2013 Nonprofit and Association Roundtable Series

September 18

Advanced Nonprofit Accounting

Presented by:

Bobbie Hales, CPA

Matt Krehe, CPA

Gilbert Associates, Inc.
CPAs and Advisors
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Discussion Items

- Endowments
- Agency Transactions
- Split-Interest Agreements
- Consolidation of Related Entities
- Net Assets

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Definition: Endowment Funds

- An established fund of cash, securities, or other assets to provide income for the maintenance of a not-for-profit entity
- Use of the assets of the fund may be permanently restricted, temporarily restricted, or unrestricted
- Generally are established by donor-restricted gifts and bequests to provide either of the following:
  - Permanent endowment, which is to provide a permanent source of income
  - Term endowment, which is to provide income for a specified period

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Endowment Components

- Endowment fund components to evaluate:
  - Original gift
  - Gains and losses
  - Interest and dividends

- *Each component is considered unrestricted unless its use is temporarily or permanently restricted by explicit donor stipulations or by law.*

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Endowments Without Specifications

- Governing board must determine the amount of the fund that must be permanently retained if the donor did not plainly specify
- Gains – Temporarily restricted (time) until appropriated for expenditure at which time they will be either temporarily restricted (purpose) or unrestricted, based on direction of the donor
- Losses – Reduce temporarily restricted net assets to the extent of donor imposed restrictions on the net appreciation and then unrestricted net assets

Example: Endowments

- Mary Smith provided a gift of $1,000,000 to Children Services, Inc. to be held as a permanent endowment
- The income of which will be used for repairs and maintenance
- In 2013 the endowment had unrealized losses of $10,000 and interest income, net of fees, of $5,000

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Example: Situation 1

- As the terms are silent to the treatment of gains/losses, the effect of 2013 activity would be:
  - Increase temporarily restricted net assets by $5,000 for interest income
  - Decrease temporarily restricted net assets by $5,000 for losses
  - Decrease unrestricted net assets by $5,000 for the remaining losses

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Example: Situation 2

- If the endowment also stated that "gains and losses on the underlying investments are to remain in the endowment and only net interest income is to be used for repairs and maintenance," the effect of 2013 activity would be:
  - Increase temporarily restricted net assets by $5,000 for interest income.
  - Recognize a $10,000 unrealized loss on investments as a reduction of permanently restricted net assets.

Agency Transactions

- NPO enters into agreement where it acts as an agent, trustee, or intermediary for another party
- NPO does not receive a contribution or earn revenue under an exchange transaction with the assets they receive,
- NPO does not make a contribution or recognize expenses when they disburse the assets to other entities

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Agency Transactions

- Variance Power:
  - Unilateral power to redirect the use of the transferred assets to another beneficiary
  - 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

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Agency Transactions

- Financially Interrelated Entities:
  - Recipient entity and a specified beneficiary are financially interrelated if the relationship between them has both characteristics:
    - One entity has the ability to influence the operating and financial decisions of the other
    - One entity has an ongoing economic interest in the net assets of the other

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Agency Transactions

- Financially Interrelated Entities
  - Ability to exercise influence over operation and financial decisions may be demonstrated by:
    - Entities are affiliates
    - Entity has considerable representation on the governing board of the other entity
    - Charter or bylaws of one entity limit its activities to those that are beneficial to the other entity
    - Agreement between the entities allows one entity to actively participate in the policy making processes of the other

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Agency Transaction vs. Contribution

- Contribution should be recognized if:
  - NPO has variance power and can choose the beneficiaries of the assets
  - NPO is financially interrelated to a specified beneficiary (and not a trustee)

Agency Transaction vs. Contribution

- Example: Contribution NOT recognized
  - Donor selects a beneficiary from a list of potential beneficiaries that have been prequalified or identified by the NPO
  - Donor specifies eligibility criteria and states that the proceeds must be transferred to all who meet those criteria
  - Donor responds to a campaign request from an NPO that indicates that the proceeds will be distributed to a specific beneficiary

Agency Transaction vs. Contribution

- Example: Contribution recognized
  - NPO asks the donor to select one or more fields of interest
  - Donor uses broad generalizations to describe the beneficiaries (e.g. students)

Example: Agency Transaction vs. Contribution

- Mary Smith gives $10,000 to Human Services, Inc. and stipulates that $10,000 is to be distributed to Children Services, Inc. over a two-year period
- Upon receipt of the cash, Human Services, Inc. will record the following:
  - Debit “Cash” $10,000
  - Credit “Funds held on behalf of others” liability $10,000
  - As the amounts are paid to Children Services, Inc. they will reduce cash and the liability

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Agency Transaction and Exchange Transactions

- Exchange Transaction
  - If the NPO will be providing a service to the donor and will be receiving a fee for serving as an agent they will recognize revenue to the extent of the services performed.

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Example: Agency Transaction and Exchange Transaction

- ABC Foundation provides a $50,000 grant to Children Services, Inc. to establish and monitor a scholarship program. Under the terms of the agreement ABC Foundation stipulates the following:
  - Student - $45,000 to be paid to John Baker in three equal payments of $15,000 annually commencing on January 1, 2014
  - Program Operator Expense - $5,000 will be retained by Children Services, Inc. for program development and monitoring of the student in accordance with grant terms

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Example: Agency Transaction and Exchange Transaction

- Upon receipt of the cash Children Services, Inc. will record the following:
  - Debit "Cash" $50,000
  - Credit "Funds held on behalf of others" liability $45,000
  - Credit "Deferred Revenue" $5,000
- As the amounts are paid to John Baker they will reduce cash and the liability
- As revenue is earned as the Program Operator they will recognize revenue and reduce the deferred revenue liability

Split-Interest Agreements

- Another way for donors to make contributions or provide resources to NPOs
- Donors receive significant tax advantages:
  - Tax deduction when assets are transferred
  - Property removed from donor’s estate
- Created when a donor transfers assets to an NPO or places them in a trust for NPO’s benefit

Split-Interest Agreements

- Only partial interest in the assets is given to the NPO - donor either retains an interest or names a third party as recipient
- A split-interest agreement divides a single asset into two parts, each part with value on the date of the agreement
- Agreements specify two interests in the asset and the related income:
  - Lead interest
  - Remainder interest

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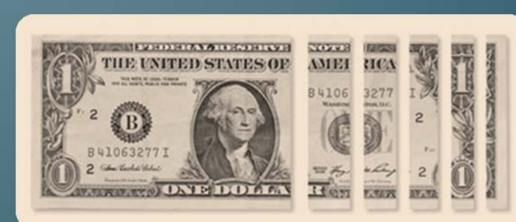
Split-Interest Agreements

- Lead interest:
  - NPO receives the distributions during the agreement's term
  - Donor or another beneficiary receives the assets remaining at the end of the agreement's term
- Remainder interest:
  - Donor or the donor's designee receives the distributions during the agreement's term
  - NPO receives all, or a portion, of the assets remaining at the end of the agreement's term



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Split-Interest Agreements

- Donor may impose restrictions on the NPO's use of all, or a portion, of any assets received. Restrictions may include:
  - Gifts may be revocable or irrevocable
  - Duration of agreement is expressed either as a specific number of years or as the remaining life of individuals designated by the donor
  - Assets are invested and administered by the NPO, a trustee, or a fiscal agent
  - Distributions are made to a beneficiary or beneficiaries during the term of agreement
  - Remaining assets are distributed to, or retained by, either the NPO or other beneficiaries, or "returned" to the donor

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Example: Lead or Remainder Interest?

- Jenny Smith transfers securities to a trustee and signs a split-interest agreement under which the Hillside Children's Shelter will receive 5% of the value of the trust assets each year for the next ten years.
- At the end of ten years, the trust assets will be paid to Jenny's sister.

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Example: Lead or Remainder Interest?

- John Eggers transfers assets to a trustee and signs a split-interest agreement under which all investment income earned from the assets will be paid to him annually for 25 years
- After 25 years, the remaining trust assets are to be paid to the Central Food Bank to be used for their greatest needs

Example: Lead or Remainder Interest?

- Jim Capitol transfers assets to a trustee and signs a split-interest agreement under which he will receive a quarterly payment of $500 from the trust until his death
- Upon his death, the remaining trust assets will be paid to the Marcy Milton Foundation for use in its child's programs

Terms and Details

- Several types of split-interest agreements
  - Agreements that form a trust have trustees; for others, the NPO or someone else is designated as fiscal agent
  - Agreements have at least one NPO beneficiary and generally at least one non-NPO beneficiary (e.g., the donor or a family member)
  - Agreements must specify the party obligated to make distributions
- Payout types
  - “Sum certain” means a fixed annuity payment
  - Fixed percentage
  - Actual income earned on the assets

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Recognition and Measurement

- Ask yourself the following questions:
  - Is agreement revocable or irrevocable?
  - Does agreement have conditions or restrictions imposed by donor?
  - Have related assets been received?
  - Are related assets held by the not-for-profit entity or an unrelated third party acting as a trustee or agent?
  - Does agreement involve a lead trust, remainder trust, or a perpetual trust?
  - Does agreement contain an embedded derivative?
- Valuation of asset is made as of the date of the gift and is revalued each subsequent year

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Recognition and Measurement

- Major factors involved in valuing the NPO's interest include:
  - Trust payout provisions
  - Anticipated trust earnings
  - Appropriate rate for discounting future cash flows
  - Life expectancy of donor or established term

The calculations can be tricky, we are here to help!

Financial Statement Presentation and Disclosure

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- Assets and liabilities recognized under split-interest agreements shall be disclosed separately from other assets and liabilities (recognized at NPV)
- Contribution revenue and recognized changes in the value of split-interest agreements shall be disclosed as separate line items
- Notes to the financial statements should include:
  - Description of the general terms of existing split-interest agreements
  - Basis, either fair value or cost, used for recognizing assets
  - Discount rates and actuarial assumptions used in calculating present value

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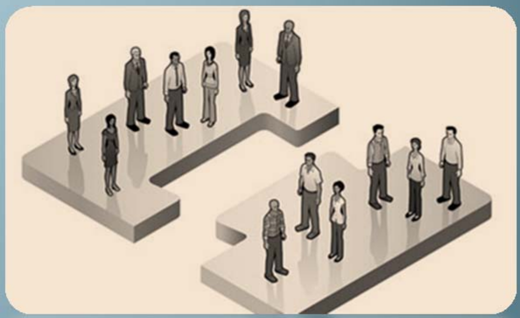
Consolidation of Related Entities



- Consolidation required of for-profit subsidiaries and financially interrelated NPOs that are subject to common control
- Control
  - For-profit subsidiary: usually comes with majority ownership interest
  - Related NPO: usually comes with majority voting interest in board of other entity, either by direct vote or appointment of voting members
- Economic interest
  - Other entity holds or utilizes significant resources that must be used for the NPO
  - Reporting organization is responsible for the liabilities of the other organization

Examples: Economic Interest

- Other entity solicit funds in name of NPO. All funds solicited are intended by contributor or required to be transferred to NPO or used at its discretion
- NPO transfers significant resources to another entity whose resources are held for the benefit of the NPO
- NPO assigns certain significant functions to another entity
- NPO provides, or committed to provide funds for, or guarantees significant debt of, another entity
- NPO has right to or responsibility for operating results of another entity; Or upon dissolution, the reporting entity is entitled to net assets or is responsible for any deficit of another entity

Is Consolidation Required?

- Control of a related but separate NPO 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
- Control may be through contract or affiliation agreement
  - Consolidation is *permitted but not required*
  - *Various related party-type disclosures required,* if consolidated statements are not presented

Net Assets: Restriction Expirations

- Reclassifications simultaneous increase one net asset class and decrease another. This is done when the following occur:
  - NPO satisfies a purpose restriction
  - Donor-imposed restrictions expire with the passage of time or with the death of a split-interest agreement beneficiary; In some cases a secondary purpose restriction may exist
  - Donor changes a previously imposed restriction or a court action removes a restriction

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Net Assets: Restriction Expirations

- Expiration of Donor-Imposed Restrictions
  - Should be recognized in the period which the restriction expires
  - If two or more restrictions are imposed, the expiration should be recognized in the period in which the last remaining restriction has expired
  - If an expense is incurred for a purpose restriction for which both unrestricted and temporarily restricted net assets are available, temporarily restricted net assets should be used first

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Net Assets: Restriction Expirations

- Expiration of Restrictions on Promises to Give
  - Reasonable to assume that by specifying future payment dates, donor indicates that gift is to support activities in each period in which a payment is scheduled
  - If donor also stipulates purpose restriction, it would be inappropriate to look back in a prior to determine if restriction was met
  - If time period inherent in the donor’s purpose restriction is different than period that payment is scheduled, net assets would be released upon satisfaction of the purpose restriction

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Example: Restriction Expirations

- Expiration of Restrictions on Promises to Give
  - Donor makes a $500,000 pledge to be payable over 5 years as part of a capital campaign to construct a new building
  - In the current year the temporarily restricted net assets would be released upon completion of the building

Net Assets: Restriction Expirations

- Expiration of Restrictions on Gifts of Long-Lived Assets or Gifts for Their Purchase
  - If donor specifies a time period that long-lived assets must be used, temporarily restricted net assets should be released over that period of time
  - If donor does not specify a time period for use, the NPO may elect to release net assets over the life of the asset, equal to annual depreciation, or entirely in the year the asset is put into service

Whatever treatment is chosen must be applied consistently to all long-lived assets

Net Assets: Restriction Expirations

- Restrictions That Are Met in the Same Year as the Contribution Was Received
  - If NPO meets donor-imposed restrictions on all or a portion of the amount contributed in the same period, the contribution may be reported as unrestricted
    - Must be done consistently for all periods
    - Must be applied to all gifts
    - Policy must be disclosed in the footnotes

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Questions?

- Bobbie Hales
  - bobbie@gilbertcpa.com
- Matt Krehe
  - mkrehe@gilbertcpa.com