered. The purpose criterion is met based on the other evidence because (a) the employees performing the activity are not members of the fund-raising department and perform other non-fund-raising activities and (b) internal management memoranda indicate that the purpose of the annual report is to fulfill one of the university's management and general responsibilities.

B-56 The audience criterion is met because the audience is selected based on its reasonable potential for use of the management and general component. Although the activity is directed primarily at those who have previously made significant contributions, the audience was selected based on its presumed interest in NFP I's annual report (prior donors who have made significant contributions are likely to have an interest in matters discussed in the annual report).

B-57 The content criterion is met because the activity (distributing annual reports) fulfills one of the entity's management and general responsibilities (reporting concerning management's fulfillment of its stewardship function).

Example 10: Compliance With IRS Regulations

Facts

B-58 In accordance with internal management memoranda documenting its policies requiring it to comply with IRS regulations, NFP J mails prior donors the contribution substantiation documentation required by the IRS. The documentation is included on a

perforated piece of paper. The information above the perforation line pertains to the documentation required by the IRS. The information below the perforation line includes a request for contributions and may be used as a donor reply card.

Conclusion

B-59 The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that the costs of the information below the perforation line are identifiable with fund-raising and therefore should be charged to fund-raising.)

B-60 The activity has elements of management and general functions. Therefore, no call for specific action is required. Neither of the factors in paragraphs 40–44 of FASB ASC 958-720-45 (see the compensation or fees test in paragraphs 13.87–.90) or paragraphs 45–46 of FASB ASC 958-720-45 (see the separate and similar activities test in paragraphs 13.91–.92) is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraphs 6–9 of FASB ASC 958-720-55 (see paragraph 13.94), should be considered. The purpose criterion is met based on the other evidence because internal management memoranda indicate that the purpose of the activity is to fulfill one of NFP J's management and general responsibilities.

B-61 The audience criterion is met because the NFP is required to direct the management and general component of the activity to the particular audience. Although the activity is directed at those who have previously contributed, the audience was selected based on its need for the documentation.

B-62 The content criterion is met because the activity (sending documentation required by the IRS) fulfills one of the entity's management and general responsibilities (complying with IRS regulations).

Example 11: Mailing to Individuals Targeted Using a Rented List

Facts

B-63 NFP K is an animal rights organization. It mails a package of material to individuals included in lists rented from various environmental and other NFPs that support causes that NFP K believes are congruent with its own. In addition to donor response cards and return envelopes, the package includes (a) materials urging recipients to contact their legislators and urge the legislators to support legislation to protect those rights, and (b) postcards addressed to legislators urging support for legislation restricting the use of animal testing for cosmetic products. The mail campaign is part of an overall strategy that includes magazine advertisements and the distribution of similar materials at various community events, some of which are undertaken without fund-raising appeals. The advertising and community events reach audiences similar in size and demographics to the audience reached by the mailing.

Conclusion

B-64 The purpose, audience, and content criteria are met, and the joint costs should be allocated.

B-65 The activity calls for specific action by the recipient (mailing postcards to legislators urging support for legislation restricting the use of animal testing for cosmetic products) that will help accomplish the entity's mission. Therefore, the guidance in FASB ASC 958-720-45-38 (see paragraph 13.86) should be considered. Neither of the factors in paragraphs 40–44 of FASB ASC 958-720-45 (see the compensation or fees test in paragraphs 13.87–.90) or paragraphs 45–46 of FASB ASC 958-720-45 (see the separate and similar activities test in paragraphs 13.91–.92) is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraphs 6–9 of FASB ASC 958-720-55 (see paragraph 13.94), should be considered. The purpose criterion is met based on the other evidence, because (a) the program component of this activity calls for specific action by the recipient that will help accomplish the NFP's mission, and it otherwise conducts the program activity in this example without a request for contributions, and (b) performing such programs helps accomplish NFP K's mission.

B-66 The audience criterion is met because the audience (individuals included in lists rented from various environmental and other NFPs that support causes that NFP K believes are congruent with its own) is selected based on its ability to take action to assist the NFP in meeting the goals of the program component of the activity.

B-67 The content criterion is met because the activity calls for specific action by the recipient (mailing postcards to legislators urging support for legislation restricting the use of animal testing for cosmetic products) that will help accomplish the NFP's mission (to protect animal rights), and the need for and benefits of the action are clearly evident (to protect animal rights).

Example 12: Advertising of Ticket Subscription With a Request for Contributions

Facts

B-68 NFP L is a performing arts entity whose mission is to make the arts available to residents in its area. NFP L charges a fee for attending performances and sends advertisements, including subscription forms, for the performances to residents in its area. These advertisements include a return envelope with a request for contributions. NFP L evaluates the effectiveness of the advertising based on the number of subscriptions sold as well as contributions received. In performing that evaluation, NFP L places more weight on the number of subscriptions sold than on the contributions received. Also, NFP L advertises the performances on local television and radio without a request for contributions but on a smaller scale than the mail advertising.

Conclusion

B-69 The purpose, audience, and content criteria are met, and the joint costs should be allocated.

B-70 The activity calls for specific action by the recipient (attending the performances) that will help accomplish the NFP's mission. Therefore, the guidance in FASB ASC 958-720-45-38 (see paragraph 13.86) should be considered. Neither of the factors in paragraphs 40–44 of FASB ASC 958-720-45 (see the compensation or fees test in paragraphs 13.87–.90) or paragraphs 45–46 of FASB ASC 958-720-45 (see the separate and similar activities test in paragraphs 13.91–.92) is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraphs 6–9 of FASB ASC 958-720-55 (see paragraph 13.94), should be considered. The purpose criterion is met based on the other evidence because (a) the NFP measures program results and accomplishments of the joint activity and in evaluating the effectiveness of the activity, the NFP places significantly greater weight on the activity's effectiveness in accomplishing program goals than on the activity's effectiveness in raising contributions (NFP L evaluates the effectiveness of the advertising based on the number of subscriptions sold as well as contributions received and places more weight on the number of subscriptions sold than on the contributions received), (b) it otherwise conducts the program activity without a request for contributions, and (c) performing such programs helps accomplish NFP L's mission (to make the arts available to residents in its area).

B-71 The audience criterion is met because the audience (a broad segment of the population in NFP L's area) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

B-72 The content criterion is met because the activity calls for specific action by the recipient (attending the performances) that will help accomplish the NFP's mission (making the arts available to area residents), and the need for and benefits of the action are clearly evident (attending the performance is a positive cultural experience). (Note that the purchase of subscriptions is an exchange transaction and, therefore, is not a contribution.)

Example 13: University Lecture Series With Fair Value Admission

Facts

B-73 NFP M is a university whose mission is to educate the public (students) in various academic pursuits. NFP M's political science department holds a special lecture series in which prominent world leaders speak about current events. The speakers command relatively high fees and, in order to cover costs and make a modest profit, the university sets a relatively expensive fee to attend. However, the tickets are priced at the fair value of the lecture and no portion of the ticket purchase price is a contribution. NFP M advertises the lectures by sending invitations to prior attendees and to prior donors who have contributed significant amounts, and by placing advertisements in local newspapers read by the general public. At some of the lectures, including the lecture being considered in this example, deans and other faculty members of NFP M solicit significant contributions from attendees. Other lectures in the series are conducted on a scale similar to the scale of the lecture in this example without requesting contributions.

NFP M's records indicate that historically 75 percent of the attendees have attended prior lectures. Of the 75 percent who have attended prior lectures, 15 percent have made prior contributions to NFP M. Of the 15 percent who have made prior contributions to NFP M, 5 percent have made contributions in response to solicitations made at the events. (Therefore, one-half of 1 percent of attendees makes contributions in response to solicitations made at the events. However, those contributions are significant.) Overall, the audience's ability or likelihood to contribute is an insignificant factor in its selection. NFP M evaluates the effectiveness of the activity based on the number of tickets sold, as well as contributions received. In performing that evaluation, NFP M places more weight on the number of tickets sold than on the contributions received.

Conclusion

B-74 The purpose, audience, and content criteria are met, and the joint costs should be allocated. The purchase of the tickets is an exchange transaction and, therefore, is not a contribution. As discussed in FASB ASC 958-720-45-29 (see paragraph 13.77), costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event, should not be reported as fund-raising. FASB ASC 958-225-45-17 (see paragraph 13.41) provides guidance concerning reporting special events.

B-75 The activity calls for specific action by the recipient (attending the lecture) that will help accomplish the NFP's mission. Therefore, the guidance in FASB ASC 958-720-45-38 (see paragraph 13.86) should be considered. The purpose criterion is met because (a) the program component of the activity calls for specific action by the recipient that will help accomplish the NFP's mission (educating the public [students] in various academic pursuits), and (b) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (other lectures in the series are conducted on a scale similar to the scale of the lecture in this example without requesting contributions).

B-76 The audience criterion is met. The rebuttable presumption that the audience criterion is not met because the audience includes prior donors is overcome in this example because the audience (those who have shown prior interest in the lecture series, prior donors, a broad segment of the population in NFP M's area, and those attending the lecture) is also selected for its reasonable potential for use of the program component (attending the lecture). Although the audience may make significant contributions, that was an insignificant factor in its selection.

B-77 The content criterion is met because the activity calls for specific action by the recipient (attending the lecture) that will help accomplish the NFP's mission (educating the public [students] in various academic pursuits), and the need for and benefits of the action are clearly evident (attending the lecture is a positive educational experience).

Example 14: University Lecture Series With Contribution Inherent in the Admission

Facts

B-78 NFP N is a university whose mission is to educate the public (students) in various academic pursuits. NFP N's political science department holds a special lecture series in which prominent world leaders speak about current events. Admission is priced at \$250, which is above the \$50 fair value of the lecture and, therefore, \$200 of the admission price is a contribution. Therefore, the audience's likelihood to contribute to the NFP is a significant factor in its selection. NFP N advertises the lectures by sending invitations to prior attendees and to prior donors who have contributed significant amounts, and by placing advertisements in local newspapers read by the general public. NFP N presents similar lectures that are priced at the fair value of those lectures.

Conclusion

B-79 The purpose and criterion are met. The audience criterion is not met. All costs, including those that might otherwise be considered program or management and general costs if they had been incurred in a different activity, except for the costs of the direct donor benefit (the lecture), should be charged to fund-raising. Note that the purchase of the tickets is an exchange transaction and, therefore, is not a contribution. As discussed in FASB ASC 958-720-45-29 (see paragraph 13.77), costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event, should not be reported as fund-raising.) FASB ASC 958-225-45-17 (see paragraph 13.41) provides guidance concerning reporting special events.

B-80 The activity calls for specific action by the recipient (attending the lecture) that will help accomplish the NFP's mission. Therefore, the guidance in FASB ASC 958-720-45-38 (see paragraph 13.86) should be considered. The purpose criterion is met because (a) the program component of the activity calls for specific action by the recipient that will help accomplish the NFP's mission (educating the public [students] in various academic pursuits), and (b) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (other lectures in the series are conducted on a scale similar to the scale of the lecture in this example without including a contribution in the admission price).

B-81 The audience criterion is not met. The rebuttable presumption that the audience criterion is not met because the audience is selected based on its likelihood to contribute to the NFP is not overcome in this example. The fact that the \$250 admission price includes a \$200 contribution leads to the conclusion that the audience's ability or likelihood to contribute is an overwhelmingly significant factor in its selection, whereas there is no evidence that the extent to which the audience is selected for its need to use or reasonable potential for use of the action called for by the program component (attending the lecture) is overwhelmingly significant.

B-82 The content criterion is met because the activity calls for specific action by the recipient (attending the lecture) that will help accomplish the NFP's mission (educating

the public [students] in various academic pursuits), and the need for and benefits of the action are clearly evident (attending the lecture is a positive educational experience).

Example 15: Free Health Screenings

Facts

B-83 NFP O's mission is to reduce the incidence of illness from ABC disease, which primarily afflicts people over 65 years of age. One of NFP O's objectives in fulfilling that mission is to have all persons over 65 screened for ABC disease.

B-84 NFP O rents space at events attended primarily by people over 65 years of age and conducts free screening for ABC disease. NFP O's employees, who are educated about ABC disease and screening procedures and do not otherwise perform fund-raising functions, educate interested parties about the effects of ABC disease and the ease and benefits of screening for it. NFP O also solicits contributions at the events. The effectiveness of the activity is evaluated primarily based on how many screening tests are performed, and only minimally based on contributions raised. The employees are not compensated or evaluated based on contributions raised.

Conclusion

B-85 The purpose, audience, and content criteria are met, and the joint costs should be allocated.

B-86 The activity calls for specific action by the recipient (being screened for ABC disease) that will help accomplish the NFP's mission; therefore, the guidance in FASB ASC 958-720-45-38 (see paragraph 13.86) should be considered. Neither of the factors in paragraphs 40–44 of FASB ASC 958-720-45 (see the compensation or fees test in paragraphs 13.87–.90) or paragraphs 45–46 of FASB ASC 958-720-45 (see the separate and similar activities test in paragraphs 13.91–.92) is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraphs 6–9 of FASB ASC 958-720-55 (see paragraph 13.94), should be considered. The purpose criterion is met based on the other evidence, because (a) a process exists to evaluate measured program results and accomplishments and in evaluating the effectiveness of the joint activity, the NFP places significantly greater weight on the activity's effectiveness in accomplishing program goals than on the activity's effectiveness in raising contributions (NFP O evaluates the effectiveness of the activity based on the number of screening tests conducted as well as contributions received and places more weight on the number of tests conducted than on the contributions received); (b) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the employees are educated about ABC disease and the testing procedures and do not otherwise perform fund-raising functions); (c) the method of compensation for performing the activity does not indicate that it is a fund-raising activity (the employees are not compensated or evaluated based on contributions raised); and (d) performing such programs helps accomplish NFP O's mission (to prevent ABC disease).

B-87 The audience criterion is met because the audience (people over 65 years of age) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

B-88 The content criterion is met because the activity calls for specific action by the recipient (being screened for ABC disease) that will help accomplish the NFP's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

Example 16: Public Television Membership Drive

Facts

B-89 NFP P's mission is to provide cultural and educational television programming to residents in its area. NFP P owns a public television station and holds a membership drive in which it solicits new members. The drive is conducted by station employees and consists of solicitations that are shown during long breaks between the station's regularly scheduled programs. NFP P's internal management memoranda state that these drives are designed to raise contributions. NFP P evaluates the effectiveness of the activity based on the amount of contributions received. NFP P shows the programs on a similar scale, without the request for contributions. The audience is members of the general public who watch the programs shown during the drive. Station member benefits are given to those who contribute and consist of tokens of appreciation with a nominal value.

Conclusion

B-90 The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that there would be few, if any, joint costs. Costs associated with the fund-raising activities, such as costs of airtime, would be separately identifiable from costs of the program activities, such as licensing costs for a particular television program. Also, note that because no significant benefits or duties are associated with membership, member dues are contributions. Therefore, the substance of the membership-development activities is, in fact, fund-raising.)

B-91 The activity calls for specific action by the recipient (watching the television program) that will help accomplish the NFP's mission. Therefore, the guidance in FASB ASC 958-720-45-38 (see paragraph 13.86) should be considered. The purpose criterion is met because (a) the program component of the activity calls for specific action by the recipient that will help accomplish the NFP's mission, and (b) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (NFP P shows the television programs on a similar scale, without the request for contributions).

B-92 The audience criterion is met. The rebuttable presumption that the audience criterion is not met because the audience is selected based on its likelihood to contribute

is overcome in this example because the audience (members of the general public who watch the television programs shown during the drive) is also selected for its reasonable potential for use of the program component (watching the television programs). Although the audience may make contributions, that was an insignificant factor in its selection.

B-93 The content criterion is met because the activity calls for specific action by the recipient (watching the television programs) that will help accomplish the NFP's mission (providing cultural and educational television programming to residents in its area), and the need for and benefits of the action are clearly evident (watching the programs is a positive cultural and educational experience).

Appendix C — Allocation Methods

C-1 Paragraphs 26–31 of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 958-720-55 provide the following information about commonly used cost allocation methods.

Physical Units Method

C-2 Joint costs are allocated to materials and activities in proportion to the number of units of output that can be attributed to each of the materials and activities. Examples of units of output are lines, square inches, and physical content measures. This method assumes that the benefits received by the fund-raising, program, or management and general component of the materials or activity from the joint costs incurred are directly proportional to the lines, square inches, or other physical output measures attributed to each component of the activity. This method may result in an unreasonable allocation of joint costs if the units of output, for example, line counts, do not reflect the degree to which costs are incurred for the joint activity. Use of the physical units method may also result in an unreasonable allocation if the physical units cannot be clearly ascribed to fund-raising, program, or management and general. For example, direct mail and telephone solicitations sometimes include content that is not identifiable with fund-raising, program, or management and general; or the physical units of such content are inseparable.

Illustration

C-3 For example, assume a direct mail campaign is used to conduct programs of the not-for-profit entity (NFP) and to solicit contributions to support the organization and its programs. Further, assume that the appeal meets the criteria for allocation of joint costs to more than one function.

C-4 The letter and reply card include a total of 100 lines; 45 lines pertain to program because they include a call for action by the recipient that will help accomplish the NFP's mission, and 55 lines pertain to the fund-raising appeal. Accordingly, 45 percent of the costs are allocated to program and 55 percent to fund-raising.

Relative Direct Cost Method

C-5 Joint costs are allocated to each of the components on the basis of their respective direct costs. Direct costs are those costs that are incurred in connection with the multipurpose materials or activity and that are specifically identifiable with a function (program, fund-raising, or management and general). This method may result in an unreasonable allocation of joint costs if the joint costs of the materials and activity are not incurred in approximately the same proportion and for the same reasons as the direct costs of the materials and activity. For example, if a relatively costly booklet informing

the reader about the NFP's mission (including a call for action by the recipient that will help accomplish the NFP's mission) is included with a relatively inexpensive fund-raising letter, the allocation of joint costs based on the cost of these pieces may be unreasonable, particularly if the booklet and letter weigh approximately the same and therefore contribute equally to the postage costs.

Illustration

C-6 For example, the costs of a direct mail campaign that can be specifically identified with program services are the costs of separate program materials and a postcard which calls for specific action by the recipient that will help accomplish the NFP's mission. They total \$20,000. The direct costs of the fund-raising component of the direct mail campaign consist of the costs to develop and produce the fund-raising letter. They total \$80,000. Joint costs associated with the direct mail campaign total \$40,000 and would be allocated as follows under the relative direct cost method.

Program	$\$20,000/\$100,000 \times \$40,000 = \$8,000$
Fund-raising	$\$80,000/\$100,000 \times \$40,000 = \$32,000$

Stand-Alone Joint-Cost-Allocation Method

C-7 Joint costs are allocated to each component of the activity based on a ratio that uses estimates of costs of items included in joint costs that would have been incurred had the components been conducted independently. The numerator of the ratio is the cost (of items included in joint costs) of conducting a single component independently; the denominator is the cost (of items included in joint costs) of conducting all components independently. This method assumes that efforts for each component in the stand-alone situation are proportionate to the efforts actually undertaken in the joint cost situation. This method may result in an unreasonable allocation because it ignores the effect of each function, which is performed jointly with other functions, on other such functions. For example, the programmatic impact of a direct mail campaign or a telemarketing phone message may be significantly lessened when performed in conjunction with a fund-raising appeal.

Illustration

C-8 For example, assume that the joint costs associated with a direct mail campaign including both program and fund-raising components are the costs of stationery, postage, and envelopes at a total of \$100,000. The costs of stationery, postage, and envelopes to produce and distribute each component separately would have been \$90,000 for the program component and \$70,000 for the fund-raising component. Under the stand-alone joint cost allocation method, the \$100,000 in joint costs would be allocated as follows.

Program	$\$90,000/\$160,000 \times \$100,000 = \$56,250$
Fund-raising	$\$70,000/\$160,000 \times \$100,000 = \$43,750$

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Appendix D — Examples of Disclosures

D-1 Example 20 (paragraphs 167–170) of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 958-720-55 illustrates the disclosures discussed in FASB ASC 958-720-50-2 (see paragraphs 13.111–.112). Case A shows the required and encouraged information in narrative format. Case B reports that information in tabular format, as well as information concerning joint costs incurred for each kind of activity by functional classification, which is neither required nor encouraged, but which is not prohibited.

Case A: Narrative Format

Note X. Allocation of Joint Costs

In 20XX, Not-for-profit Entity B conducted activities that included requests for contributions as well as program and management and general components. Those activities included direct mail campaigns, special events, and a telethon. The costs of conducting those activities included a total of \$310,000 of joint costs, which are not specifically attributable to particular components of the activities (joint costs). [Joint costs for each kind of activity were \$50,000, \$150,000, and \$110,000 respectively.] These joint costs were allocated as follows.

Fund-raising	\$180,000
Program A	80,000
Program B	40,000
Management and general	<u>10,000</u>
Total	<u><u>\$310,000</u></u>

Note that the bracketed sentence is a disclosure that is encouraged but not required.

Case B: Tabular Format

Note X. Allocation of Joint Costs

In 20XX, Not-for-profit Entity B conducted activities that included appeals for contributions and incurred joint costs of \$310,000. These activities included direct mail campaigns, special events, and a telethon. Joint costs were allocated as follows.

	<i>Direct Mail</i>	<i>Special Events</i>	<i>Telethon</i>	<i>Total</i>
Fund-raising	\$40,000	\$50,000	\$90,000	\$180,000
Program A	10,000	65,000	5,000	80,000
Program B		25,000	15,000	40,000
Management and general		10,000		10,000
Total	\$50,000	\$150,000	\$110,000	\$310,000

Note that shading is used to highlight information that is not required, encouraged, or prohibited. However, not-for-profit entities may prefer to disclose it. Disclosing the total joint costs for each kind of activity (\$50,000, \$150,000, and \$110,000) is encouraged but not required.

Chapter 14

Reports of Independent Auditors

Reserved

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Chapter 15

Tax and Regulatory Considerations

Introduction

- 15.01** Some laws and regulations have a direct and significant effect on the determination of financial statement amounts. Other laws and regulations, when violated, have an effect on financial amounts because of resulting financial penalties. Management generally should identify federal, state, and local laws and regulations that may have a direct and material effect on the determination of financial statement amounts. The auditor should make inquiries of management concerning the client's compliance with laws and regulations. A not-for-profit entity's (NFP's) failure to maintain its tax-exempt status could have serious tax consequences and affect both its financial statements and related disclosures, and it could possibly require modification of the auditor's report. Failure to comply with tax laws and regulations could be an illegal act that may, as discussed in chapter 2, "General Auditing Considerations," have either a direct and material effect on the determination of financial statement amounts (for example, the result of an incorrect accrual for taxes on unrelated business income) or a material indirect effect on the financial statements that would require appropriate disclosures (for example, the result of a potential loss of tax-exempt status).
- 15.02** The regulatory environment for NFPs is always changing, and NFPs and their auditors run the risk of not remaining informed. The AICPA issues two helpful publications annually as a complement to this guide. For members of an NFP's financial management, governing board, and audit committee, the AICPA issues the Financial Reporting Alert *Not-for-Profit Entities: Accounting Issues and Risks*. For auditors, it issues the Audit Risk Alert *Not-for-Profit Entities Industry Developments*. These alerts provide an overview of economic and industry conditions, regulatory developments, and recently issued accounting and auditing pronouncements that may affect NFPs.
- 15.03** This chapter discusses certain tax and regulatory considerations relevant to NFPs. It does not include a detailed discussion of the Internal Revenue Code (IRC) or other laws and regulatory guidance, nor is it intended as a substitute for the appropriate research.

Internal Revenue Service

Basis of Exemption

- 15.04** The IRS determines whether an NFP qualifies for exemption from federal income tax. There are more than 25 different types of tax exemption. The following are some of the more common types of tax-exempt NFPs:

- Section 501(c)(3)—Corporations, united funds, other funds, and foundations organized and operated (a) exclusively for religious, charitable, scientific, testing-for-public-safety, literary, or educational purposes; (b) to foster national or international amateur sports competition; or (c) for the prevention of cruelty to children or animals
- Section 501(c)(4)—Civic leagues, NFPs operated exclusively for the promotion of social welfare (including certain war veterans' organizations), and certain local associations of employees
- Section 501(c)(5)—Labor, agricultural, and horticultural organizations
- Section 501(c)(6) —Business leagues, chambers of commerce, real estate boards, boards of trade, and professional football leagues that are not organized for profit
- Section 501(c)(7)—Social clubs organized for pleasure, recreation, and other not-for-profit purposes
- Section 501(c)(8)—Fraternal beneficiary societies, orders, associations, and so on that provide life, sick, accident, or other benefits to members
- Section 501(c)(10)—Domestic fraternal societies, orders, associations, and so on that do not provide life, sick, accident, or other benefits
- Section 501(c)(13)—Cemeteries, crematoria, and like corporations
- Section 501(c)(19)—A post, organization, auxiliary unit, and so on, of past or present members of the Armed Forces of the United States

15.05 The IRS considers all charitable organizations (that is, those that are tax-exempt under Section 501(c)(3)) to be private foundations unless they qualify as public charities. The distinction is important because private foundations are subject to more restrictions under the tax laws, as discussed in paragraph 15.36. Per Section 509(a), a Section 501(c)(3) entity is classified as a public charity if it meets one of the following descriptions:

- Churches, hospitals, qualified medical research organizations affiliated with hospitals, schools, colleges, and universities.
- Entities formed exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports that normally receive a substantial portion of their support from direct or indirect contributions from many sources, including the general public, governmental agencies, corporations, private foundations, or other public charities.

- Entities that meet both of the following mechanical tests, based on actual support during the previous five years:
 - The entity receives not more than one-third of its support from gross investment income.
 - The entity receives more than one-third of its support from a combination of the following:
 - Contributions, gifts, grants, and membership fees, except when such support is received from disqualified persons.
 - Gross receipts from admissions, sale of merchandise, performance of services, or furnishing facilities, all of which must be derived from an activity related to the organization's exempt purpose. Excluded from the gross receipts are any amounts from any one person, governmental unit, or company in excess of \$5,000 or 1 percent of total support (whichever is greater) and amounts received from disqualified persons.
- Entities that are organized, and at all times thereafter are operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more organizations described previously.

15.06 Tax exemption is a privilege and not a right. At the federal level, the IRS has the authority to revoke exemptions for any one of several reasons. Examples of potential threats to an NFP's federal tax-exempt status include, but are not limited to, the following:

- Material changes in the NFP's character, purpose, or method of operation
- Private inurement
- Private benefit
- Commerciality
- Lobbying
- Political campaign activities
- Unrelated business income
- Failure of the NFP to meet the commensurate test
- Violation of public policy by the NFP
- Failure to comply with annual reporting obligations

Material Changes in the NFP's Character, Purpose, or Method of Operation

- 15.07** The IRS requires that an NFP disclose on its annual information return (Form 990, "Return of Organization Exempt From Income Tax;" Form 990-EZ, "Short Form Return of Organization Exempt From Income Tax;" or Form 990-PF, "Return of Private Foundation or Section 4947[a][1] Nonexempt Charitable Trust Treated as a Private Foundation) any changes in the kinds of exempt activities the NFP conducts, any changes in its governing documents, and whether there has been a liquidation, dissolution, or substantial contraction. If an NFP is unsure about whether a proposed change in its purposes or activities is consistent with its status as a tax-exempt organization or as a public charity, it may request IRS guidance in a private letter ruling. An NFP may also request a determination letter to reclassify the NFP as a public charity or a private foundation.

Private Inurement and Private Benefit

- 15.08** NFPs are generally prohibited from making distributions to individuals who control or substantially support them financially. IRS inurement rules regulate transactions between an NFP and insiders. Insiders are individuals with a personal or private interest in the NFP, such as governing board members, officers, certain employees, and substantial contributors. Transactions between insiders and NFPs are permitted, but the NFP has the burden of proving that the transactions do not result in private inurement. The NFP must be able to satisfy the IRS that the transaction was reasonable, was adequately documented, had independent approval, and did not violate any law or regulation. Employee compensation can create an inurement problem if it is judged to be "unreasonably high." IRC provisions are stricter for private foundations than for other NFPs. Paragraph 15.36 briefly discusses those more restrictive provisions.
- 15.09** The concept of private benefit prohibits an NFP from providing excessive benefits for the private interests of any specific individual or group—both insiders and outsiders. Incidental levels of private benefits are permitted, but the NFP is required to demonstrate that such benefits are a necessary concomitant of a public related benefit. The NFP generally should have sound policies for transactions with both insiders and outsiders, and these policies ordinarily should document that the transactions were appropriate and were approved by disinterested parties.
- 15.10** Intermediate sanctions legislation (IRC Section 4958), enacted in 1996, provides for monetary penalties against certain individuals who are unjustly benefited at the expense of the NFP. The legislation applies to 501(c)(3) organizations (not including private foundations) and 501(c)(4) organizations. Before this statute was enacted, the only sanction available to the IRS for private inurement was revocation of exempt status, which the IRS was reluctant to impose except in cases of very serious violations. Consequently, lesser violations often went unpunished for lack of an appropriate remedy.
- 15.11** Under intermediate sanctions, certain individuals who, in general, are in a position of substantial influence with respect to the NFP are *disqualified persons*. Penalties may be

assessed against individuals who participated in transactions resulting in excess benefit received by disqualified persons. Examples of excess benefit transactions include excessive compensation, purchases of goods and services at prices in excess of fair value, and sales of goods and services at prices less than fair value.

Commerciality

- 15.12** An NFP cannot qualify for tax exemption or can have its tax-exempt status revoked if it is, in reality, a commercial enterprise. Engaging in commercial activity, however, does not *per se* disqualify the NFP from tax-exempt status unless the commercial activity becomes the NFP's primary purpose. A gray area exists between commercial and noncommercial activities. To avoid problems with commerciality, many NFPs have found it advantageous to create separate for-profit subsidiaries. These for-profit subsidiaries must file commercial federal and state tax returns. They are also disclosed on Schedule R to the Form 990 of the related NFP.

Lobbying

- 15.13** The IRC allows public charities (but not private foundations) to lobby to influence federal, state, and local legislation (including initiatives and referenda), but it places limits on how much lobbying they can do. The IRS uses two tests to determine whether lobbying is substantial: the substantial-part test or the expenditure test.
- 15.14** The substantial-part test looks at all the pertinent facts and circumstances. It considers a variety of factors, including the time that both compensated and volunteer workers devote to lobbying and the expenditures the organization devotes to lobbying. Under this test, an NFP that conducts excessive lobbying in any taxable year may lose its tax-exempt status and may be subject to an excise tax on its lobbying expenditures for the year that it lost its tax-exempt status.
- 15.15** Alternatively, if an NFP is not a church or a private foundation, it can elect to have its lobbying activities measured using the expenditure test. This is known as a 501(h) election. Under the expenditure test, a 501(c)(3)'s lobbying activity will not jeopardize its tax-exempt status so long as its expenditures related to that activity normally do not exceed an amount specified in IRC Section 4911. Under the expenditure test, an NFP that engages in excessive lobbying over a four-year period may lose its tax-exempt status, making all its income for that period taxable. If the NFP exceeds its lobbying expenditure dollar limit in a particular year, it must pay an excise tax on the excess.
- 15.16** Membership organizations that are granted tax-exempt status under IRC Section 501(c)(4)(5) or (6) and lobby are required to make disclosures to their members regarding the portion of membership dues allocable to nondeductible lobbying expenses, as required by IRC Section 6033(e) or pay a proxy tax. A membership entity may establish and sponsor a political action committee (PAC) whose mission is to further the interests of the membership entity. Consolidation of a PAC is discussed in paragraph 3.68 of this guide.

Political Campaign Activities

- 15.17** Public charities are prohibited from engaging in partisan political campaign activities—that is, directly or indirectly participating or intervening in any political campaign on behalf of, or in opposition to, any candidate for public office. IRS Publication 4221-PC, *Compliance Guide for 501(c)(3) Public Charities*, can be helpful in determining permitted and prohibited activities. Prohibited political activities include contributing to candidates or political organizations, including, for example, in-kind contributions of services, publicity, advertising, paid staff time, facilities, and office space. Also prohibited are evaluating candidates and their positions on specific issues and encouraging voter registration for a specific political group. Certain voter education activities, including holding public forums and publishing voter education guides, are permissible if conducted in a nonpartisan way. In addition, activities intended to encourage people to participate in the electoral process, such as voter registration and get-out-the-vote drives, are also allowed if conducted in a nonpartisan way. Violation of the law can result in imposition of an excise tax, or in extreme cases, a loss of tax exempt status.
- 15.18** NFPs that are not public charities may be permitted to engage in a limited amount of political activities as long as that is not a primary activity. However, any expenditures the NFP makes for political activities may be subject to tax.

Unrelated Business Income

- 15.19** NFPs can lose their tax-exempt status if the IRS determines that the percentage of their income that is from business activities unrelated to their specific exempt purposes is excessive. There is, however, no specific percentage of unrelated business income defined by the IRS as too large a percentage. The facts and circumstances of each unrelated business income situation would be considered. Unrelated business income and the unrelated business income tax are discussed in more detail in paragraphs 15.27–.30.

Failure to Meet the Commensurate Test

- 15.20** An NFP can lose its tax-exempt status if it fails the commensurate test, which provides that the scope of the NFP's programs must be commensurate with its financial resources. The test requires that an NFP have a charitable program that is both real and, taking the NFP's circumstances and financial resources into account, substantial. This means that fund-raising expenses and administrative expenses should not be an excessive percentage of total expenses. Although no specific payout percentage has been established and individual facts and circumstances must be considered, low levels of program spending invite IRS scrutiny.

Violation of Public Policy

- 15.21** An NFP can also lose its tax exemption because it violates public policy. For example, a social club (that is, a section 501(c)(7) organization) is not exempt from income tax if any

written policy statement, including the governing instrument and bylaws, allows discrimination on the basis of race, color, or religion. A private school must annually file Form 5578, “Annual Certification of Racial Nondiscrimination for a Private School Exempt From Federal Income Tax,” to provide the IRS with its certification that it does not discriminate against applicants and students on the basis of race, color, and national or ethnic origin.

Failure to Comply With Reporting Obligations

15.22 Almost all NFPs—even very small ones—have federal annual return or notice filing obligations. As described in Part B of the Form 990 instructions, certain religious organizations, certain government organizations, certain political organizations, and certain organizations that file different types of annual information returns are exempt from filing a Form 990, 990-EZ, 990-PF, or 990-N, “Electronic Notification (e-Postcard) For Tax-Exempt Organizations Not Required to File Form 990 or 990-EZ.” Unless specifically exempted, each NFP is required to file Form 990, 990-EZ, 990-PF, or 990-N. For information on which form the NFP must file, see paragraph 15.23. There are consequences for failure to file. If an NFP does not file for three consecutive years, its tax exempt status will be revoked as of the filing due date for the third return. If tax-exempt status is revoked on this basis, the NFP must again apply for tax-exempt status.

IRS Filing Requirements

15.23 As noted in paragraph 15.22, most NFPs must file annual returns with the IRS. There are three returns for public charities—the one the charity files depends upon its gross receipts and total assets. Form 990 is filed by NFPs with gross receipts greater than or equal to \$200,000 or total assets greater than or equal to \$500,000 at the end of the tax year. Form 990-EZ is filed by NFPs with gross receipts less than \$200,000 and total assets at the end of the tax year less than \$500,000. NFPs that normally have \$50,000 or less in gross receipts submit Form 990-N, unless they choose to file a complete Form 990 or Form 990-EZ. All private foundations file Form 990-PF.

15.24 The stated goals of the IRS for Form 990 are to enhance transparency, promote tax compliance, and minimize the burden on filing NFPs. The form and its instructions are modified by the IRS annually. The basic structure of the form consists of a 12-page core form, which is to be completed by all filers, and 16 schedules designed by topic (lobbying, related parties, compensation, and so on). The form has a checklist that allows a preparer to determine quickly which schedules are required for the NFP. In addition, the Form 990 includes the following:

- A summary page designed to provide a financial "snapshot" of the NFP
- Questions regarding organizational governance practices
- Disclosure of information from the NFP's audited financial statements

- Compensation information
- Disclosures regarding programs and activities of the NFP

- 15.25** E-filing of Form 990 and 990-PF is required for certain large NFPs. The electronic filing requirement applies to NFPs with \$10 million or more in total assets if the NFP files at least 250 returns in a calendar year, including income, excise, employment tax, and information returns (such as Forms W-2 and 1099). Private foundations and nonexempt charitable trusts are required to file Form 990-PF electronically regardless of their asset size, if they file at least 250 returns annually. If an NFP is required to file a return electronically but does not, the NFP is considered not to have filed its return. All Forms 990-N are required to be electronically filed.
- 15.26** NFPs must provide a copy of their Form 990, Form 990-EZ, or Form 990-PF, and Form 1023, “Application for Recognition of Exemption under Section 501(c)(3) of the Internal Revenue Code,” to persons requesting it either in person or in writing. A reasonable charge may be made for copying. There are penalties for failure to make the forms available. Donor information on Schedule B, “Schedule of Contributors,” is confidential. Certain NFPs that file Form 990-T, “Unrelated Business Income Tax Return,” must also provide a copy of that return, as discussed in paragraph 15.30.

Unrelated Business Income

- 15.27** Unrelated business income is gross income from an unrelated trade or business less expenses directly connected with the unrelated trade or business, certain net operating losses, and qualified charitable contributions. An unrelated trade or business of an exempt organization is any trade or business that is regularly carried on, and whose conduct is not substantially related to the exercise or performance of its exempt purpose. The IRS is interested in how the unrelated business income was earned, not in how it is used. Thus, unrelated business income is taxable even if it is used to further the NFP's tax-exempt purpose. Unrelated business income is subject to tax at federal corporate rates, including the alternative minimum tax (or in some cases, trust tax rates). The first \$1,000 of net unrelated business income is excluded from taxation, and corporate net operating losses carryforwards and various tax credits are allowed. Because the tax is an income tax, the requirements of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 740, *Income Taxes*, should be applied by the NFP.
- 15.28** The unrelated-business-income tax requirements apply to all NFPs except (a) corporations that have been organized under Acts of Congress and that are instrumentalities of the United States and (b) certain charitable trusts not subject to the tax on private foundations.
- 15.29** Income from certain specified activities that might otherwise be considered unrelated business income is excluded from taxation. For example, unrelated business income does not include dividends, interest, royalties, and gains on the sale of property (unless that property was used in an unrelated trade or business). Unrelated business income also

excludes income from activities in which substantially all of the work is done by volunteers, income from the sale of donated merchandise, and rents from certain real property. Examples of activities that may produce unrelated business income activities include the following:

- Advertising income
- Corporate sponsorship activities (in some cases)
- Income from investments in partnerships and certain other alternative investments that are pass-through entities for tax purposes
- Rents from debt-financed property
- Rents based on a percentage of net income rather than gross income
- Rents on personal property
- Unrelated debt-financed income
- Sales of items unrelated to the NFP's mission in gift shops, pro shops, online storefronts, and similar retail establishments
- The sale of products or services that are available because of excess capacity, such as banquet space and meals sold to the nonmembers by a country club or the sale of unused computer time
- Interest, annuities, royalties, and rents from a controlled taxable corporation, if those items reduced the tax of the controlled corporation

15.30 Form 990-T and its related schedules are filed to report unrelated income taxes and to compute and remit the tax. 501(c)(3) organizations must make the return available to the public upon request for a period of three years from the date required to be filed (including extensions). All information must be made available unless specifically excluded by statute.

Alternative Investments

15.31 Some NFPs invest in hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds, offshore fund vehicles, and funds of funds, which are commonly referred to as *alternative investments*. NFPs should be aware of supplementary tax filing responsibilities in connection with investments in these arrangements, which can include returns for unrelated business income tax (Form 990-T), transfers of tangible and nontangible property to a foreign corporation (Form 926), investment activity with foreign partnerships (Form 8865), investment activity with foreign corporations (Form 5471), reportable transactions (Form 8886), and reports of foreign bank accounts (Form

TD F90-22.1). Penalties for noncompliance can be severe, so NFPs should be careful to comply with these requirements.

Tax Shelters

- 15.32** IRC Section 4965 imposes excise taxes and disclosure requirements on any tax-exempt entity (including a public charity, a private foundation, or other tax-exempt organization) that is a party to prohibited tax shelter transactions. In certain cases, penalties are also imposed on the tax-exempt entity's managers. Under the final regulations, issued in July 2010, a tax-exempt entity is a party to a prohibited tax shelter transaction if the entity (a) facilitates a prohibited tax shelter transaction by reason of its tax-exempt, tax indifferent, or tax-favored status, or (b) is identified in published guidance, by type, class, or role, as a party to a prohibited tax shelter transaction. The regulations provide (1) rules regarding the form, manner, and timing of disclosure obligations, and (2) return requirements accompanying payment of excise taxes.

Employment Taxes

- 15.33** Personnel costs easily constitute the single largest type of expense for many NFPs. In most ways, including the necessary tax filings, accounting for personnel costs is similar to for-profit entities. Employers do not have broad discretion over whether workers are classified as employees or independent contractors. The burden of proof generally falls to the NFP, and incorrect classifications can result in significant financial consequences. It is important to remember that neither the number of hours worked nor the amount paid affects the classification of a worker. The IRS methodology for distinguishing employees from independent contractors uses the three categories of behavioral control, financial control, and the type of relationship. Those categories provide evidence about the degree of control exercised by the NFP over the worker. IRS Publication 15-A, *Employer's Supplemental Tax Guide*, provides guidance to help make the proper determination.
- 15.34** If an NFP has employees, it is responsible for federal income tax withholding and Social Security and Medicare taxes and state and local employment taxes. Public charities are exempt from federal unemployment taxes; other NFPs must pay federal unemployment taxes. In some states, an NFP can elect not to pay into the state unemployment insurance fund. However, this leaves the NFP self insured, and if an unemployment claim is successfully filed, the NFP will receive a large bill from the state.
- 15.35** To acknowledge beliefs against socialized insurance that are held by certain religious organizations, Congress provided an elective exemption from social security taxes for churches, including church-controlled organizations and associations and conventions of churches. An objection based on religious beliefs is the only valid reason for making the election. The election must be made by the due date of the church's initial quarterly payroll tax return (Form 941) after hiring a nonminister employee. Thus, unless the church is newly created or made the election in the past, the election is not available. The election by the church does not relieve church employees from paying Social Security

taxes; they pay self-employment taxes on their income, although they are employees for all other purposes.

Private Foundations

- 15.36** Private foundations are subject to more restrictions under the tax law than are public charities. These restrictions include statutory prohibitions against self-dealing, excess business holdings, jeopardy investments, failing to distribute income, and taxable expenditures. In addition, private foundations are subject to an excise tax on their net investment income and are required to make annual distributions of 5 percent of the average market value of their noncharitable-use assets for charitable, educational, scientific, and similar purposes. (Noncharitable-use assets are assets that are not used or held for use directly in carrying on the NFP's exempt purpose; they include assets held for investment and the production of investment income.)
- 15.37** Excise tax is paid on net investment income and is determined in accordance with IRC Section 4940. Although practice is mixed concerning whether the excise tax is an income tax, the Financial Reporting Executive Committee (FinREC) believes that best practice is to follow the requirements of FASB ASC 740. Thus, temporary differences for capital gains and losses may result in deferred tax assets and liabilities. Deferred tax assets and liabilities are discussed further in paragraphs 15.43–.44.

Income Tax Positions

- 15.38** NFPs adopt many tax positions relative to tax laws, including those adopted in determining whether tax is due, a refund is owed, or a tax return needs to be filed. Tax considerations may result in an NFP (or its for-profit or not-for-profit subsidiaries) taking a tax position pertaining to whether a transaction or event must be reported in a tax return. The FASB ASC glossary defines *tax position* as a position in a previously filed tax return or a position expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets and liabilities for interim or annual periods. A tax position can result in a permanent reduction of income taxes payable, a deferral of income taxes otherwise currently payable to future years, or a change in the expected realizability of deferred tax assets. A tax position also can result in or affect the measurement of a current or deferred tax asset or liability in the statement of financial position. The term *tax position* encompasses, but is not limited to, the following:
- A decision to classify a transaction, entity, or other position in a tax return as tax exempt or subject to a lower rate of tax
 - A decision not to file a tax return, such as a decision that a Form 990T need not be filed
 - The characterization of income, such as a characterization of income as passive, or a decision to exclude reporting taxable income in a tax return

- The characterization of an expense as deductible
- An allocation or a shift of income between jurisdictions (federal, state, local, or foreign)
- An entity's status, including its status as a tax-exempt NFP

15.39 The following are among possible uncertain tax positions of NFPs:

- Aspects of the definition of *unrelated business income* are subject to judgment concerning whether an activity is considered a “trade or business,” is “unrelated” to the NFP’s exempt purpose, and is “regularly carried on.”
- Whether activities are exceptions from unrelated business income tax—because they are carried on largely by volunteers, involve selling of donated merchandise, or are carried on for the convenience of members, students, patients—is subject to interpretation.
- A change in an NFP’s activities over time may cause an NFP to claim that certain activities are related to their exempt purposes but the activity bears little relation to the exempt activities for which it was granted exempt status.
- Once a source of unrelated business income is identified, there may be uncertainty in computing the amount of gross income from the activity or in allocating expenses for personnel costs, occupancy, administrative expenses, and so forth.
- NFPs that have multistate operations or employees may have state nexus and may be required to file state returns. Similarly, NFP’s that have operations via partnership investments in other states may be required to file state returns for unrelated business income tax.
- NFPs with foreign operations may not have researched whether tax filings and payments are required by foreign jurisdictions.

15.40 The validity of a tax position is a matter of tax law. In some cases, the law is subject to varied interpretation and whether a tax position will ultimately be sustained may be uncertain. FASB ASC 740-10-25-6, which applies to income taxes, limits the recognition of uncertain tax positions to only the financial statement effects of a tax position when it is more likely than not, based on the technical merits, that the position will be sustained upon examination.

15.41 FASB ASC 740-10-55-225 provides examples of tax positions to be considered if an NFP enters into transactions that may be subject to income tax on unrelated business income. FASB ASC 740-10-50-15 requires that entities disclose the amounts of income tax-related interest and penalties recognized in the statement of activities, the total amounts of interest and penalties recognized in the statement of financial position,

information about positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date, and a description of tax years that remain subject to examination by major tax jurisdictions. Although information returns are not within the scope of FASB ASC 740 because they are not income tax returns, FinREC encourages disclosure of relevant information required by FASB ASC 740-10-50-15, particularly for open tax years. NFPs typically disclose that tax years are open for 3 years from the date of filing.

- 15.42** If an NFP's financial statements for a tax year include a note addressing the NFP's liability for uncertain tax positions under FASB ASC 740-10-50, the NFP must provide the text of that note, verbatim, in Schedule D of Form 990. This requirement includes, for example, the description of a liability for unrelated business income tax, or tax that may be assessed as a result of the revocation of exempt status. The full text of the note is required even if the NFP did not report any liability for uncertain tax positions.

Deferred Tax Assets and Liabilities

- 15.43** Although NFPs are generally tax-exempt under various IRC sections,^{fn 1} some may be subject to taxes on various portions of their income, such as federal excise taxes on investment income or federal and state income taxes on unrelated business income. FASB ASC 740 provides guidance on recognizing (a) the amount of taxes payable (or refundable) for the current year and (b) deferred-tax liabilities (and assets) for the estimated future tax consequences of temporary differences and carryforwards.
- 15.44** An NFP may be required by FASB ASC 740-10 to report a deferred tax asset or liability for the estimated future tax effects attributable to temporary differences or net operating loss carryforwards for unrelated business income. If an NFP incurs unrelated business income tax, they may have deferred tax liabilities related to items such as those described in paragraphs 18–29 of FASB ASC 740-10-25. Although practice is mixed regarding whether the excise tax is an income tax, FinREC believes that the excise taxes on unrealized gains and losses for investments of private foundations should also be considered temporary differences for which deferred tax assets and liabilities should be recognized in accordance with FASB ASC 740-10.

State and Local Regulations

State Charitable Solicitation Laws

^{fn 1} Some not-for-profit entities (NFPs) may meet the definition of an NFP as discussed in paragraphs 1.01–.02 but may nevertheless not be tax-exempt under the Internal Revenue Code (IRC). For example, an NFP that may otherwise qualify for tax-exempt status under the IRC may lose its tax exemption because it has violated the private inurement rules applicable to tax-exempt entities. Examples of potential threats to an NFP's federal tax-exempt status are discussed in paragraphs 15.06–.22.

- 15.45** NFPs are generally subject to the laws of the state of incorporation as well as the laws of states in which they conduct significant activities. Each state has its own laws that govern exemption from its taxes, and those laws provide the applicable definitions and requirements. Exemptions may be available for state and local sales, real estate, and other taxes and vary from state to state.
- 15.46** Most states have regulatory bodies that oversee NFPs and can revoke an NFP's state tax-exempt status (without regard to its federal tax-exempt status) and prevent the NFP from operating in that state. Most states require NFPs to register and submit annual filings. These requirements are based on one of the following criteria:
- Registration requirements for NFPs (and their paid solicitors) soliciting funds within the state
 - Registration of NFPs (including trusts) holding property in the state
 - Registration of entities doing business in the state
- 15.47** An Internet site maintained by the National Association of State Charity Officials (NASCO) and the National Association of Attorneys General (www.multistatefiling.org) provides information with regard to individual state registration and reporting requirements. The information appears with the Unified Registration Statement, a form that is used in most states for filings. Some states require information in addition to the Unified Registration Statement, such as submission of annual financial statements. Some states accept a copy of the NFP's information return as a filing document, although some states require audited financial statements.
- 15.48** The application of those individual state registration requirements to NFPs that fundraise over the Internet is addressed by The Charleston Principles. Those principles, developed by NASCO, are a guide to state regulators regarding when NFPs and their fundraisers may be required to register, in what jurisdictions they may be required to register, and when they may be subject to enforcement action when fund-raising is conducted via the Internet. States are encouraged to use the principles to implement their specific state laws, but they are not binding on state regulators. The Charleston Principles can be found at www.nasconet.org.

State and Local Gaming Regulations

- 15.49** Most states and local jurisdictions have laws about the conduct of raffles, bingo, casino nights, pull-tabs, and other games of chance conducted for fund-raising purposes. In many areas, there may be more than one governmental body that has jurisdiction over gaming. It is advisable to check with both the state and local governments far in advance of hosting a gaming event because the process of obtaining any necessary licenses and permits can be complex or time-consuming or both.

Uniform Prudent Management of Institutional Funds Act

- 15.50** The Uniform Prudent Management of Institutional Funds Act (UPMIFA) is the law in all states except Pennsylvania and Mississippi for the management of donor-restricted endowment funds. This law affects the classification of the net assets of endowment funds and their investment income, gains, and losses. UPMIFA is a uniform act developed by the Uniform Law Commission (the National Conference of Commissioners on Uniform State Laws) to do three things: provide guidance on the management and investment of charitable funds, provide rules on spending from endowment funds, and provide rules on when and how a charity can release or modify a restriction imposed by a donor. UPMIFA supports two general principles: (a) assets should be invested prudently in diversified investments that seek growth as well as income, and (b) appreciation of investments may prudently be spent for the purposes of the endowment fund held by a charitable institution. The discussion in this chapter is based upon UPMIFA, but each state enacts its own version of the law and may make changes to UPMIFA's language. Therefore, an NFP should consult its own state law to determine if there were changes, and it may wish to consult legal counsel.
- 15.51** When a donor directs a charity to “spend only the income” from a gift or to “hold this gift as an endowment,” the donor has created a donor-restricted endowment. But the donor's instructions for the administration of the endowment are usually incomplete (and this is done purposely to allow for flexibility in a fund of permanent duration). When a donor and a charity have not reached a specific agreement for management of an endowment, then the state law will apply.
- 15.52** UPMIFA provides a standard of conduct for managing and investing institutional funds. It requires investment “in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances.” It requires prudence in incurring investment costs, authorizing “only costs that are appropriate and reasonable in relation to the assets, the purposes of the institution, and the skills available to the institution.” UPMIFA emphasizes that in making decisions about whether to acquire or retain an asset, the institution should consider the institution's mission, its current programs, and the desire to cultivate additional donations from a donor, in addition to factors related more directly to the asset's potential as an investment, such as the expected tax consequences, if any, of investment decisions or strategies. No investment decision may be made in isolation, but must be made in light of the institution's entire portfolio, and “as a part of an overall investment strategy having risk and return objectives reasonably suited to the fund and to the institution.”
- 15.53** UPMIFA provides guidance for prudent spending of a donor-restricted endowment fund. It states that the institution “may appropriate for expenditure or accumulate so much of an endowment fund as the institution determines to be prudent for the uses, benefits, purposes and duration for which the endowment fund is established.” Seven criteria guide the institution in its annual expenditure decisions:
- Duration and preservation of the endowment fund
 - The purposes of the institution and the endowment fund

- General economic conditions
- Possible effect of inflation or deflation
- The expected total return from income and the appreciation of investments
- Other resources of the institution
- The investment policy of the institution

15.54 UPMIFA also provides the following four methods for removal or modification of donor-imposed restrictions on the management, investment or purpose of an endowment fund.

- An institution can remove or modify a restriction provided that the donor consents in writing (or other record) and that any new purpose for the fund is a charitable purpose of the institution.
- An institution can ask the court to modify a donor's restriction if the restriction has become impracticable or wasteful, if it impairs the management or investment of the fund, or if, because of circumstances not anticipated by the donor, a modification of a restriction will further the purposes of the fund.
- An institution can ask the court to modify a donor's restriction for the purpose of a fund if the purpose becomes unlawful, impracticable, impossible to achieve, or wasteful.
- An institution may release or modify a donor's restriction on its own for small funds that have existed for a substantial period of time. The size of the fund and the period of time are specified in the state's law.

In each case except for the first (direct contact with the donor), the institution must notify an official named in the law (generally the state's Attorney General) of the desire to remove or modify the restriction, and the official must be given an opportunity to respond. (In effect, the official represents the donor's interests.) To the extent practicable, any modification is to be consistent with the donor's probable intention.

15.55 Chapter 4, "Cash, Cash Equivalents, and Investments," discusses how state law affects the classification of the net assets of an endowment fund and its investment income, gains, and losses.

Securities Regulation

15.56 NFPs engage in a wide variety of activities that may involve the issuance of securities. They might issue notes, bonds, and other debt instruments to raise funds for general operations or for the construction or purchase of churches, schools, hospitals, retirement homes, or other facilities. Some NFPs, most commonly church extension funds and other

religious organizations, might issue taxable bonds for the purpose of raising capital for the construction of churches and the support of other entities affiliated with the denomination. Others may accept contributions in the form of split-interest agreements. In some cases, a group of NFPs may pool their funds for common investment. All of these activities may require NFPs to comply with securities laws.

- 15.57** Federal and state governmental agencies generally attempt to avoid regulation of nonprofit entities by granting the entities privileges and exemptions not available to others. The Philanthropy Protection Act of 1995 exempts NFPs from regulation by the Securities and Exchange Commission (SEC) in most cases, although anti-fraud provisions always apply. However, some states have securities or insurance regulations that apply to the transactions in the previous paragraph. NFPs must look to the laws and rules of each state in which they have activity to determine the applicable requirements. Some states require a registration of nonprofit offerings; a few require the NFP to register as a broker-dealer or issuer-dealer.
- 15.58** In some states, the acceptance of split-interest agreements, especially charitable gift annuities, may be regulated and overseen by the state's department of insurance or a similar department. States may require registration to offer such products to donors, may require annual reports to be filed, and may limit the types of investments such agreements can hold. The American Council on Gift Annuities maintains a website (www.acga-web.org) that has links to the states' laws.
- 15.59** The SEC oversees the municipal bond market, in which colleges, universities, and other NFPs actively participate. Some NFPs—either on their own or through conduit debt issued by state government authorities—issue public debt. Appendix A, “Municipal Securities Regulation,” of chapter 10, “Debt and Other Liabilities,” discusses municipal securities regulation, and paragraphs 10.48–.52 discuss IRS considerations for tax-exempt bonds.

Sarbanes Oxley and Governance Policies

- 15.60** Although the Public Company Accounting Reform and Investor Protection Act (commonly referred to as the Sarbanes-Oxley Act or SOX) requires that publicly traded companies adhere to significant new governance standards, which are intended to raise the bar for integrity and competence for publicly traded companies, its effect also has been to promote greater accountability within the nonprofit and private sectors. Although nearly all of the provisions of SOX apply only to publicly traded companies, many NFPs have adopted policies and altered governance practices in response to the Act. Two provisions of SOX specifically apply to all entities, including NFPs:
- SOX expanded protection for whistle-blowers and created criminal penalties for entities retaliating against individuals who expose actual or potential conduct of a federal offense.

- SOX criminalizes the alteration, destruction, concealment, or falsification of documents when the intent is to interfere with an official investigation, contemplated or active, or a judicial proceeding.

- 15.61** Partially in reaction to SOX and partially in reaction to reform efforts of the U.S. Senate Finance Committee, the Panel on the Nonprofit Sector, convened by the Independent Sector, developed a publication, *Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations*. The publication, which is available at www.nonprofitpanel.org, outlines 33 practices designed to support board members and staff leaders as they work to improve their operations and strengthen governance, transparency, and ethical standards. The publication is not authoritative, but it does provide best practices for governance as developed via a rigorous due process.
- 15.62** The IRS has also issued a publication on governance policies and practices, which is available on its website (www.irs.gov) as part of its Life Cycle of a Public Charity. The publication discusses the following six topics: mission, organizational documents, governing body, governance and management policies, financial statements and Form 990 reporting, and transparency and accountability.

Executive Compensation

- 15.63** Executive compensation is an area of significant focus and concern for NFPs, partly due to a public perception that large executive salaries are incompatible with charitable activity, which can make even reasonable compensation front-page news, harming the reputation of the NFP and its ability to attract support. If compensation is excessive, an NFP's tax exempt status may be in jeopardy due to private inurement, and the IRS views unreasonable compensation as an excess benefit transaction (paragraph 15.11), which can result in excise tax penalties of 25 percent or more of the excess benefit. Compensation of governing board members, officers, and certain employees is included in the Form 990, Form 990-EZ, or Form 990-PF information return filed by the NFP, as is the number of individuals who were paid more than \$100,000 in compensation. Because the return is a public document (refer to paragraph 15.26), compensation can't be considered a private matter.
- 15.64** Compensation included in the information returns includes all compensation that was reported (or should have been reported) on Form W-2 or Form 1099, including salaries, bonuses, and taxable fringe benefits. The IRS Publication 15-B, *Employer's Tax Guide to Fringe Benefits*, is useful for determining whether fringe benefits should be included as compensation. In the instructions to the Form 990 and Form 990-EZ, the IRS describes three specific procedures that an NFP must follow if it wants to establish a rebuttable presumption that compensation is reasonable. To be protected by the rebuttable presumption, a governing board (or other authorized body) must document the various types of salary, bonuses, and benefits paid to the individual, its intent to include them in compensation, and that it considered them when determining that compensation was reasonable. Care must be taken to include all types of compensation required to be reported, because if an individual receives a taxable benefit that should have been

reported as compensation but was not, the amount will be treated automatically as an excess benefit transaction, even if the total compensation including the unreported item would have been reasonable.

- 15.65** NFPs commonly use a combination of qualified and nonqualified retirement plans as a part of compensation, including 403(b) plans, 401(k) plans, 457 plans, and nonqualified deferred compensation plans (such as rabbi trust arrangements). Some NFPs also have defined benefit plans. Those plans, like those used by for-profit entities, are subject to complex rules and reporting requirements under the Employment Retirement Income Security Act, the IRS, or both.

Other Regulatory Activities

U.S. Department of the Treasury Anti-Terrorist Financing Guidelines: Voluntary Best Practices for U.S.-Based Charities

- 15.66** An executive order signed on November 13, 2001, and the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA Patriot Act) prohibit transactions with individuals and organizations deemed to be associated with terrorism. The executive order allows the federal government to freeze all assets controlled by or in the possession of the terrorist entities and those who support them, including during the investigation of the alleged association. The Patriot Act imposes fines, imprisonment, or both to any individual or entity that provides or helps conceal material support or resources knowing or intending that they are to be used in preparation for, or in carrying out, terrorist acts. In addition, the Patriot Act gives private parties a civil cause of action against those who provide material or financial support for terrorism.
- 15.67** From the government's perspective, the onus is on grantmakers to understand the counter-terrorism measures in effect and to ensure that grants they make do not end up unintentionally in the hands of terrorists. Two publications are especially helpful to NFPs that attempt to comply with the federal requirements related to anti-terrorist financing:
- U.S. Department of the Treasury *Anti-Terrorist Financing Guidelines: Voluntary Best Practices for U.S.-Based Charities*, a report issued in 2006 that is designed to assist charities that attempt in good faith to protect themselves from terrorist abuse.
 - *Principles of International Charity*, a report issued by a working group of more than 40 charities and the Council on Foundations, in response to concerns about the practicality of the Treasury's guidelines and their effectiveness and potential to discourage international charitable activities by U.S. organizations.
- 15.68** Adherence to the guidelines in either of these reports is voluntary, and following the Treasury guidelines does not constitute a legal defense against any civil or criminal liability for violating any local, state, or federal laws or regulations. Instead, the measures

are intended to build upon pre-existing controls and protective measures already in place to assist in compliance with the laws.

DRAFT

Chapter 16

Fund Accounting

Introduction

16.01 Many not-for-profit entities (NFPs) use fund accounting for internal recordkeeping, even though fund accounting is not required by generally accepted accounting principles (GAAP). Fund accounting segregates assets, liabilities, and fund balances into separate accounting entities associated with specific activities, donor-imposed restrictions, or objectives; thus it can be used to track an NFP's fiduciary responsibilities to use assets in accordance with donor-imposed restrictions, legal and contractual limitations, and internal designations. The financial reporting model for NFPs also focuses on an NFP's fiduciary responsibilities, but it differs from fund accounting because it is based on net assets, reflects only donor-imposed restrictions in its classification of net assets, and requires an NFP's external financial reporting to focus on aggregate information about the entity as a whole, rather than on individual funds.^{fn 1} Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 958-205-45-3 permits the continued disclosure, for external financial reporting purposes, of disaggregated data classified by fund groups, provided that the information required by GAAP is presented. This chapter provides an overview of fund accounting and discusses the reporting of information derived from an internal fund accounting system in conformity with the reporting requirements of the financial reporting model for NFPs.^{fn 2}

Fund Accounting and External Financial Reporting

16.02 *Fund accounting* is a system of recording resources whose use may be limited by donors, granting agencies, governing boards, other individuals or entities, or by law. To keep records of these limitations for internal purposes, NFPs that use fund accounting maintain separate funds for specific purposes. Each fund consists of a self-balancing set of asset, liability, and fund balance accounts. Prior to 1996, most NFPs prepared fund accounting-based external financial statements by combining funds with similar characteristics into fund groups.

16.03 For external financial reporting purposes, the total of all assets and liabilities included in all funds and changes in net assets should be measured and reported on an NFP's financial statements in conformity with FASB ASC 958, *Not-for-Profit Entities*. Fund balances should be classified on a statement of financial position as unrestricted,

^{fn 1} Both fund balances and net assets represent residual interests in assets less liabilities. Fund balances, however, are not the same as net asset balances.

temporarily restricted, or permanently restricted net assets based on the existence and type of donor-imposed restrictions.^{fn 3} Because of differences in the types of limitations a fund accounting system tracks, for external financial reporting purposes, a fund balance may have to be divided among more than one net asset class.

- 16.04** FASB ASC 958-210-45-2 states that the requirement to display total assets and liabilities results in certain practical limits on how interfund items are displayed in a financial statement. For example, because receivables and payables between fund groups are not assets or liabilities of the reporting entity, a statement of financial position should clearly label and arrange those interfund items to eliminate their amounts when displaying total assets or liabilities.
- 16.05** The remainder of this chapter describes seven commonly used groups of funds and discusses how their fund balances would be reported based on the requirements of FASB ASC 958.

Unrestricted Current (or Unrestricted Operating or General) Funds

- 16.06** Unrestricted current funds (also called *unrestricted operating* or *general* funds) are used to record an NFP's activities that are supported by resources over which governing boards have discretionary control. Amounts designated by governing boards for specific purposes may be included in unrestricted current funds, or those amounts may be accounted for in other funds, such as plant funds, endowment funds, and loan funds. The principal sources of unrestricted current funds are unrestricted contributions from donors; exchange transactions with members, clients, students, customers, and others; and unrestricted investment income. The resources of unrestricted current funds are used to help meet the costs of providing the NFP's programs and supporting services.
- 16.07** Fund balances of unrestricted current funds should be classified on a statement of financial position as "unrestricted net assets." If the fund balances include some donor-restricted resources, they should be separated into unrestricted net assets and temporarily restricted net assets. For example, if the unrestricted current funds include unconditional promises to give that are for the general support of the NFP, the net assets associated with those promises should be included in temporarily restricted net assets if the promises are subject to time restrictions. In accordance with FASB ASC 958-210-50-2, significant limits on the use of unrestricted current funds that result from contractual agreements with suppliers, creditors, and others should be disclosed on the face of the financial statements or in the notes to the financial statements. Unrestricted fund balances that have been designated by governing bodies for specific purposes (such as quasi endowment, funds functioning as endowment, funds for long-term investment, self-insurance reserve

^{fn 3} Accounting for contributions received with donor-imposed restrictions is discussed in chapter 5, "Contributions Received and Agency Transactions," of this guide.

funds, or future development funds) should be classified as unrestricted net assets. The net assets of board-designated endowment funds are required to be disclosed per FASB ASC 958-205-50-2; other board designations are permitted to be disclosed, as discussed in chapters 3, “Financial Statements, the Reporting Entity, and General Financial Reporting Matters,” and 11, “Net Assets and Reclassifications of Net Assets.”

Restricted Current (or Restricted Operating or Specific-Purpose) Funds

- 16.08** Restricted current funds (also called *restricted operating* or *specific-purpose funds*) are used to record NFPs' activities that are supported by resources whose use is limited by external parties to specific operating purposes. The principal sources of restricted current funds are contributions from donors; contracts, grants, and appropriations; and income on donor-restricted endowment funds.
- 16.09** Fund balances of restricted current funds are resources held for specified operating activities that have not yet been used. As stated in FASB ASC 958-210-45-9, the amounts for each of three classes of net assets are based on the existence or absence of *donor-imposed* restrictions. Thus, the portion of the fund balances that represents amounts contributed subject to donor-imposed restrictions should be classified as temporarily restricted net assets. However, if restricted current fund balances are subject only to legal restrictions imposed by an entity other than a donor, they should be included in unrestricted net assets. For example, fund balances representing amounts received only with contractual limitations should be classified as unrestricted net assets. Any portion of the fund balances that represents unearned revenue resulting from exchange transactions should be classified as a liability.

Plant (or Land, Building, and Equipment) Funds

- 16.10** Some NFPs record plant and equipment (and resources held to acquire them) in a plant (or land, building, and equipment) fund or funds. A plant fund may be a single group of accounts or may be subdivided into some or all of the following subfund account groups:
- Unexpended plant funds
 - Funds for renewal and replacement
 - Funds for retirement of indebtedness
 - Investment (or net investment) in plant
- 16.11** Unexpended plant fund balances and renewals and replacement fund balances are resources that have not yet been used to acquire, renew, and replace plant and equipment. Retirement-of-indebtedness fund balances are resources held to service debt related to the acquisition or construction of plant and equipment. The portion of those fund balances that represents amounts received with donor-imposed restrictions that have not yet been met should be classified in a statement of financial position as temporarily restricted or

permanently restricted net assets, depending on the nature of the restrictions. Other fund balances, including those arising under agreements with trustees under bond indentures and those designated by the NFP's governing board from unrestricted resources for the purchase, construction, renewal, or replacement of property and equipment should be classified as unrestricted net assets. Board designations and limitations imposed by bond agreements on the use of those unrestricted net assets may be described on the face of the financial statements or in the notes, as discussed in chapters 3 and 11.

- 16.12** Investment-in-plant fund balances represent assets invested in property and equipment less any liabilities related to those assets. These fund balances should be classified as permanently restricted net assets to the extent that (1) donors have imposed restrictions on the assets' use that neither expire by passage of time nor can be fulfilled or removed by actions of the NFP—for example, land that must be held in perpetuity—or (2) the proceeds from the ultimate sale or disposal of contributed long-lived assets must be reinvested in perpetuity. Amounts representing property and equipment acquired with unrestricted resources or with resources whose use is limited by parties other than donors should be classified as unrestricted net assets. Significant limitations on the use of property and equipment should be described in notes to the financial statements.^{fn 4}
- 16.13** If property and equipment were acquired by gift or were acquired with resources contributed by a donor for the purpose of purchasing property and equipment, the classification of the fund balances related to those assets depends upon donors' restrictions and the NFP's policy of implying a time restriction on the use of gifts of long-lived assets or gifts for the purchase of long-lived assets, as discussed in paragraph 9.04.
- 16.14** If a donor contributed property or equipment and also specified a time period over which the donated asset must be used, some portion of the fund balance related to that property or equipment would be classified as temporarily restricted net assets, unless the donor-specified time period has expired. The portion classified as temporarily restricted net assets depends upon how much of the donor-specified period has passed. The remainder of the fund balance would be classified as unrestricted net assets because using the equipment over time, as required by the donor, releases the restrictions, as explained in paragraphs 11.45–48. If the donor contributed cash (or other assets) and restricted the use of the donated cash (or other assets) to the purchase of property or equipment that must be used for a specified time period, the related fund balance would be similarly classified as partly temporarily restricted net assets and partly unrestricted net assets.
- 16.15** If a donor contributed property or equipment and did not specify a time period over which the asset must be used, FASB ASC 958-605-45-6 (which is discussed in paragraph 5.85) states that an NFP may elect a policy to imply a time restriction that expires over

^{fn 4} Examples of significant limitations on the use of property and equipment that should be described in the notes to the financial statements are provided in chapter 9, “Property, Plant, and Equipment,” of this guide.

the useful life of the donated long-lived assets. An NFP that adopts that policy (of implying time restrictions) also should imply a time restriction on long-lived assets acquired with gifts of cash or other assets restricted for those acquisitions. When an NFP's policy is to imply a restriction that expires over the useful life of the asset, some portion of the fund balance for that property or equipment is classified as temporarily restricted net assets unless the useful life of the asset has expired. The portion classified as temporarily restricted net assets depends upon how much of the useful life has passed. The remainder of the fund balance would be classified as unrestricted net assets. Likewise, if the NFP has a policy of implying a time restriction on the use of long-lived assets and it has purchased property or equipment with gifts restricted for that purchase, some portion of the fund balance for the purchased asset will be classified as temporarily restricted net assets until the end of the useful life of the property or equipment that was purchased. If the NFP does not have such a policy, and the donor has not imposed restrictions on the use of the gift, the investment-in-plant funds balance will be classified as unrestricted net assets.

Loan Funds

- 16.16** Some NFPs use loan funds to account for loans made to students, employees, and other constituents and resources available for those purposes. The assets initially made available for the loans may be provided by donors or various governmental and other granting agencies or designated by governing boards. These entities or individuals may also stipulate qualifications for individual borrowers. Some loan funds are self-perpetuating—that is, the principal and interest repayments on outstanding loans are used to make additional loans. Other loan funds are created on a temporary basis, and the original resource providers must be repaid. In some situations, repayments may be forgiven by resource providers if certain conditions are met.
- 16.17** Fund balances of loan funds are resources available for lending. The portion of the fund balances representing resources restricted by donors in perpetuity for use in making loans (for example, a revolving fund) should be classified as permanently restricted. If a portion of the loan funds is subject only to donor-imposed restrictions that expire (for example, loan funds that make loans on a one-time, rather than revolving, basis), that portion should be classified as temporarily restricted until the loans are made. If a portion of the loan funds may be used for the unrestricted purposes of the NFP (such as loan program administration), that portion is classified as unrestricted net assets. Amounts that have been designated by governing boards to be used as loan funds, such as amounts designated as matching funds for government loan programs (for example, government loans to students that require colleges and universities to match a portion of those loans) and other amounts used for loans that have not been restricted by donors, should be classified as unrestricted net assets. Any portion of loan fund balances that represents refundable advances, such as under a government loan program, should be reported as a liability.

Endowment Funds

- 16.18** Some NFPs record cash, securities, or other assets held to provide income for the maintenance of the NFP in an endowment fund or funds. Three kinds of endowment may be identified: permanent endowment, term endowment, and quasi endowment (also called funds functioning as endowment). *Permanent endowment* refers to amounts that have been contributed with donor-specified restrictions that the gift be invested to provide a permanent source of support (often stated as “principal to be invested in perpetuity”); income from those investments may also be restricted by donors. *Term endowment* is similar to permanent endowment, except that at some future time or upon the occurrence of a specified future event, the resources originally contributed become available for unrestricted or purpose-restricted use by the entity. *Quasi endowment* refers to resources designated by an entity's governing board to be retained and invested for specified purposes for a long but unspecified period.
- 16.19** Fund balances of endowment funds are resources for which various limitations exist on the use of the resources invested and, in some cases, on the income generated by those resources. Amounts that are resources restricted by donors in perpetuity should be classified as permanently restricted. If donor-imposed restrictions exist that preclude the use of gains and losses (net appreciation) on permanent endowment, either as a result of explicit or implicit donor stipulation or by the NFP's interpretation of the relevant law, those gains and losses should also be classified as permanently restricted. In the absence of such restrictions, those gains and losses should be classified as temporarily restricted until they are appropriated by the governing board for expenditure. If the fair value of the assets of a donor-restricted endowment fund is less than the amount required to be maintained permanently, the deficit is classified as unrestricted net assets. Chapter 4, “Cash, Cash Equivalents, and Investments,” provides additional information about the classification of the net assets of endowment funds.
- 16.20** Fund balances that represent term endowments for which the gift must be invested for a specific period and then used at the end of the term for a specified purpose should be classified as temporarily restricted net assets. Amounts representing resources that will be permanently restricted at the end of the specified term should be classified as permanently restricted net assets.
- 16.21** Fund balances that are quasi endowments should be classified as unrestricted net assets if they were created by a designation of the NFP's governing board from unrestricted net assets. Fund balances that are quasi endowments should be classified as temporarily restricted net assets if they were created by a designation of the NFP's governing board from temporarily restricted resources and the restrictions are not yet met. For example, if an NFP receives a large gift restricted for a specific purpose and the gift is far in excess of the NFP's current needs, the governing board may decide to invest the gift and use a spending rate to determine the amount it will annually spend for the restricted purpose. Over time, temporarily restricted resources of the quasi endowments become unrestricted net assets because of the requirement to use restricted resources first, as discussed in paragraphs 11.33–.36. Because those quasi endowments are temporarily restricted gifts, rather than donor-restricted endowments, they are not subject to a time restriction until appropriated by the governing board. Thus, the resources are entirely available to support

expenditures for the specified purpose even if the governing board does not appropriate them; and the net assets will be reclassified to unrestricted net assets as the purpose restrictions are met. The net assets of board-designated endowment funds are required to be disclosed per FASB ASC 958-205-50-2.

Annuity and Life-Income (Split-Interest) Funds

16.22 Annuity and life-income (or split-interest) funds may be used by NFPs to account for resources provided by donors under various kinds of agreements in which the NFP has a beneficial interest in the resources but is not the sole beneficiary. These agreements include charitable lead and remainder trusts, charitable gift annuities, pooled (life) income funds, and life interests in real estate. Split-interest agreements are discussed in chapter 6, "Split-Interest Agreements and Beneficial Interests in Trusts."

16.23 Fund balances of annuity and life-income funds represent an NFP's beneficial interest in the resources contributed by donors under split-interest agreements. Any portion of the fund balances representing amounts that will become part of permanent endowment when the agreements terminate should be classified as permanently restricted net assets. Any portion of the fund balances representing amounts that will be available for restricted purposes or for unrestricted use by the NFP when the split-interest agreements terminate should be classified as temporarily restricted net assets. If the donor gives the NFP the immediate right to use the assets it receives without restriction, as discussed in paragraph 6.19, the fund balance should be classified as unrestricted net assets.

Agency (Or Custodian) Funds

16.24 Agency (or custodian) funds are used by NFPs to account for resources held by the NFP as an agent for resource providers until those resources are transferred to third-party recipients specified by the resource providers. The NFP has little or no discretion over the use of those resources. Accounting for agency transactions and distinguishing agency transactions from contributions are discussed in chapter 5, "Contributions Received and Agency Transactions." Because the assets and liabilities are always equal in agency funds, the fund balances of agency funds are always zero and no net assets are reported.

Summary

16.25 The following exhibit summarizes the net asset classes into which various kinds of fund balances will typically be classified.

Typical Classification of Fund Balances

<i>Net Asset Class</i>			
<i>Fund Type</i>	<i>Permanently Restricted</i>	<i>Temporarily Restricted</i>	<i>Unrestricted</i>

Unrestricted Current (or Unrestricted Operating or General)	Not applicable	Fund balances with donor-imposed restrictions that expire with the passage of time (not usually present in unrestricted current funds).	Unrestricted fund balances, including those designated by governing bodies for specific purposes.
Restricted Current (or Restricted Operating or Specific Purpose)	Not applicable	Fund balances with donor-imposed restrictions that expire with the passage of time or that can be fulfilled or removed by actions of the not-for-profit entity (NFP).	Fund balances that are limited as to use by legal or contractual restrictions, rather than donor-imposed restrictions, including those designated by governing bodies for specific purposes. ¹
Plant (or Land, Building, and Equipment)	Fund balances with donor-imposed restrictions that do not expire with the passage of time or cannot be fulfilled or removed by actions of the NFP. ²	Fund balances with donor-imposed restrictions that expire with the passage of time or that can be fulfilled or removed by actions of the NFP. ³	Fund balances that are limited as to use by legal or contractual restrictions, rather than donor-imposed restrictions, including those designated by governing bodies for specific purposes. ⁴
Loan	Fund balances with donor-imposed restrictions that do not expire with the passage of time or cannot be fulfilled or removed by actions of the NFP.	Fund balances with donor-imposed restrictions that expire with the passage of time or that can be fulfilled or removed by actions of the NFP.	Fund balances that are limited as to use by legal or contractual restrictions, rather than donor-imposed restrictions, including those designated by governing bodies for specific purposes.
Endowment	Permanent endowment. ⁵	Temporary (or term) endowment ⁶	Quasi endowment created from

		or quasi endowment created from temporarily restricted resources for which the restrictions are not yet met.	unrestricted resources.
Annuity and Life-Income (Split Interests)	Donor-restricted in perpetuity.	Amounts available for unrestricted or time-or-purpose restricted use when agreement terminates.	Fund balances for which the donor gives the NFP the immediate right to use the assets it receives without restriction, including those designated by governing bodies for specific purposes.
Agency (or Custodian)	Not applicable.	Not applicable.	Not applicable

¹ Any portion of the fund balances representing unearned revenue from exchange transactions should be classified as a liability.

² This would include contributed assets such as land and capitalized collection items that must be held in perpetuity and other contributed assets when donors have stipulated that the proceeds from their ultimate sale or disposal must be reinvested in perpetuity.

³ Amounts representing assets contributed without donor-imposed restrictions about how long the land, building, or equipment must be used should be classified as unrestricted or temporarily restricted net assets, depending on the accounting policy adopted by the NFP, as discussed in paragraphs 16.13–15.

⁴ Amounts representing assets contributed without donor-imposed restrictions about how long the land, building, or equipment must be used should be classified as unrestricted or temporarily restricted net assets, depending on the accounting policy adopted by the NFP, as discussed in paragraphs 16.13–15.

⁵ Includes gains and losses on permanent endowment when donor restrictions or law permanently preclude their use.

⁶ Includes gains on permanent endowment if donor restrictions or law specify their use, if the gains have not been appropriated for expenditure, or both.

Glossary

The following terms can be found in the Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary:

acquiree. The business or businesses that the acquirer obtains control of in a business combination. This term also includes a nonprofit activity or business that a not-for-profit acquirer obtains control of in an acquisition by a not-for-profit entity (NFP).

acquirer. The entity that obtains control of the acquiree. However, in a business combination in which a variable interest entity is acquired, the primary beneficiary of that entity always is the acquirer.

acquisition by a not-for-profit entity. A transaction or other event in which a not-for-profit acquirer obtains control of one or more nonprofit activities or businesses and initially recognizes their assets and liabilities in the acquirer's financial statements. When applicable guidance in FASB ASC 805, *Business Combinations*, is applied by an NFP, the term *business combination* has the same meaning as this term has for an NFP. Likewise, a reference to business combinations in guidance that links to FASB ASC 805 has the same meaning as a reference to acquisitions by not-for-profit entities.

acquisition date. The date on which the acquirer obtains control of the acquiree.

activities. Activities are efforts to accomplish specific objectives. Some activities include producing and distributing materials. For example, if an NFP undertakes a mass mailing that includes a letter and a pamphlet, producing and distributing the letter and pamphlet are part of the activity. Other activities may include no materials, such as an annual dinner or a radio commercial.

affiliate. A party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an entity.

agency transaction. A type of exchange transaction in which the reporting organization acts as an agent, trustee, or intermediary for another party that may be a donor or donee. See **agent**, **trustee**, and **intermediary**.

agent. An entity that acts for and on behalf of another. Although the term agency has a legal definition, the term is used broadly to encompass not only legal agency, but also the relationships described in FASB ASC 958, *Not-for-Profit Entities*. A recipient entity acts as an agent for and on behalf of a donor if it receives assets from the donor and agrees to use those assets on behalf of or transfer those assets, the return on investment of those assets, or both to a specified beneficiary. A recipient entity acts as an agent for and on behalf of a beneficiary if it agrees to solicit assets from potential donors specifically for the beneficiary's use and to distribute those assets to the beneficiary. A recipient entity also acts as an agent if a beneficiary can compel the recipient entity to make distributions on its behalf.

board-designated endowment fund. An endowment fund created by an NFP's governing board by designating a portion of its unrestricted net assets to be invested to provide income for a long but unspecified period (sometimes called *funds functioning as endowment* or *quasi endowment funds*). See **endowment fund**. See also **designated net assets**.

business. An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants. Additional guidance on what a business consists of is presented in paragraphs 4–9 of FASB ASC 805-10-55.

business combination. A transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as true mergers or mergers of equals also are business combinations. See also **acquisition by a not-for-profit entity**.

charitable gift annuity. A transfer of assets to an NFP in connection with a split-interest agreement that is in part a contribution and in part an exchange transaction. The NFP accepts the contribution and is obligated to make periodic stipulated payments to the donor or a third-party beneficiary for a specified period of time, usually either a specified number of years or until the death of the donor or third-party beneficiary.

charitable lead annuity trust. A trust established in connection with a split-interest agreement, in which an NFP receives distributions of a fixed amount during the agreement's term. Upon termination of the trust, the remainder of the trust assets is paid to the donor or to third-party beneficiaries designated by the donor.

charitable lead trust. A trust established in connection with a split-interest agreement, in which the NFP receives distributions during the agreement's term. Upon termination of the trust, the remainder of the trust assets is paid to the donor or to third-party beneficiaries designated by the donor.

charitable lead unitrust. A trust established in connection with a split-interest agreement, in which an NFP receives distributions of a fixed percentage of the fair value of the trust's assets during the agreement's term. Upon termination of the trust, the remainder of the trust assets is paid to the donor or to third-party beneficiaries designated by the donor.

charitable remainder annuity trust. A trust established in connection with a split-interest agreement, in which the donor or a third-party beneficiary receives distributions of a fixed amount during the agreement's term. Upon termination of the trust, an NFP receives the assets remaining in the trust.

charitable remainder trust. A trust established in connection with a split-interest agreement, in which the donor or a third-party beneficiary receives specified distributions during the agreement's term. Upon termination of the trust, an NFP receives the assets remaining in the trust.

charitable remainder unitrust. A trust established in connection with a split-interest agreement, in which the donor or a third-party beneficiary receives distributions of a fixed percentage of the fair value of the trust's assets during the agreement's term. Upon termination of the trust, an NFP receives the assets remaining in the trust.

collections. Works of art, historical treasures, or similar assets that meet all of the following criteria: (a) they are held for public exhibition, education, or research in furtherance of public service rather than financial gain, (b) they are protected, kept unencumbered, cared for, and preserved, and (c) they are subject to an organizational policy that requires the proceeds of items that are sold to be used to acquire other items for collections. Collections generally are held by museums, botanical gardens, libraries, aquariums, arboreta, historic sites, planetariums, zoos, art galleries, nature, science, and technology centers, and similar educational, research, and public service organizations that have those divisions; however, the definition is not limited to those entities nor does it apply to all items held by those entities.

compensation or fees. Reciprocal transfers of cash or other assets in exchange for services performed.

conditional promise to give. A promise to give that depends on the occurrence of a specified future and uncertain event to bind the promisor.

contribution. An unconditional transfer of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner. Those characteristics distinguish contributions from exchange transactions, which are reciprocal transfers in which each party receives and sacrifices approximately equal value; from investments by owners and distributions to owners, which are nonreciprocal transfers between an entity and its owners; and from other nonreciprocal transfers, such as impositions of taxes or legal judgments, fines, and thefts, which are not voluntary transfers. In a contribution transaction, the value, if any, returned to the resource provider is incidental to potential public benefits. In an exchange transaction, the potential public benefits are secondary to the potential proprietary benefits to the resource provider. The term *contribution revenue* is used to apply to transactions that are part of the entity's ongoing major or central activities (revenues), or are peripheral or incidental to the entity (gains). See also **inherent contribution**.

control of a not-for-profit entity. The direct or indirect ability to determine the direction of management and policies through ownership, contract, or otherwise.

costs of joint activities. Costs incurred for a joint activity. Costs of joint activities may include joint costs and costs other than joint costs. Costs other than joint costs are costs that are identifiable with a particular function, such as fund-raising, program, management and general, and cost of sales. For example, some costs incurred for printing, paper, professional fees, and salaries to produce donor cards are not joint costs, although they may be incurred in connection with conducting joint activities.

designated net assets. Unrestricted net assets subject to self-imposed limits by action of the governing board. Designated net assets may be earmarked for future programs, investment, contingencies, purchase or construction of fixed assets, or other uses.

donor-imposed condition. A donor stipulation that specifies a future and uncertain event whose occurrence or failure to occur gives the promisor a right of return of the assets it has transferred or releases the promisor from its obligation to transfer its assets.

donor-imposed restriction. A donor stipulation that specifies a use for the contributed asset that is more specific than broad limits resulting from the following: (a) the nature of the (NFP, (b) the environment in which it operates, and (c) the purposes specified in its articles of incorporation or bylaws, or comparable documents for an unincorporated association. A donor-imposed restriction on an NFP's use of the asset contributed may be temporary or permanent. Some donor-imposed restrictions impose limits that are permanent, for example, stipulating that resources be invested in perpetuity (not used up). Others are temporary, for example, stipulating that resources may be used only after a specified date, for particular programs or services, or to acquire buildings and equipment.

donor-restricted endowment fund. An endowment fund that is created by a donor stipulation requiring investment of the gift in perpetuity or for a specified term. Some donors may require that a portion of income, gains, or both be added to the gift and invested subject to similar restrictions. The term does not include a board-designated endowment fund. See **endowment fund**.

economic interest. An NFP's interest in another entity that exists if any of the following criteria are met: (a) the other entity holds or utilizes significant resources that must be used for the unrestricted or restricted purposes of the NFP, either directly or indirectly by producing income or providing services, or (b) the NFP is responsible for the liabilities of the other entity.

endowment fund. An established fund of cash, securities, or other assets to provide income for the maintenance of an NFP. The use of the assets of the fund may be permanently restricted, temporarily restricted, or unrestricted. Endowment funds generally are established by donor-restricted gifts and bequests to provide (a) a permanent endowment, which is to provide a permanent source of income, or (b) a term endowment, which is to provide income for a specified period.

equity interests. Used broadly to mean ownership interests of investor-owned entities; owner, member, or participant interests of mutual entities; and owner or member interests in the net assets of NFPs.

financial asset. Cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right to do either (a) receive cash or another financial instrument from a second entity or (b) exchange other financial instruments on potentially favorable terms with the second entity. A financial asset exists if and when two or more parties agree to payment terms and those payment terms are

reduced to a contract. To be a financial asset, an asset must arise from a contractual agreement between two or more parties, not by an imposition of an obligation by one party on another.

financial flexibility. The ability of an entity to take effective actions or alter amounts and timing of cash flows so it can respond to unexpected needs and opportunities.

financial liability. A contract that imposes on one entity an obligation to do either (a) deliver cash or another financial instrument to a second entity or (b) exchange other financial instruments on potentially unfavorable terms with the second entity.

financially interrelated entity. A recipient entity and a specified beneficiary are financially interrelated entities if the relationship between them has both of the following characteristics: (a) one of the entities has the ability to influence the operating and financial decisions of the other and (b) one of the entities has an ongoing economic interest in the net assets of the other.

functional classification. A method of grouping expenses according to the purpose for which the costs are incurred. The primary functional classifications are program services and supporting activities.

fund-raising activities. Activities undertaken to induce potential donors to contribute money, securities, services, materials, facilities, other assets, or time.

funds functioning as endowment. Unrestricted net assets designated by an entity's governing board, rather than restricted by a donor or other outside agency, to be invested to provide income for a long but unspecified period. A board-designated endowment, which results from an internal designation, is not donor-restricted and is classified as unrestricted net assets. The governing board has the right to decide at any time to expend the principal of such funds. (Sometimes referred to as quasi endowment funds.) See also **designated net assets**.

goodwill. An asset representing the future economic benefits arising from other assets acquired in a business combination or an acquisition by an NFP that are not individually identified and separately recognized. For ease of reference, this term also includes the immediate charge recognized by NFPs in accordance with FASB ASC 958-805-25-29.

identifiable. An asset is identifiable if it meets either of the following criteria: (a) it is separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so, or (b) it arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

inherent contribution. A contribution that results if an entity voluntarily transfers assets (or net assets) or performs services for another entity in exchange for either no

assets or for assets of substantially lower value and unstated rights or privileges of a commensurate value are not involved.

intangible assets. Assets (not including financial assets) that lack physical substance. (The term *intangible assets* is used to refer to intangible assets other than goodwill.)

intermediary. Although in general usage the term intermediary encompasses a broad range of situations in which an entity acts between two or more other parties, in this usage, it refers to situations in which a recipient entity acts as a facilitator for the transfer of assets between a potential donor and a potential beneficiary (donee) but is neither an agent or trustee nor a donee and donor.

joint activity. An activity that is part of the fund-raising function and has elements of one or more other functions, such as programs, management and general, membership development, or any other functional category used by the entity.

joint costs. The costs of conducting joint activities that are not identifiable with a particular component of the activity. For example, the cost of postage for a letter that includes both fund-raising and program components is a joint cost. Joint costs may include the following costs: salaries, contract labor, consultants, professional fees, paper, printing, postage, event advertising, telephones, airtime, and facility rentals.

lead interest. The right to the benefits (cash flows or use) of assets during the term of a split-interest agreement, which generally starts upon the signing of the agreement and terminates at either of the following times: (a) after a specified number of years (period-certain) or (b) upon the occurrence of a certain event, commonly either the death of the donor or the death of the lead interest beneficiary (life-contingent).

legal entity. Any legal structure used to conduct activities or to hold assets. Some examples of such structures are corporations, partnerships, limited liability companies, grantor trusts, and other trusts.

management and general activities. Activities that are not identifiable with a single program, fund-raising activity, or membership-development activity but that are indispensable to the conduct of those activities and to an entity's existence.

medium. A means of mass communication, such as direct mail, direct response advertising, or television.

membership-development activities. Membership-development activities include soliciting for prospective members and membership dues, membership relations, and similar activities. However, if there are no significant benefits or duties connected with membership, the substance of membership-development activities may, in fact, be fund-raising.

merger date. The date on which the merger becomes effective.

merger of not-for-profit entities. A transaction or other event in which the governing bodies of two or more NFPs cede control of those entities to create a new NFP.

natural expense classification. A method of grouping expenses according to the kinds of economic benefits received in incurring those expenses. Examples of natural expense classifications include salaries and wages, employee benefits, supplies, rent, and utilities.

net assets. The excess or deficiency of assets over liabilities of an NFP, which is classified into three mutually exclusive classes according to the existence or absence of donor-imposed restrictions. See **unrestricted net assets**, **temporarily restricted net assets**, and **permanently restricted net assets**.

net income unitrust. A trust established in connection with a split-interest agreement, in which the donor or a third-party beneficiary receives distributions during the agreement's term of the lesser of the net income earned by the trust or a fixed percentage of the fair value of the trust's assets, with or without recovery and distribution of the shortfall in a subsequent year. Upon termination of the trust, an NFP receives the assets remaining in the trust.

noncontrolling interest. The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a *minority interest*.

nonfinancial asset. An asset that is not a financial asset. Nonfinancial assets include land, buildings, use of facilities or utilities, materials and supplies, intangible assets, or services.

nonprofit activity. An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing benefits, other than goods or services at a profit or profit equivalent, as a fulfillment of an entity's purpose or mission (for example, goods or services to beneficiaries, customers, or members). As with an NFP, a nonprofit activity possesses characteristics that distinguish it from a business or a for-profit business entity.

nonreciprocal transfer. A transaction in which an entity incurs a liability or transfers an asset to another entity (or receives an asset or cancellation of a liability) without directly receiving (or giving) value in exchange.

not-for-profit entity. An entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity: (a) contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return, (b) operating purposes other than to provide goods or services at a profit, and (c) absence of ownership interests like those of business enterprises. Entities that clearly fall outside this definition include the following: (a) all investor-owned enterprises and (b) entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance companies, credit unions, farm and rural electric cooperatives, and employee benefit plans.

ongoing economic interest in the net assets of another. A residual right to another NFP's net assets that results from an ongoing relationship. The value of those

rights increases or decreases as a result of the investment, fund-raising, operating, and other activities of the other entity.

owners. Used broadly to include holders of ownership interests (equity interests) of investor-owned entities, mutual entities, or NFPs. Owners include shareholders, partners, proprietors, or members or participants of mutual entities. Owners also include owner and member interests in the net assets of NFPs.

permanent restriction. A donor-imposed restriction that stipulates that resources be maintained permanently but permits the NFP to use up or expend part or all of the income (or other economic benefits) derived from the donated assets.

permanently restricted net assets. The part of the net assets of an NFP resulting from the following: (a) contributions and other inflows of assets whose use by the NFP is limited by donor-imposed stipulations that neither expire by passage of time nor can be fulfilled or otherwise removed by actions of the NFP, (b) other asset enhancements and diminishments subject to the same kinds of stipulations, and (c) reclassifications from (or to) other classes of net assets as a consequence of donor-imposed stipulations.

pooled income fund. A trust in which donors are assigned a specific number of units 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 designated beneficiary or beneficiaries) is paid the actual income (as defined under the arrangement) earned on the donor's assigned units. Upon the donor's death, the value of these assigned units reverts to the NFP.

program services. The activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the NFP exists. Those services are the major purpose for and the major output of the organization and often relate to several major programs.

promise to give. A written or oral agreement to contribute cash or other assets to another entity. A promise carries rights and obligations—the recipient of a promise to give has a right to expect that the promised assets will be transferred in the future, and the maker has a social and moral obligation, and generally a legal obligation, to make the promised transfer. A promise to give may be either conditional or unconditional.

quasi endowment funds. See **funds functioning as endowment.**

reclassification. Simultaneous increase of one class of net assets and decrease of another, usually as a result of the release or lapsing of restrictions.

remainder interest. The right to receive all or a portion of the assets of a split-interest agreement at the end of the agreement's term.

restricted support. Donor-restricted revenues or gains from contributions that increase either temporarily restricted net assets or permanently restricted net assets. See also **unrestricted support.**

spending rate. The portion of total return on investments used for fiscal needs of the current period, usually used as a budgetary method of reporting returns of investments. It is usually measured in terms of an amount or a specified percentage of a moving average market value. Typically, the selection of a spending rate emphasizes the use of prudence and a systematic formula to determine the portion of cumulative investment return that can be used to support fiscal needs of the current period and the protection of endowment gifts from a loss of purchasing power as a consideration in determining the formula to be used.

split-interest agreement. An agreement in which a donor enters into a trust or other arrangement under which an NFP receives benefits that are shared with other beneficiaries. A typical split-interest agreement has the following two components: (a) a lead interest and (b) a remainder interest.

stipulation. A statement by a donor that creates a condition or restriction on the use of transferred resources.

supporting activities. All activities of an NFP other than program services. Generally, they include the following: (a) management and general activities, (b) fund-raising activities, and (c) membership development activities.

temporarily restricted net assets. The part of the net assets of an NFP resulting from the following: (a) contributions and other inflows of assets whose use by the NFP is limited by donor-imposed stipulations that either expire by the passage of time or can be fulfilled and removed by actions of the NFP pursuant to those stipulations, (b) other asset enhancements and diminishments subject to the same kinds of stipulations, and (c) reclassifications from or to other classes of net assets as a consequence of donor-imposed stipulations, their expiration by passage of time, or their fulfillment and removal by actions of the NFP pursuant to those stipulations.

temporary restriction. A donor-imposed restriction that permits the donee to use up or expend the donated assets as specified and that is satisfied either by the passage of time or by actions of the donee.

term endowment. An endowment fund established to provide income for a specified period. See **endowment fund**.

total return. A measure of investment performance that focuses on the overall return on investments, including interest and dividend income as well as realized and unrealized gains and losses on investments. Frequently used in connection with a spending-rate formula to determine how much of that return will be used for fiscal needs of the current period.

trustee. An entity that has a duty to hold and manage assets for the benefit of a specified beneficiary in accordance with a charitable trust agreement. In some states, NFPs are organized under trust law rather than as corporations. Those NFPs are not trustees as defined because, under those statutes, they hold assets in trust for the community or some other broadly described group, rather than for a specific beneficiary.

unconditional promise to give. A promise to give that depends only on passage of time or demand by the promisee for performance.

unrestricted net assets. The part of net assets of an NFP that is neither permanently restricted nor temporarily restricted by donor-imposed stipulations. The only limits on the use of unrestricted net assets are the broad limits resulting from the following: (a) the nature of the NFP, (b) the environment in which the NFP operates, (c) the purposes specified in the NFP's articles of incorporation or bylaws, and (d) limits resulting from contractual agreements with suppliers, creditors, and others entered into by the NFP in the course of its business. Unrestricted net assets generally result from revenues from providing services, producing and delivering goods, receiving unrestricted contributions, and receiving dividends or interest from investing in income-producing assets, less expenses incurred in providing services, producing and delivering goods, raising contributions, and performing administrative functions.

unrestricted support. Revenues or gains from contributions that are not restricted by donors. See also **restricted support**.

variance power. The unilateral power to redirect the use of the transferred assets to another beneficiary. A donor explicitly grants variance power if the recipient entity's unilateral power to redirect the use of the assets is explicitly referred to in the instrument transferring the assets. Unilateral power means that the recipient entity can override the donor's instructions without approval from the donor, specified beneficiary, or any other interested party.

voluntary health and welfare entities. An NFP that is formed for the purpose of performing voluntary services for various segments of society and that is tax exempt (organized for the benefit of the public), supported by the public, and operated on a not-for-profit basis. Most voluntary health and welfare entities concentrate their efforts and expend their resources in an attempt to solve health and welfare problems of our society and, in many cases, those of specific individuals. As a group, voluntary health and welfare entities include those NFPs that derive their revenue primarily from voluntary contributions from the general public to be used for general or specific purposes connected with health, welfare, or community services. For purposes of this definition, the general public excludes governmental entities when determining whether an NFP is a voluntary health and welfare entity.

The following is a list of additional terms that have been used in this guide:

corpus. The principal amount of a gift or trust. Usually refers to the portion of a split-interest gift or an endowment fund that must be maintained over a specified period or in perpetuity.

equity. See **net assets**.

help accomplish the not-for-profit entity's mission. Actions that help accomplish the NFP's mission are actions that either benefit the recipient (such as by improving

the recipient's physical, mental, emotional, or spiritual health and well-being) or benefit society (by addressing societal problems).

funds held in trust by others. Resources held and administered, at the direction of the resource provider, by an outside trustee for the benefit of an NFP, frequently in connection with a split-interest agreement or permanent endowment.

life interest in real estate. Also referred to as a *life estate*, is the right of an individual to use or live in property during their lifetime. Upon the death of the life tenant, or their relinquishment of the right to use, the remainder interest owner receives the property without limitation. A charitable life estate provides for a charitable contribution deduction under U.S. tax law when a donor transfers ownership of a residence or farm to a qualified charitable organization and retains a life tenant interest in the property. Under such an arrangement, the charitable organization receives title and ownership of the property outright, subject to the life use rights.

life tenant. One who possesses a life-use right to property, frequently used in connection with a split-interest agreement.

net investment (equity) in land, buildings, and equipment. The total carrying value (after accumulated depreciation) of all property, plant, and equipment, less directly related liabilities. This amount is exclusive of real properties that are held for investment purposes.

official statement. The common term used for the offering document or offering circular prepared in connection with a new issue of municipal securities. Although functionally equivalent to the prospectus used in connection with registered securities, an official statement for municipal securities is exempt from the prospectus requirements of the Securities Act of 1933.

program activities. See **program services**.

restricted net assets. Resources whose use is restricted by donors as contrasted with those over which the NFP has complete control and discretion. Restricted net assets may be permanently or temporarily restricted.