Reporting Deficiencies

NCACPA Not-for-Profit Conference

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Agenda

- Leder Man's Top 10 List
- A Deeper Dive:
  - Fair Value Disclosures
  - Promises to Give
  - Net Assets Released from Restrictions
  - Endowments
  - Income Taxes
  - Business Combinations
  - Special Events
  - Split Interest Agreements

“Leder Man’s Top 10 List

High Level Deficiencies

10. Omitting required totals for assets, liabilities, net assets
9. Classification of assets and liabilities not consistent
8. Donor restricted cash is shown as unrestricted
7. Dues receivable is recorded
6. Board designated net assets are shown as restricted
5. Negative restricted net assets
4. Reporting contributed services that do not meet specified criteria
3. Failure to disclose capitalization policy
2. Reclassifications of net assets
1. Lack of review of footnotes

Fair Value

Required Disclosures Under ASC 820-10

- Fair value measurement at end of reporting period
  - If nonrecurring, the reason for the measurement
- Level in fair value hierarchy
- Transfers between Level 1 and 2
- For Level 2 and 3: Description of valuation techniques and inputs used
- If highest and best use for nonfinancial assets differs from its current use, description of why

Required Disclosures Under ASC 820-10 (Continued)

- For Level 3 measurements:
  - Information about significant unobservable inputs
  - Reconciliation for beginning and ending balances (roll-forward)
    - ◊ Include unrealized gain/loss separately
  - Description of the valuation process used by the reporting entity
  - Sensitivity of measurement changes in unobservable inputs

Scope Exceptions:

- **Nonpublic entities not required to disclose:**
  - Transfers between Level 1 and 2
  - Sensitivity of measurement changes in unobservable inputs

- **For nonrecurring measurement, not required to disclose:**
  - Transfers between Level 1 and 2
  - Sensitivity of measurement changes in unobservable inputs
  - Reconciliation for beginning and ending balances (roll-forward)

	FV Recognized in Balance Sheet						FV Only Disclosed		
	Recurring			Nonrecurring					
Requirement	**L1**	**L2**	**L3**	**L1**	**L2**	**L3**	**L1**	**L2**	**L3**
FV measurement at end of period	R	R	R	R	R	R			
Reasons for measurement				R	R	R			
Hierarchy level	R	R	R	R	R	R	Y	Y	Y
All transfers in between hierarchy	X	X	R						
Description of valuation technique		R	R		R	R		Y	Y
Changes to valuation technique and reasons		R	R		R	R		Y	Y
Information about significant unobservable inputs			R						
Reconciliation of beg and end balances			R						
Description of valuation policies and processes			R			R			
Sensitivity to changes in unobservable inputs			X						
Why highest and best use not used	R	R	R	R	R	R	X	X	X

R = all entities; **X** = Public entities only; **Y** = public entities w/ assets over $100 million & no derivatives

Common Deficiencies

- Including items in the hierarchy not reported at fair value (cash, CDs, cash surrender value of life insurance)
- Failure to break out investments by class
- Transfers between hierarchy levels for recurring measurements
- Inputs and valuation techniques for Level 2 and 3
- Failure to break out unrealized gain/loss separately in roll-forward (Level 3)
- Reasons for non-recurring measurements

One last item:

- If investment is measured using NAV, additional disclosures are required:
  - The fair value measurement of the investments and a description of the significant investment strategies of the investee(s)
  - Estimate of the period of time over which the underlying assets are expected to be liquidated by the investees
  - The amount of the reporting entity's unfunded commitments
  - Description of the terms and conditions upon which the investor may redeem investments
  - Others

Investments Measured using NAV:

	Net Asset Value	Unfunded Commitments	Redemption Frequency	Redemption Notice Period
Multi-Strategy Hedge Funds (a)	$ 21,083	$ -	Qrtly/Semi-Annual	65-95 days
Real Estate Funds (b)	14,509	2,350	Quarterly	65 days
Equity Hedge Funds (c)	14,859	-	Quarterly	65 days
Total	$ 50,451	$ 2,350		

(a) This class invests in hedge funds that pursue multiple strategies to diversify risk and reduce volatility. The hedge funds' composite portfolio includes investments in approximately 50 percent U.S. common stocks, 3(percent global real estate projects, and 20% arbitrage investments. The fair values have been estimated using the net asset value per share.

(b) Real estate funds include investments in public real estate equity investment trusts, private real estate, direct investments in properties, land mortgages, loans, public natural resource equities and commodities, as well as private and public investments in energy, oil and gas, timber, industrial and precious metals or other hard assets. Twenty percent of the investments in this class is planned to be sold. Because it is not probable that any individual investment will be sold, the fair value of each individual investment has been estimated using the NAV of the Company's ownership interest in partners' capital.

(c) This class includes investments in hedge funds that invest both long and short primarily in U.S. common stocks. Management has the ability to shift investments from value to growth strategies, from small to large cap stocks, and from a net long to a net short position. Investments representing 22 percent of the value in this class cannot be redeemed because the investments include restrictions that do not allow for redemption in the first 12-18 months after acquisition.

Grants, Contributions, and Promises to Give

Example #1

- Agency A receives $25,000 from the State of North Carolina to carry out one of its program activities (providing counseling for underprivileged children)

- As part of this agreement:
  - Agency A must provide services to 50 children each month for 6 months
  - Agency must submit an expense report at end of each month
  - Agency must return any unspent funds at the end of the 6 months

Example #2

- Agency A receives $25,000 from the State of North Carolina to carry out one of its program activities (providing counseling for underprivileged children)

- As part of this agreement:
  - Agency must submit an expense report at end of each month

Indicators – Contribution vs Exchange

Indicator	Contribution	Exchange Transaction
Recipient's Intent	Seeking resources as a contribution	Seeking resources in exchange for specified benefits
Donor's Intent	Transferring resources to support the NFP's programs	Transferring resources in exchange for specified benefits
Method of Delivery	Delivery of asset to third-parties is at discretion of the NFP	Delivery of asset to third-parties is specified by resource provider
Method of Determining Amount of Payment	Resource provider determines amount of payment	Payment is the value of assets or services provided by the NFP
Penalties Assessed if NFP fails to Make Timely Delivery of Assets	Limited to delivery of assets already produced & return of unspent amount	Penalties exist beyond amount of payment
Delivery of assets by NFP	Assets are to be delivered to third-parties (not resource provider)	Assets are to be delivered to the resource provider

Contributions - Conditions

- 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
  - Dr. Cash
  - Cr. Refundable Advance

- But, there is an exception:
  - If the possibility that the condition will not be met is **remote**, a conditional promise to give may be considered unconditional

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Conditional Promises to Give

- A *conditional promise to give* occurs when a donor promises to contribute assets to an organization if specified future and uncertain events occur.

- Do not record a conditional promise to give:
  - Unless the conditions are satisfied
  - The likelihood of not meeting the conditions is remote

◊ Pledg ec ble XX

◊ Defer d Revenu $XXX

Unconditional Promises to Give

- How should an unconditional promise to give be recorded?

  – Unrestricted
  – Temporarily Restricted
  – Permanently Restricted

Common Deficiencies

- Recording of grants and/or pledges
- Conditional promises
- Discount rate is changed period to period
  - OK if fair value option is elected
- Use of the direct write-off method
- Allowance for amounts determined to be uncollectible at the time pledge was received
- Donated facilities

Donated Facilities

- Contributions of free (or below market) use of facilities should be recorded in the period received at fair value.
- Unconditional promises to give free or below market use of facilities for several years should be recorded when promise is received.
- Present value techniques are necessary
  - Contribution can not exceed fair value of the asset being used
- Should be recorded as an increase in temporarily restricted net assets (time restriction)

Donated Facilities – Example

- NFP A will receive the free use of office space for 5 years beginning January 1, 2014. This promise was received in December 2013 and is considered collectible. Market rate of the space is $10,000 per year and the fair value of the office space is $100,000.

- Total undiscounted rent = $50,000
- NPV of rent payments at 4% = $44,518 (will be ignored for the example)

Donated Facilities – Example (Continued)

- **When the promise is received:**
  - ◊ Dr. Promise to Give $50,000
  - ◊ Cr. Temp restricted net assets $50,000

- **After Year 1:**
  - ◊ Dr. Rent Expense $10,000
  - ◊ Cr. Promise to Give $10,000

  - ◊ Cr. Temp restricted net assets $10,000
  - ◊ Cr. Net Assets Released $10,000

Net Assets Released from Restrictions

Net Assets Released from Restrictions

- **Four other commonly missed items in this area:**
  - Contributions whose restrictions are met within the same year
  - Expenditures for which both unrestricted and temporarily restricted net assets are available
  - When to release net assets restricted for purchase of long-lived assets
  - For pledges, the time restriction ends, when the payment is due

Endowments

UPMIFA – The Law

- 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."

- It requires investment "in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances."
  - Nonprofits may delegate investment management as long as the Board acts prudently in doing so

Historic Dollar Value Lives On for Accounting

- Historic dollar value is the concept of maintaining the original corpus of the gift as an amount below which you can not go – this was the concept that drove most of the prior GAAP
- The concept disappears from UPMIFA
- The concept lives on in the accounting world and shows up in the examples within the accounting standards
- UPMIFA requires consideration of maintenance of purchasing power as only one of a number of considerations

Required Disclosures

- Guidance: ASC 958-205
  - Description of Board's interpretation of the laws that underlie its net asset classification of donor-restricted endowment funds
  - Description of policy for appropriation for expenditures
  - Description of investment policies
  - Composition of endowment by net asset class
  - Roll-forward of endowments by class
  - Description of deficiencies in endowment funds

Common Deficiencies

- Classification of endowment funds
- Deficiencies in endowment funds not noted
- Footnote not properly tailored
- Organization deviated from spending policy but its not disclosed
- Quasi-endowment funds not properly disclosed
  - Remember: Quasi-endowment funds not subject to UPMIFA

Income Taxes

Required Disclosures

- Guidance: ASC 958-720
  - Tax exempt status (501(c)3, 501(c)6, etc.)
  - Significant components of unrelated business income
    - ◊ Nature of activities resulting in income tax expense
    - ◊ Amount of income tax expense
    - ◊ Deferred tax expense or benefit
  - Amount of excise tax expense on investment income
  - Amount of interest and/or penalties
  - Disclosure of any uncertain tax positions
  - Years still open to examination by the IRS
  - Others

Examples of Uncertain Tax Positions for NFPs

- That the organization is tax-exempt
- Aspects of UBI
- Whether activities are exceptions from unrelated business income tax, because they:
  - are carried on largely by volunteers
  - involve selling of donated merchandise
  - are carried on for the convenience of members, students, patients
- A change in an NFP's activities over time, and the current activities bear little relation to the tax-exempt purpose
- Uncertainty in computing the amount of gross income from UBI activity, or in allocating expenses for personnel costs, occupancy, administrative expenses, etc.

Common Deficiencies

- If entity is exempt under 501(c)3, there is no description of whether it is a private foundation or a public charity
- Tax years open to examination are omitted
- Disclosure of significant UBI (or failure to consider if UBI is significant)
- Footnote omitted if there is no UBI present

Business Combinations
(Mergers and Acquisitions)

What is a merger and acquisition?

- **A merger** is a transaction in which the governing bodies of two or more nonprofit organizations cede control to create a new nonprofit organization
  - ◊ Carry-over method (book value)

- **An acquisition** is a transaction in which an organization obtains control of one or more nonprofit businesses
  - ◊ Acquisition method (fair value)

Merger Disclosures

- Name and description of each merging entity
- Merger date
- Reasons for the merger
- For each merging entity, the amounts recognized for each major class of assets, liabilities and net assets
- Nature of any adjustments made to conform accounting policies

Acquisition Disclosures

- Name and description of acquiree
- Merger date
- Reasons for the merger
- Percentage ownership
- Nature of any adjustments made to conform accounting policies
- Description of goodwill
- Value of consideration (by class)
- Any contingent consideration
- Other

Common Deficiencies

- When to record goodwill
- Entities under common control
- Open tax returns disclosure still required from previous organizations

Special Events

Required Reporting

- Guidance: ASC 958-225-55
  - Is the event ongoing and major activity?
    - ◊ If so, report revenues and expenses gross
    - ◊ If not, can report gross or net
  - Three alternatives to report direct benefit to donors:
    - ◊ Present costs of direct benefits as a line item deducted from special event gross revenues
    - ◊ Present special event gross revenues in the revenue section and costs of direct benefits to donors similar to other programs or supporting services
    - ◊ Present the contribution and exchange portions of the gross revenues separately, with the costs of direct benefits to donors deducted from the exchange portion of the gross revenue

Option 1 - Present costs of direct benefits as a line item deducted from special event gross revenues

CONTRIBUTIONS AND NET REVENUE FROM SPECIAL EVENTS		
Contributions		$500
Special event revenue	$200	
Less: Costs of direct benefits to donors	(30)	170
TOTAL CONTRIBUTIONS AND NET REVENUE FROM SPECIAL EVENTS		670
EXPENSES		
Program		100
Management and general		20
Fund-raising		45
TOTAL EXPENSES		165
INCREASE IN UNRESTRICTED NET ASSETS		$505

Option 2 - Present special event gross revenues in the revenue section and costs of direct benefits to donors similar to other programs or supporting services

REVENUE	
Contributions	$500
Special event revenue	200
TOTAL REVENUE	700
EXPENSES	
Program	100
Costs of direct benefits to donors	30
Management and general	20
Fund-raising	45
TOTAL EXPENSES	195
INCREASE IN UNRESTRICTED NET ASSETS	$505

Option 3 - Present the contribution and exchange portions of the gross revenues separately, with the costs of direct benefits to donors deducted from the exchange portion of the gross revenue

CONTRIBUTIONS AND NET REVENUE FROM SPECIAL EVENTS		
Contributions		$650
Dinner sales	$50	
Less: Costs of direct benefits to donors	(30)	20
TOTAL CONTRIBUTIONS AND NET REVENUE FROM SPECIAL EVENTS		670
EXPENSES		
Program		100
Management and general		20
Fund-raising		45
TOTAL EXPENSES		165
INCREASE IN UNRESTRICTED NET ASSETS		$505

Common Deficiencies

- Revenues and expenses are netted when they shouldn’t be
- Direct benefit amounts are not properly reported or disclosed
- Special event information is not disclosed at all!!!

Split Interest Agreements

Common Split Interest Agreements

- Charitable Lead Trust
- Charitable Remainder Trust
- Charitable Gift Annuity

Required Disclosures under ASC 958-30

- Assets and liabilities should be disclosed separately from other assets and liabilities, or in the notes to the financial statements
- Description of the agreement terms
- The basis used for recognizing assets
- Required fair value disclosures discussed previously
- The discount rates and actuarial assumptions used

Example – Charitable Lead Trust (Third-Party Trustee)

- John Smith establishes an irrevocable charitable lead annuity trust with assets of $500,000. He names Fidelity Bank as the trustee and the Hope Organization as the beneficiary. The Hope Organization will receive $25,000 each year until John Smith's death, at which point the remaining assets will become part of his estate. There are no restrictions on the annual distributions to the Hope Organization. The Hope Organization estimates the present value of amounts to be received as $230,000.

Example – Charitable Lead Trust (Third-Party Trustee)

- **Initial Recording**
  - Beneficial Interest in Lead Trust $230,000
  - Contribution Revenue (Temp Rest.) $230,000

- **Receipt of Distributions**
  - Cash $25,000
  - Beneficial Interest in Lead Trust $25,000

  - Temporarily Restricted Net Assets $25,000
  - Net Assets Released from Restrictions $25,000

Example – Charitable Lead Trust (Third-Party Trustee) (Continued)

- **Remeasuring Fair Value or Future Distributions**
  - Beneficial Interest in Lead Trust $17,000
  - Change in Value of SIA (Temp Rest.) $17,000

- **Termination of Agreement**
  - Change in Value of SIA (Temp Rest.) $31,000
  - Beneficial Interest in Lead Trust $31,000

Common Deficiencies

- Beneficial interest is not properly recorded when entity is not the trustee:
  - Amount not recorded net of estimated liability
  - Amount not recorded at all (organization is not aware of gift)
- Amounts are not recorded at fair value each period
- Discount rate used to calculate the present value amounts

Thank You!

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