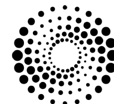
NPGT17

CHECKPOINT LEARNING®

SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

Companion to PPC's Guide to

Nonprofit GAAP



THOMSON REUTERS™

(800) 231-1860
cl.thomsonreuters.com

© 2017 Thomson Reuters/Tax & Accounting. Thomson Reuters, Checkpoint, PPC, and the Kinesis logo are trademarks of Thomson Reuters and its affiliated companies.

This material, or parts thereof, may not be reproduced in another document or manuscript in any form without the permission of the publisher.

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional service. If legal advice or other expert assistance is required, the services of a competent professional person should be sought.—*From a Declaration of Principles jointly adopted by a Committee of the American Bar Association and a Committee of Publishers and Associations.*

The following are registered trademarks filed with the United States Patent and Trademark Office:

Checkpoint® Tools
PPC's *Practice Aids*™
PPC's *Workpapers*™
PPC's *Engagement Letter Generator*®
PPC's *Interactive Disclosure Libraries*™
PPC's *SMART Practice Aids*®
Engagement CS™

Checkpoint Learning is registered with the National Association of State Boards of Accountancy (NASBA) as a sponsor of continuing professional education on the National Registry of CPE Sponsors. State boards of accountancy have final authority on the acceptance of individual courses for CPE credit. Complaints regarding registered sponsors may be submitted to the National Registry of CPE Sponsors through its website: **www.nasbaregistry.org**.

Checkpoint Learning is also approved for "QAS Self Study" designation.

Registration Numbers:
Texas: 001615
New York: 001076
NASBA Registry: 103166
IRS Approved Provider: 0YC0C

Interactive Self-study CPE

Companion to PPC's Guide to Nonprofit GAAP

TABLE OF CONTENTS

	Page
COURSE 1: SELECTED TOPICS SPECIFIC TO NONPROFIT ORGANIZATIONS	
Overview	1
Lesson 1: Fund Accounting	3
Lesson 2: Debt and Equity Securities Investments	11
Lesson 3: Equity Method and Joint Ventures Investments	21
Lesson 4: Other Investments	31
Lesson 5: Related Entities	43
Lesson 6: Split-interest Agreements	57
Examination for CPE Credit	79
Glossary	91
Index	93
COURSE 2: SELECTED TOPICS SPECIFIC TO NONPROFIT ORGANIZATIONS	
Overview	95
Lesson 1: Asset Retirement and Environmental Obligations	97
Lesson 2: Commitments and Contingencies	105
Lesson 3: Debt	119
Lesson 4: Derivatives and Hedging	141
Lesson 5: Exit or Disposal Cost Obligations and Guarantees	161
Lesson 6: Inventory	169
Lesson 7: Receivables—Other	179
Lesson 8: Transfers of Financial Assets	189
Examination for CPE Credit	201
Glossary	211
Index	215

ANSWER SHEETS AND EVALUATIONS

Course 1: Examination for CPE Credit Answer Sheet 217
Course 1: Self-study Course Evaluation 218
Course 2: Examination for CPE Credit Answer Sheet 219
Course 2: Self-study Course Evaluation 220

INTRODUCTION

Companion to PPC's Guide to Nonprofit GAAP consists of two interactive self-study CPE courses. These are companion courses to *PPC's Guide to Nonprofit GAAP* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **cl.thomsonreuters.com/ogs** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **December 31, 2018**. Complete instructions for grading are included below and in the Test Instructions preceding the Examination for CPE Credit.

Taking the Courses

Each course is divided into lessons. Each lesson addresses an aspect of nonprofit GAAP. You are asked to read the material and, during the course, to test your comprehension of each of the learning objectives by answering self-study quiz questions. After completing each quiz, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the reason for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied that you understand the material, **answer the examination questions at the end of the course**. You may record your answer choices by printing the **Examination for CPE Credit Answer Sheet** or by logging on to our Online Grading System.

Qualifying Credit Hours—NASBA Registry (QAS Self-Study)

Checkpoint Learning is registered with the National Association of State Boards of Accountancy (NASBA) as a sponsor of continuing education on the National Registry of CPE Sponsors. State boards of accountancy have final authority on the acceptance of individual courses for CPE credit. Complaints regarding registered sponsors may be submitted to the National Registry of CPE Sponsors through its website: **www.nasbaregistry.org**.

Checkpoint Learning is also approved for "QAS Self Study" designation.

The requirements for NASBA Registry membership include conformance with the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. Each course is designed to comply with the *Standards*. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*. Credit hours for CPE courses vary in length. Credit hours for each course are listed on the **Overview** page before each course.

CPE requirements are established by each state. You should check with your state board of accountancy to determine the acceptability of this course. We have been informed by the North Carolina State Board of Certified Public Accountant Examiners and the Mississippi State Board of Public Accountancy that they will not allow credit for courses included in books or periodicals.

Obtaining CPE Credit

Online Grading. Log onto our Online Grading Center at **cl.thomsonreuters.com/ogs** to receive instant CPE credit. Click the purchase link and a list of exams will appear. You may search for the exam using wildcards. Payment for the exam of $89 is accepted over a secure site using your credit card. For further instructions regarding the Online Grading Center, please refer to the Test Instructions preceding the **Examination for CPE Credit**. A certificate documenting the CPE credits will be issued for each examination score of 70% or higher.

Print Grading. You can receive CPE credit by emailing, mailing, or faxing your completed **Examination for CPE Credit Answer Sheet** to Thomson Reuters (Tax & Accounting) Inc. for grading. Answer sheets are located at the end of the course PDFs. They may be printed from electronic products; they can also be scanned for email grading, if desired. The answer sheet is identified with the course acronym. Please ensure you use the correct answer sheet

for each course. Payment (by check or credit card) must accompany each answer sheet submitted. We cannot process answer sheets that do not include payment. Payment for emailed or faxed answer sheets is $89. There is an additional $10 charge for manual print grading, so please include a total of $99 with answer sheets sent by regular mail. Please take a few minutes to complete the **Self-study Course Evaluation** so that we can provide you with the best possible CPE.

You may fax your completed **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation** to **(888) 286-9070** or email them to *CPLGrading@thomsonreuters.com*. The mailing address is provided on the Overview and Exam Instructions pages.

If more than one person wants to complete this self-study course, each person should complete a separate **Examination for CPE Credit Answer Sheet.** Payment must accompany each answer sheet submitted ($89 when sent by email or fax; $99 when sent by regular mail). We would also appreciate a separate **Self-study Course Evaluation** from each person who completes an examination.

Retaining CPE Records

For all scores of 70% or higher, you will receive a *Certificate of Completion.* You should retain it and a copy of these materials for at least five years.

COMPANION TO PPC'S GUIDE TO NONPROFIT GAAP

COURSE 1

SELECTED TOPICS SPECIFIC TO NONPROFIT ORGANIZATIONS (NPGTG171)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course takes a look at generally accepted principles (GAAP) for topics related specifically to nonprofit organizations. Lesson 1 discusses the use of fund accounting to track compliance with fiduciary responsibilities to use assets in accordance with donor-imposed restrictions, legal and contractual limitations, and internal designations. Lesson 2 takes a look at how debt securities and equity securities with determinable fair values should be measured. Lesson 3 covers how the equity method is used to account for investments in common and in-substance stock. Lesson 4 provides guidance on accounting for other investments and investments in insurance contracts. Lesson 5 discusses how nonprofit organizations can hold ownership interests in for-profit entities or be related to other nonprofit entities. Lastly, lesson 6 covers how split-interest agreement contributions are shared by nonprofit organizations and other beneficiaries.
PUBLICATION/REVISION DATE:	December 2017
RECOMMENDED FOR:	Users of *PPC's Guide to Nonprofit GAAP*
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of accounting for nonprofit entities
CPE CREDIT:	6 NASBA Registry "QAS Self-Study" Hours This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*.
FIELD OF STUDY:	Accounting
EXPIRATION DATE:	Postmark by **December 31, 2018**
KNOWLEDGE LEVEL:	Basic

Learning Objectives:

Lesson 1—Fund Accounting

Completion of this lesson will enable you to:

- Determine how organizations use fund accounting to track compliance with fiduciary responsibilities to use assets in accordance with donor-imposed restrictions, legal and contractual limitations, and internal designations.

Lesson 2—Debt and Equity Securities Investments

Completion of this lesson will enable you to:

- Identify how debt securities and equity securities with determinable fair values are measured.

Lesson 3—Equity Method and Joint Ventures Investments

Completion of this lesson will enable you to:

- Determine how the equity method is used to account for investments in common and in-substance stock.

Lesson 4—Other Investments

Completion of this lesson will enable you to:

- Identify the guidance used for accounting for investments and investments in insurance contracts.

Lesson 5—Related Entities

Completion of this lesson will enable you to:

- Determine how nonprofit organizations can hold ownership interests in for-profit entities or be related to other nonprofit entities.

Lesson 6—Split-interest Agreements

Completion of this lesson will enable you to:

- Recognize how split-interest agreement contributions are shared by nonprofit organizations and other beneficiaries.

TO COMPLETE THIS LEARNING PROCESS:

Log onto our Online Grading Center at **cl.thomsonreuters.com/ogs.** Online grading allows you to get instant CPE credit for your exam.

Alternatively, you can submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

- Email to: *CPLGrading@thomsonreuters.com*
- Fax to: **(888) 286-9070**
- Mail to:

Thomson Reuters
Tax & Accounting—Checkpoint Learning
NPGTG171 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

See the test instructions included with the course materials for additional instructions and payment information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 431-9025 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Fund Accounting

INTRODUCTION

Although GAAP for nonprofit organizations focuses on the entity as a whole, it does not preclude the use of fund accounting for internal recordkeeping. Some organizations choose to use fund accounting to track compliance with fiduciary responsibilities to use assets in accordance with donor-imposed restrictions, legal and contractual limitations, and internal designations. While the financial reporting model in GAAP also focuses on an organization's fiduciary responsibilities, it is based on net assets and reflects only donor-imposed restrictions in its classification of net assets, and it requires the organization to focus on aggregate information about the entity as a whole, rather than on individual funds, for external financial reporting. An organization may disclose disaggregated data classified by fund groups in its external financial reports as long as the information required by GAAP is presented.

Interfund receivables and payables should be labeled and arranged to eliminate those amounts when displaying total assets and liabilities on the statement of financial position.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine how organizations use fund accounting to track compliance with fiduciary responsibilities to use assets in accordance with donor-imposed restrictions, legal and contractual limitations, and internal designations.

ACCOUNTING REQUIREMENTS

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. Each fund consists of a self-balancing set of asset, liability, and fund balance accounts.

Disaggregated reporting by fund groups is not a necessary part of external reporting, but GAAP does not preclude it. GAAP establishes a financial reporting model for nonprofit organizations that focuses on the entity as a whole, with net assets classified solely on the presence or absence of donor-imposed restrictions. Fund accounting is not prohibited for external reporting, however, as long as organizations conform with the net assets reporting model. Therefore, if fund accounting is presented, fund balances should be reported on the statement of financial position based on the absence or existence of donor-imposed restrictions. In addition, because GAAP reporting focuses on the organization as a whole, interfund receivables and payables should eliminate when total assets and liabilities are displayed on the statement of financial position.

Some of the common funds used by nonprofit organizations include the following:

- *Unrestricted current (operating or general) funds*, which are used to record activities supported by resources over which the organization board has discretionary control

- *Restricted current funds*, which are used to record activities supported by resources limited by external parties to specific operating purposes

- *Plant fund*, which is used to record property and equipment and resources held to acquire them

- *Loan funds*, which are used to account for loans made to students, employees, or other constituents, and resources available to make loans

- *Endowment funds*, which are used to account for assets held to provide income for the maintenance of the organization and may include endowments, term endowments, and quasi-endowments

- *Annuity and life-income (split-interest) funds*, which are used to account for resources provided by donors when the organization has a beneficial interest but is not the sole beneficiary

- *Agency or custodian funds*, which are used to account for resources held by the organization on behalf of others

If an organization uses fund accounting for external reporting, each of its fund balances must be allocated between the appropriate net asset classes to report the total amounts for each of the classes of net assets required by GAAP.

Presentation of Fund Balances Before the Effective Date of ASU 2016-14

Organizations should analyze the composition of each fund balance and determine whether any amounts have been restricted by donors or by law. All amounts except those existing as a result of donor-imposed restrictions or by law represent *unrestricted net assets*.

Some fund balances may represent more than one net asset class. For example:

a. *Current restricted funds* may include a combination of donor-restricted contributions and grants, contracts, and appropriations that represent exchange transactions with limitations on the use of the funds. If so, only the fund balance amount subject to donor-imposed restrictions should be classified as temporarily restricted. Restricted current fund balances subject only to legal restrictions imposed by an entity other than the donor are unrestricted.

b. A *plant fund* might be comprised of several individual components, such as (1) unexpended plant funds, (2) renewals and replacement funds, (3) retirement of indebtedness funds, and (4) investment-in-plant funds. The funds may or may not have donor-imposed restrictions associated with them.

   Resources that have not yet been used to acquire, renew, and replace plant and equipment are *unexpended plant fund balances* and *renewals and replacement fund balances*. Resources held to service debt related to the acquisition or construction of plant and equipment are *retirement-of-indebtedness fund balances*. Depending on the nature of the restrictions, the portion of these fund balances that represents amounts received with donor-imposed restrictions that have not yet been met are classified as temporarily restricted or permanently restricted net assets. Other fund balances, including those designated by the organization's governing board from unrestricted resources for the purchase, construction, renewal, or replacement of property and equipment are classified as unrestricted net assets, as are fund balances that arise under bond indentures.

   Assets invested in property and equipment, less any liabilities related to those assets, represent *investment-in-plant fund balances*. These funds are classified as permanently restricted net assets to the extent that (1) donors have imposed restrictions on the assets' use that neither expire by the passage of time nor can be fulfilled or removed by actions of the organization (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. However, funds that represent property and equipment acquired with unrestricted resources or with resources whose use is limited by parties other than donors are classified as unrestricted net assets.

c. *Loan funds* might include multiple net asset classes, depending on donor restrictions. For example, in a revolving loan fund, the portion of the fund balance restricted by donors in perpetuity for use in making loans should be classified as permanently restricted. In loan funds that make loans on a one-time, rather than revolving, basis, the portion of the loan funds that is subject only to donor-imposed restrictions that expire should be classified as temporarily restricted until the loans are made. The portion of loan funds that may be used for the unrestricted purposes of the organization, if any, is classified as unrestricted net assets. Board-designated loan funds and other amounts used for loans that have not been restricted by donors are classified as unrestricted net assets. Also, if a portion of a loan fund balance represents refundable advances (for example, as required under a government loan program), that amount is reported as a liability, not as net assets.

d. *Endowment fund* balances also might include multiple net asset classes. Term endowments, based on their nature, generally represent temporarily restricted net assets, while permanent endowments normally represent permanently restricted net assets.

Quasi endowments, also called funds functioning as endowments, are board-designated resources to be held and invested for specified purposes for a long but unspecified period of time. These fund balances are classified as unrestricted net assets if they were created from unrestricted net assets and as temporarily restricted net assets if they were created from temporarily restricted resources and the restrictions are not yet met.

Exhibit 1-1 presents an Illustrative statement of financial position for an organization using fund accounting for external reporting. If an organization uses a similar columnar fund format for the statement of activities, the statement must present the change in net assets for each of the three net asset classifications (unrestricted, temporarily restricted, and permanently restricted).

PRESENTATION OF FUND BALANCES AFTER THE EFFECTIVE DATE OF ASU 2016-14

Organizations should analyze the composition of each fund balance and determine whether any amounts have been restricted by donors or by law. Some fund balances may represent more than one net asset class. Exhibit 1-2 presents an illustrative statement of financial position for an organization using fund accounting for external reporting. If an organization uses a similar columnar fund format for the statement of activities, the statement must present the change in net assets for each class of net assets.

Exhibit 1-1 presents an illustrative statement of financial position for an organization using fund accounting for external reporting. If an organization uses a similar columnar fund format for the statement of activities, the statement must present the change in net assets for each of the three net asset classifications (unrestricted, temporarily restricted, and permanently restricted).

Exhibit 1-1

Illustrative Net Asset Presentation When an Organization Uses Fund Accounting for External Reporting Before the Effective Date of ASU 2016-14

Assumptions:

- The organization's current unrestricted fund balance at December 31, 20X1 was $50,000.
- The $45,000 current restricted fund balance at December 31, 20X1, was comprised of restricted donor contributions of $25,000 and government grant funds from exchange transactions of $20,000.
- Of the total $55,000 plant fund balance at December 31, 20X1, $25,000 represented donated land required to be held in perpetuity by the organization, and $14,000 represented donor funds restricted for future property purchases.
- The $266,000 endowment fund at December 31, 20X1, consisted of a $2,000 term endowment, a board-designated quasi-endowment of $19,000, and permanent endowment funds of $245,000.

Statement of Financial Position at December 31, 20X1:

	Current Unrestricted	Current Restricted	Plant	Endowment	Total
ASSETS					
Cash and equivalents	$ 6,000	$ —	$ —	$ —	$ 6,000
Accounts receivable	31,000	20,000			51,000
Contributions receivable	24,000	4,000			28,000
Investments, short-term	12,000	28,000			40,000
Interfund receivables/payables	7,000	(7,000)			—
Assets restricted to purchase equipment			14,000		14,000
Investments, long-term				21,000	21,000
Property and equipment			41,000		41,000
Assets restricted for permanent endowment				245,000	245,000
TOTAL ASSETS	$ 80,000	$ 45,000	$ 55,000	$ 266,000	$ 446,000
LIABILITIES					
Accounts payable	$ 17,000	$ —	$ —	$ —	$ 17,000
Compensation	13,000				13,000
TOTAL LIABILITIES	30,000	—	—	—	30,000
NET ASSETS					
Unrestricted	50,000	20,000	16,000	19,000	105,000
Temporarily restricted	—	25,000	14,000	2,000	41,000
Permanently restricted	—	—	25,000	245,000	270,000
TOTAL NET ASSETS	50,000	45,000	55,000	266,000	416,000
TOTAL LIABILITIES AND NET ASSETS	$ 80,000	$ 45,000	$ 55,000	$ 266,000	$ 446,000

*   *   *

Exhibit 1-2

Illustrative Net Asset Presentation When an Organization Uses Fund Accounting for External Reporting After the Effective Date of ASU 2016-14

Assumptions:

- The organization's current unrestricted fund balance at December 31, 20X1 was $50,000.
- The $45,000 current restricted fund balance at December 31, 20X1, was comprised of restricted donor contributions of $25,000 and government grant funds from exchange transactions of $20,000.
- Of the total $55,000 plant fund balance at December 31, 20X1, $25,000 represented donated land required to be held in perpetuity by the organization, and $14,000 represented donor funds restricted for future property purchases.
- The $266,000 endowment fund at December 31, 20X1, consisted of a $2,000 term endowment, a board-designated quasi-endowment of $19,000, and donor-restricted endowment funds that are perpetual in nature of $245,000.

Statement of Financial Position at December 31, 20X1:

	Current Unre- stricted	Current Restricted	Plant	Endowmen t	Total
ASSETS					
Cash and equivalents	$ 6,000	$ —	$ —	$ —	$ 6,000
Accounts receivable	31,000	20,000			51,000
Contributions receivable	24,000	4,000			28,000
Investments, short-term	12,000	28,000			40,000
Interfund receivables/payables	7,000	(7,000)			—
Assets restricted to purchase equip- ment			14,000		14,000
Investments, long-term				21,000	21,000
Property and equipment			41,000		41,000
Assets restricted for donor-restricted endowment				245,000	245,000
TOTAL ASSETS	$ 80,000	$ 45,000	$ 55,000	$ 266,000	$ 446,000
LIABILITIES					
Accounts payable	$ 17,000	$ —	$ —	$ —	$ 17,000
Compensation	13,000				13,000
TOTAL LIABILITIES	30,000	—	—	—	30,000
NET ASSETS					
Without donor restrictions	50,000	20,000	16,000	19,000	105,000
With donor restrictions	—	25,000	39,000	247,000	311,000
TOTAL NET ASSETS	50,000	45,000	55,000	266,000	416,000
TOTAL LIABILITIES AND NET ASSETS	$ 80,000	$ 45,000	$ 55,000	$ 266,000	$ 446,000

* * *

DISCLOSURE REQUIREMENTS

A nonprofit organization that uses fund accounting for external reporting purposes should clearly identify and arrange interfund receivables and payables in the statement of financial position so that their amounts eliminate when total assets and liabilities are displayed.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Which of the following type of funds records the activities that support resources limited by external parties to certain operating purposes?

    a. Endowment funds.

    b. Restricted current funds.

    c. Loan funds.

2. Which of the following statements regarding fund balances that represent multiple asset classes is correct?

    a. Assets invested in equipment and property; minus any liabilities that relate to those assets represent unexpended plant fund balances.

    b. Restricted current fund balances that are subject only to legal restrictions imposed by an entity other than the donor are considered restricted.

    c. Funds are classified as unrestricted net assets when they represent equipment and property acquired with unrestricted resources.

    d. Renewals and replacement funds are a component of agency funds.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Which of the following type of funds records the activities that support resources limited by external parties to certain operating purposes? **(Page 3)**

   a. Endowment funds. [This answer is incorrect. Endowment funds are used to account for assets held to provide income for the maintenance of the organization and may include endowments, term endowments, and quasi-endowments.]

   b. Restricted current funds. [This answer is correct. Restricted current funds are used to record activities supported by resources limited by external parties to specific operating purposes as stated in the Audit Guide, paras. 1606–.24.]

   c. Loan funds. [This answer is incorrect. Loan funds are used to account for loans made to students, employees, or other constituents, and resources available to make loans.]

2. Which of the following statements regarding fund balances that represent multiple asset classes is correct? **(Page 4)**

   a. Assets invested in equipment and property; minus any liabilities that relate to those assets represent unexpended plant fund balances. [This answer is incorrect. Assets invested in property and equipment, less any liabilities related to those assets, represent investment-in-plant fund balances.]

   b. Restricted current fund balances that are subject only to legal restrictions imposed by an entity other than the donor are considered restricted. [This answer is incorrect. Restricted current fund balances subject only to legal restrictions imposed by an entity other than the donor are unrestricted.]

   c. Funds are classified as unrestricted net assets when they represent equipment and property acquired with unrestricted resources. [This answer is correct. Funds that represent property and equipment acquired with unrestricted resources or with resources whose use is limited by parties other than donors are classified as unrestricted net assets.]

   d. Renewals and replacement funds are a component of agency funds. [This answer is incorrect. A plant fund might be comprised of several individual components, such as (1) unexpended plant funds, (2) renewals and replacement funds, (3) retirement of indebtedness funds, and (4) investment-in-plant funds.]

Lesson 2: Debt and Equity Securities Investments

INTRODUCTION

Before the effective date of ASU 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, investments in debt securities and equity securities with readily determinable fair values should be measured at fair value upon acquisition if contributed or at cost if purchased. Such investments are reported at fair value in subsequent periods. After the effective date of ASU 2016-01, equity securities that have readily determinable fair value will continue to be reported at fair value, except for those accounted for under the equity method of accounting or those that result in consolidation of the investee. The standards for those investments, however, will move from FASB ASC 958-320 to FASB ASC 958-321. In addition, ASU 2016-01 provides an alternative to fair value measurement for investments in equity securities that do not have readily determinable fair values.

Gains, losses, dividends, interest, and other investment income generally should be reported on the statement of activities as increases or decreases in the appropriate class of net assets based on the existence or absence of donor restrictions.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify how debt securities and equity securities with determinable fair values are measured.

ACCOUNTING REQUIREMENTS

SOURCE: FASB ASC 958-320

Nonprofit organizations may hold a variety of assets as investments including equity and debt securities; interests in partnerships or joint ventures; and other property. This lesson presents the guidance that applies to all investments in debt securities and investments in equity securities that have readily determinable fair values before the effective date of ASU 2016-01. The lesson also presents the amended guidance that applies to all investments in debt securities and equity securities after the effective date of ASU 2016-01.

Debt and Equity Securities Before the Effective Date of ASU 2016-01

Investments in equity securities with readily determinable fair values and debt securities initially should be reported at acquisition cost (net of brokerage and other transaction fees) if purchased or fair value if received by contribution or by agency transaction.

Equity securities have readily determinable fair values if they meet one of the following criteria:

a. Sales prices or bid-and-asked quotations are currently available on a Securities and Exchange Commission (SEC) registered securities exchange or in the over-the-counter market, provided the over-the-counter market prices are publicly reported by the National Association of Securities Dealers Automated Quotations systems or by OTC Markets Group Inc. (Restricted stock does not meet this criterion unless the restriction terminates within a year.)

b. If traded only on a foreign market, the market is of a breadth and scope comparable to one of the U.S. markets referred to in a.

c. If the investment is in a mutual fund, the investment's fair value per share or unit is determined, published, and used as the basis for current transactions.

At each reporting period, nonprofit organizations should report investments in debt and equity securities at fair value in the statement of financial position. A security's fair value is the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date. Quoted prices in active markets provide the most reliable evidence of fair value and should generally be used to measure fair value whenever available.

Pooling of Investments

Investments need not be invested and managed separately based on the absence or existence of donor-imposed restrictions. Many nonprofit organizations pool a portion or all of their investments for greater flexibility in managing their portfolios. The implementation guidance illustrated beginning at FASB ASC 958-320-55-4 includes investments that are held in an investment pool.

Investment Income, Gains and Losses Before the Effective Date of ASU 2016-14

Investment income, such as dividends, interest, and royalties, should be recognized as it is earned and generally should be reported as an increase in unrestricted net assets. If a donor has placed temporary restrictions on the use of investment income, however, the income should be recorded as an increase in temporarily restricted net assets. Likewise, if permanent restrictions on the use of investment income have been imposed, investment income should be reported as an increase in permanently restricted net assets.

Investment gains and losses can be unrealized or realized.

Unless explicitly restricted by donor stipulation or by law, realized and unrealized gains and losses on debt and equity investments generally should be reported in the statement of activities as increases or decreases in unrestricted net assets. If temporary donor restrictions are imposed on an asset's use, however, investment gains and losses should be recorded as increases or decreases in temporarily restricted net assets. Similarly, if the asset's use is permanently restricted, related gains and losses should be reported as increases or decreases in permanently restricted net assets. Realized and unrealized losses on investments may be netted against realized and unrealized gains on the statement of activities.

Donor-restricted investment income and gains whose restrictions are met in the same reporting period may be reported as unrestricted if the organization (a) reports consistently from period to period, (b) follows the same policy for reporting donor-restricted contributions, and (c) discloses its accounting policy.

Investment Revenue Recorded on a Total Return Basis. Some nonprofit organizations determine spendable amounts of endowment revenue based on a total return formula. Total return is a concept that focuses on the overall return on investments and includes both investment income and net appreciation. The total return formula calculates a spending rate that represents the percentage of the invested assets available to fund current operations. GAAP defines *spending rate* as the portion of the total return on investments used in the current period, usually as a budgetary method of reporting investment return. Organizations using a total return spending rate may segregate their unrestricted investment return into operating and nonoperating amounts, and present the operating portion (computed using the spending rate) as operating investment income on the face of the statement of activities or in the notes to the financial statements.

Gains and Losses from Donor-restricted Endowment Funds. A *donor-restricted endowment fund* is created when a donor stipulates that the contributed assets be invested for a specific period of time or in perpetuity. Because restricted net assets result only from a donor's stipulation, gains and losses on donor-restricted endowment funds should be reported as changes in unrestricted net assets unless restricted by explicit donor stipulations or by a law that extends the donor's asset restrictions to the gains and losses. In that event, they should be classified as increases or decreases in temporarily restricted or permanently restricted net assets depending on the nature of the restrictions. For example, if a donor contributes a specific investment security and requires that it be held in perpetuity, gains and losses on the security are subject to the same permanent restriction unless the donor explicitly states otherwise. On the other hand, if the donor allows the organization to choose suitable investment vehicles, gains should not be classified as permanently restricted unless otherwise explicitly restricted by the donor or by law. Instead, those gains should be classified as unrestricted if investment income is unrestricted, or temporarily restricted if investment income is temporarily restricted by the donor or by law.

In states that have enacted a version of the Uniform Prudent Management of Institutional Funds Act (UPMIFA), the donor's restriction extends to the net appreciation on the endowment fund because the governing board must consider the duration and preservation of the fund when determining the amount of the fund that must be retained permanently. Thus, in the absence of explicit stipulations, the portion of a donor-restricted endowment fund that is not permanently restricted by the donor or by the board, consistent with the relevant law, should be classified as temporarily restricted net assets (time restricted) until appropriated for expenditure by the governing board.

Unless donor stipulations or law require otherwise, net losses on investments held in donor-restricted endowment funds should first reduce (a) net gains from that fund earned in prior periods and held in temporarily restricted net assets and (b) temporarily restricted income earned by the investments in the donor-restricted endowment fund for which donor restrictions have not been met. Any loss in excess of those amounts should be recorded as a decrease in unrestricted net assets. Subsequent gains should be reported as increases in unrestricted net assets to the extent losses were charged to unrestricted net assets.

Investment Expenses Before the Effective Date of ASU 2016-14

Investment expenses consist of custodial fees and internal and external investment advisory costs. They may be netted against related investment income, gains, or losses on the statement of activities provided they are disclosed on the statement of activities or in the notes to the financial statements. If the organization presents a statement of functional expenses, investment expenses netted against investment revenue should be reported by their functional classification.

Investment Income, Expenses, Gains and Losses After the Effective Date of ASU 2016-14

Recognized gains and losses on investments, and dividends, interest, and other investment income should be reported as increases or decreases in net assets without donor restrictions unless their use is limited by donor-imposed restrictions or by law that extends donor restrictions. For example, net investment gains are reported as increases in net assets without donor restrictions unless the donor (or a law that extends donor restrictions) restricts their use to a specific purpose or future period.

Donor-restricted investment income and gains whose restrictions are met in the same reporting period may be reported as increases in net assets without donor restrictions if the organization (a) reports consistently from period to period, (b) follows the same policy for reporting donor-restricted contributions, and (c) discloses its accounting policy.

Investment return related to total return investing (and not programmatic investing) is reported net of external and direct internal investment expenses. Direct internal investment expenses relate to the direct conduct or supervision of the strategic and tactical activities for generating investment return. Such expenses include costs associated with generating investment return; e.g., the salaries and benefits for management and staff who are responsible for the development and execution of the investment strategy, and related allocable costs.

Investment Returns from Donor-restricted Endowment Funds. A *donor-restricted endowment fund* is created when a donor stipulates that the contributed assets be invested for a specific period of time or in perpetuity. Donors can include entities that make grants. Donors or laws may require that a portion of income, gains, or both be added to the donor's gift and invested in accordance with restrictions. Donor-restricted endowment funds do not include board-designated endowment funds.

The original gift that establishes a donor-restricted endowment fund, additional gifts, and investment returns generated by the assets in the fund are initially classified with net assets with donor restrictions. In general, those assets are donor-restricted until they are appropriated for expenditure, in accordance with any donor stipulations, by the governing board of the nonprofit organization.

Debt and Equity Securities After the Effective Date of ASU 2016-01

In January 2016, the FASB issued ASU 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities,* which intended to improve GAAP by enhancing the reporting model for financial instruments to provide financial statement users with more decision-useful information. The amendments in ASU 2016-01 primarily affect the accounting for investments in equity securities and certain presentation and disclosure requirements. The following paragraphs provide an overview of those changes. (ASU 2016-01 also amends the guidance for the presentation of the change in fair value of a liability that is measured in accordance with the fair value option, and clarifies the guidance for valuation allowances on certain deferred tax assets.)

For nonprofit organizations, ASU 2016-01 is effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019.

Investments in Debt Securities

ASU 2016-01 amends FASB ASC 320 and FASB ASC 958-320 to remove the guidance related to investments in equity securities from those parts of the FASB ASC. As revised, FASB ASC 320 and FASB 958-320 apply only to investments in debt securities. For nonprofit organizations, ASU 2016-01 does not significantly change the recognition and measurement requirements for investments in debt securities. Accordingly—

- Investments in debt securities initially should be reported at acquisition cost (net of brokerage and other transaction fees) if purchased or fair value if received by contribution or by agency transaction.

- At each reporting period, nonprofit organizations should report investments in debt securities at fair value in the statement of financial position.

The guidance for reporting gains, losses, and income from investments in debt securities in FASB ASC 958-320 is superseded by ASU 2016-01; instead, that guidance is found in FASB ASC 958-225-45-18 through 45-26.

Investments in Equity Securities

ASU 2016-01 creates a new topic at FASB ASC 321, *Investments—Equity Securities*, for the recognition, measurement, and disclosure guidance for investments in equity securities by all entities. A new subtopic at FASB ASC 958-321 provides nonprofit organizations with incremental guidance for applying that accounting and reporting guidance for equity securities. FASB ASC 958-321-15-2 states the measurement guidance applies to all investments in equity securities and other ownership interests (if in equity securities) such as investments in partnerships, unincorporated joint ventures, and limited liability companies. However, FASB ASC 958-321 does not apply to consolidated investments, investments accounted for under the equity method, investments in derivative instruments, investments held by a financially interrelated entity, and short sales of securities.

All investments in equity securities initially should be reported at acquisition cost (net of brokerage and other transaction fees) if purchased or fair value if received by contribution or by agency transaction. Such investments should be reported at fair value in subsequent reporting periods. Unrealized gains and losses from holding equity securities generally should be reported in the statement of activities. However, if the nonprofit organization is acting as an agent, realized and unrealized gains and losses related to investments in equity securities should be reported as agency transactions.

Measurement Alternative for Equity Securities without Readily Determinable Fair Values. An alternative to fair value measurement is provided for investments in equity securities that do not have readily determinable fair values. Those investments may be recorded at cost, adjusted for observable price changes and any subsequent impairment. However, the alternative is not available for equity investments that qualify for the *net asset value* practical expedient.

If the measurement alternative is elected, the carrying value of investments in equity securities without readily determinable fair values should be adjusted whenever there are observable price changes. Observable price changes that are relevant for that purpose include only price changes in orderly transactions for the identical or similar instrument of the same issuer. A reasonable effort should be made to identify price changes that are known or can be known. When determining whether a security of the same issuer is similar, differences in rights and obligations of the security, such as voting rights, conversion rights, and distribution rights and preferences need to be considered. The observable price of a similar security should be adjusted for the different rights and obligations to determine the upward or downward observable price adjustment.

The measurement alternative is elected separately for each equity investment without a readily determinable fair value. Once elected, it should be applied consistently to that investment unless it ceases to qualify for the measurement alternative. Each reporting period, the nonprofit organization should re-evaluate whether the equity investment continues to qualify for the measurement alternative. If a readily determinable fair value becomes available for an equity investment (for example, as a result of an initial public offering), the measurement alternative is no longer permitted, and the investment should be measured at fair value.

Impairment of Equity Securities without Readily Determinable Fair Values. Investments in equity securities without readily determinable fair values that are reported using the measurement alternative discussed earlier must be tested for impairment. GAAP provides a one-step impairment test. Under the one-step test, a qualitative assessment to identify impairment is performed each reporting period. The qualitative assessment considers indicators such as the following:

- Significant deterioration in the investee's credit rating, asset quality, earnings performance, or business prospects.
- Significant adverse change in the investee's technological, economic, or regulatory environment.
- Significant adverse change in the general market condition of the industry or geographical area in which the investee operates.
- A bona fide offer to purchase, an offer by the investee to sell, or an agreed-upon sale price for the same or similar investment that is less than the carrying amount of the investment.
- Factors that raise significant doubt about the investee's ability to continue as a going concern, such as working capital deficiencies, negative cash flows from operations, or noncompliance with debt covenants or capital requirements.

If the qualitative assessment indicates that impairment exists, the fair value of the investment is estimated and the difference between the fair value and the carrying amount is recognized in the statement of activities.

Presentation and Disclosure

Under existing GAAP, nonprofit organizations are required to disclose the fair value of financial instruments when:

- Total assets exceed $100 million, or
- The entity has financial instruments accounted for as derivatives (with certain exceptions).

ASU 2016-01 exempts all nonpublic entities from that disclosure requirement.

A new presentation requirement has been added that requires financial assets and financial liabilities to be presented separately on the face of the statement of financial position or in the notes to the financial statements, grouped by measurement category and type of financial asset.

When an organization elects to report investments in equity securities without readily determinable fair values using the measurement alternative discussed earlier, the following disclosures are required:

- Carrying value.
- The amount of impairment and downward adjustments for observable price changes, both annual and cumulative.
- The amount of upward adjustments for observable price changes, both annual and cumulative.
- Additional information to enable financial statement users to understand the preceding quantitative disclosures and the information considered in determining carrying amounts and upward or downward adjustments for observable price changes.

Early Adoption and Transition

Nonprofit organizations may elect to adopt the guidance in ASU 2016-01 in fiscal years (and interim periods within those fiscal years) beginning after December 15, 2017. In addition, the provision exempting nonprofit organizations from the requirement to disclose the fair values of financial instruments may be adopted immediately in any financial statements of fiscal years and interim periods that have not yet been made available for issuance.

Most of the new guidance in ASU 2016-01 should be applied by means of a cumulative effect adjustment to beginning net assets in the period of adoption. However, changes to the accounting for investments in equity securities without readily determinable fair values should be applied prospectively.

In the period of adoption, the following disclosures for a change in accounting principle are required:

- The nature of and reason for the change in accounting principle, and an explanation of the principle.
- Method of applying the change.
- Material effects on specific line items in the statement of financial position (excluding subtotals) at the beginning of the period of adoption.
- Cumulative effect of the change to net assets at the beginning of the period of adoption.

DISCLOSURE REQUIREMENTS

Nonprofit organizations should disclose the following information related to equity investments with readily determinable fair values and all investments in debt securities:

a. For each statement of financial position presented, the aggregate carrying value of each major investments type.

b. For the most recent statement of financial position presented, the nature of and carrying value for each investment or group of investments that represents a significant concentration of market risk.

c. Before the adoption of ASU 2016-14, for each statement of activities presented:

   (1) Information about the components of investment return, including investment income, net gains and losses on investments reported at fair value, and net realized gains and losses on investments reported at other than fair value

   (2) If investment return is separated into operating and non-operating amounts, a reconciliation of investment return to amounts reported in the statement of activities

(3) A description of the policy used to determine the amount of investment return included in the operating amount and, if applicable, the reason for any changes to that policy

d. Before the adoption of ASU 2016-14, the amount of investment expenses reported on the statement of activities as a reduction of investment income, gains, and losses.

e. The policy for reporting donor-restricted gains and investment income whose restrictions are met in the same reporting period if the organization chooses to report them as increases in unrestricted net assets (net assets without donor restrictions after the adoption of ASU 2016-14).

Additional disclosures about significant concentrations of credit risk as described in FASB ASC 825-10-50-21 may be required.

Some nonprofit organizations find it useful to present additional information about realized and unrealized gains and losses and historical costs of equity investments and investments in debt securities. For example, if a state adopted a law that allows nonprofit organizations to spend only realized gains or if an organization pays taxes on realized gains and losses, information that distinguishes between realized and unrealized amounts may be useful. GAAP does not preclude disclosing that information.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

3. When was ASU 2016-01 released?

   a. January 2016.

   b. February 2016.

   c. March 2016.

   d. May 2016.

4. FASB ASC 958-321 applies to all except which of the following?

   a. Investments in partnerships.

   b. Unincorporated joint ventures.

   c. Consolidated investments.

   d. Limited liability companies.

5. Nonprofit organizations should disclose certain information related to equity investments with fair values and all investments in debt securities that are readily determinable. Which of the following organizations disclosed the correct information for each financial position statement presented?

   a. A Org. discloses the aggregate carrying value of each major investments type.

   b. B Org. discloses the carrying value and nature of each investment that represents a significant market risk concentration.

   c. C Org. discloses information regarding the components of investment return.

   d. D Org. discloses the policy for reporting restricted gains and investment income.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

3. When was ASU 2016-01 released? **(Page 14)**

   a. January 2016. [This answer is correct. ASU 2016-01 was released in January of 2016.]

   b. February 2016. [This answer is incorrect. ASU 2016-01 was released in 2016, but not in the month of February.]

   c. March 2016. [This answer is incorrect. ASU 2016-01 was released in 2016, but not in the month of March.]

   d. May 2016. [This answer is incorrect. ASU 2016-01 was released in 2016, but not in the month of May.]

4. FASB ASC 958-321 applies to all except which of the following? **(Page 14)**

   a. Investments in partnerships. [This answer is incorrect. FASB ASC 958-321 does apply to investments in partnerships.]

   b. Unincorporated joint ventures. [This answer is incorrect. FASB ASC 958-321 does apply to unincorporated joint ventures.]

   c. Consolidated investments. [This answer is correct. FASB ASC 958-321 does not apply to consolidated investments, among other investments types.]

   d. Limited liability companies. [This answer is incorrect. FASB ASC 958-321 does apply to limited liability companies.]

5. Nonprofit organizations should disclose certain information related to equity investments with fair values and all investments in debt securities that are readily determinable. Which of the following organizations disclosed the correct information for each financial position statement presented? **(Page 16)**

   a. A Org. discloses the aggregate carrying value of each major investments type. [This answer is correct. As stated in FASB ASC 958-320-2, A Org. should include the aggregate carrying value of each major investments type for each statement of financial position presented.]

   b. B Org. discloses the carrying value and nature of each investment that represents a significant market risk concentration. [This answer is incorrect. B Org. should disclose the nature of and carrying value for each investment or group of investments that represents a significant concentration of market risk for the most recent statement of financial position presented.]

   c. C Org. discloses information regarding the components of investment return. [This answer is incorrect. C Org. should disclose information about the components of investment return, including investment income, net gains and losses on investments reported at fair value, and net realized gains and losses on investments reported at other than fair value.]

   d. D Org. discloses the policy for reporting restricted gains and investment income. [This answer is incorrect. D Org. should disclose the policy for reporting restricted gains and investment income whose restrictions are met in the same reporting period if the organization chooses to show them as unrestricted support.]

Lesson 3: Equity Method and Joint Ventures Investments

INTRODUCTION

The equity method is used to account for an investment in common stock or in-substance common stock if a nonprofit organization (a) has the ability to significantly influence the investee's financial and operating policies, (b) is not required or has not elected to record the investment at fair value, and (c) is not required to consolidate the investment. Under the equity method, an investment is initially recorded at cost. Thereafter, the carrying amount of the investment is (a) increased for the organization's proportionate share of the investee earnings and (b) decreased for the organization's proportionate share of the investee's losses or for dividends received from the investee.

Other adjustments similar to those made in consolidated financial statements are also made, such as the elimination of intra-entity gains and losses. The investment generally is shown on the organization's statement of financial position as a single amount and earnings and losses from the investment are shown on the organization's statement of activities as a single amount. Because the organization's change in net assets and net assets at the end of the period are generally the same as if the investment had been consolidated, the equity method is sometimes referred to as a "one-line consolidation."

Learning Objectives:

Completion of this lesson will enable you to:

- Determine how the equity method is used to account for investments in common and in-substance stock.

ACCOUNTING REQUIREMENTS

SOURCE: FASB ASC 323 and 958-810

Criteria for Using the Equity Method

An organization should use the equity method to account for its noncontrolling interest in the common stock or in-substance common stock of a for-profit entity if it has the ability to significantly influence the entity's operating and financial policies, unless it is required or chooses to report the investment at fair value. *Absent predominant evidence to the contrary*, an organization is presumed to have the ability to significantly influence an entity if it owns (directly or indirectly) 20% or more of the entity's voting stock.

A nonprofit organization also should generally use the equity method if it has a noncontrolling interest in a partnership, limited liability company, or similar legal entity and it can exercise significant influence over the investee. A limited liability company should be considered similar to a limited partnership for the purpose of assessing control if it maintains specific ownership accounts for each investor, similar to a partnership account structure.

Under certain circumstances, an organization may be permitted to report its noncontrolling ownership interest in a for-profit entity at fair value if it measures its investment portfolio at fair value, or if it elects the fair value option for eligible items.

Investments in In-substance Common Stock

An investment in *in-substance common stock* is an investment for which the risk and reward characteristics are similar to an investment in common stock. A nonprofit organization should consider the following characteristics when determining if an investment is substantially similar to an investment in an entity's common stock. If the

investment is considered to be in-substance common stock, the criteria for using the equity method discussed earlier in this section should be used to determine whether the accounting guidance discussed below applies.

- *Subordination.* The investment should have subordination characteristics that are substantially similar to the entity's common stock.

- *Ownership Risks and Rewards.* The investment should have risks and rewards, such as the participation in earnings and losses and capital appreciation, which are substantially similar to common stock.

- *Obligation to Transfer Value.* If there is an expectation that the investee is to transfer substantive value to the investor that is not similar to common shareholders, the investment would not be substantially similar to common stock.

APPLYING THE EQUITY METHOD

Under the equity method, the investment is initially recorded at cost, then reduced by dividends and increased or decreased by the nonprofit organization's proportionate share of the for-profit entity's net earnings or loss.

The investment is shown in the organization's statement of financial position as a single amount, and the organization's share of the for-profit entity's earnings is reported in the organization's statement of activities as a single amount. (See item d., however.) Use of the equity method generally results in the organization's net assets being the same as if the organization and for-profit entity were consolidated. The following are additional considerations for applying the equity method:

a. At acquisition, any difference between the cost of the investment and the organization's proportionate equity in the net assets of the for-profit entity should be accounted for as if the entity were a consolidated subsidiary. That is, the difference should be related to the entity's tangible and intangible assets based on their fair values. Any difference that cannot be related to specific assets should be considered to be goodwill.

b. Contingent consideration should only be included in the initial measurement of an equity investment if required by GAAP other than the requirements for business combinations. If an equity method investment agreement involves a contingent consideration agreement where the fair value of the investor's share of the investee's net assets exceeds the initial cost, a liability should be recognized. The liability should be measured as the lesser of (1) the maximum contingent consideration not otherwise recognized or (2) the excess of the investor's share of the investee's net assets over the initial cost measurement (including contingent consideration otherwise recognized).

c. An organization's equity in the operating results of the for-profit entity should be based on the shares of common stock and in-substance common stock held.

d. Intra-entity profits and losses should be eliminated until realized as if the for-profit entity were consolidated.

e. An organization should separately classify its share of an investee's accounting changes. If the investee is a for-profit entity that has items of other comprehensive income, the organization should adjust its investment by its share of those items.

f. Capital transactions of the for-profit entity that affect the organization's share of the entity's stockholders' equity should be accounted for on a step-by-step basis.

g. An organization should recognize a gain or loss on the sale of its investment equal to the difference between the selling price and the carrying amount of the investment at the time of sale.

h. An organization should recognize a loss for declines in an investment's value that are other than temporary.

i. An organization ordinarily should discontinue using the equity method when its share of the investee's losses reduces the investment in and advances to the investee to zero. Thereafter, the organization should not provide for additional losses unless it has guaranteed obligations of the entity or is otherwise committed

to provide further financial support for the entity. If the entity subsequently reports net income, the organization should resume applying the equity method only after its share of net income equals the share of net losses not recognized during the period the equity method was suspended. (There are instances, however, when an organization should *continue* to record its share of the investee's losses.

j. Dividends on the entity's cumulative preferred stock should be deducted when computing the organization's share of earnings, regardless of whether they have been declared.

Exhibit 3-1 illustrates accounting for an investment under the equity method.

Exhibit 3-1

Example Equity Method Calculations

Assumptions:

- On June 30, 20X5, ABC Organization purchased 40% of for-profit XYZ Company for $55,000. On that date, XYZ Company had a total net book value of $100,000. The difference between the amount paid and 40% of XYZ Company's net book value is attributable to goodwill.
- XYZ Company reported earnings of $20,000 for the six months ended December 31, 20X5, and $45,000 for the year ended December 31, 20X6. In addition, XYZ Company declared and paid dividends totaling $10,000 during 20X6.
- During 20X6, XYZ Company recognized a profit of $10,000 on the sale of inventory to ABC Organization. The inventory is included in ABC Organization's assets at December 31, 20X6.
- XYZ Company's effective tax rate is 30%.

Accounting for the investment on ABC Organization's books:

	Investment in XYZ Co.	Equity in XYZ Co.'s Earnings
Acquisition of 40% of XYZ Company	$ 55,000	$ —
Proportionate share of XYZ Company's earnings for the six months ended December 31, 20X5 ($20,000 × 40%)	8,000	8,000
December 31, 20X5 balances	63,000	$ 8,000
Proportionate share of XYZ Company's earnings for the year ended December 31, 20X6 ($45,000 × 40%)	18,000	$ 18,000
Dividends received ($10,000 × 40%)	(4,000)	—
Deferral of XYZ Company's profits on sale of inventory to ABC Organization net of related income taxes incurred by XYZ Company {[$10,000 − ($10,000 × 30%)] × 40%}	(2,800)	(2,800)
December 31, 20X6 balances	$ 74,200	$ 15,200

* * *

Accounting for Investee Losses When an Organization Has Other Investments in the Investee

If an investor organization (a) is not committed to provide further financial support for the investee, (b) has already reduced its investment in and advances to the investee to zero, and (c) has other investments in the investee, the organization should continue to report its share of the investee's losses up to the adjusted basis of those other investments. Examples of other investments include debt securities (including mandatorily redeemable preferred stock), preferred stock, or loans to the investee. Accounting for the investee's losses is as follows:

a. The organization's share of the investee's losses should be determined.

b. The adjusted basis of the organization's other investments in the investee should be determined. The adjusted basis of the other investments is the cost basis adjusted for any valuation allowances for investee

loans and the cumulative investee losses applied to the other investments. The cost basis is the original cost of the other investments adjusted for changes in fair value for marketable equity securities and amortization of discounts or premiums on debt securities or loans.

(1) If the adjusted basis of the other investments is positive, the adjusted basis of the other investments should be adjusted for the organization's share of the investee's losses. The losses should be applied to the other investments based on their seniority. This adjusted basis of debt and equity securities becomes the securities' basis for measuring subsequent changes in fair value.

(2) The organization's share of the investee's losses are no longer recorded once the adjusted basis of the other investments is zero. However, the unreported investee losses should be tracked. If an other investment is sold and its carrying value exceeds its adjusted basis, the difference between the cost basis and adjusted basis represents unreported investee losses that also should be tracked.

c. The adjusted basis of other investments in the investee should be adjusted for any applicable accounting principles. For example, investee loans should be adjusted for any required valuation allowances and debt and equity securities should be adjusted to fair value.

d. After the organization's share of investee income equals its share of previously unreported investee losses, subsequent investee income should be recorded as adjustments to the adjusted basis of the other investments in the reverse order of the application of the organization's share of the investee's losses.

Exhibit 3-2 illustrates accounting for investee losses as adjustments to other investments in the investee.

Exhibit 3-2

Example Accounting for Investee Losses When an Organization Has Other Investments in Investee

Assumptions:

At December 31, 20X1, XYZ Organization owned 40% of ABC, Inc. Recorded investee losses reduced the investment in ABC to zero on December 31, 20X1.

Other investments in ABC are $1,000 in ABC's preferred stock (measured at fair value) and a $1,000 loan. XYZ is not required to provide any additional financial support.

ABC's income and losses in the following table have been adjusted for intra-entity transactions.

For the year ended	ABC's Operating Income (Loss)	Carrying Value of Loan under FASB ASC 310	Fair value of Preferred Stock
December 31, 20X2	$ (2,000)	$ 950	$ 900
December 31, 20X3	(4,000)	750	900
December 31, 20X4	4,000	600	500

Accounting for the ABC, Inc. investment on XYZ Organization's books would be as follows:

	Carrying Value of Investment in Common Stock	Carrying Value of Loan	Carrying Value of Preferred Stock
December 31, 20X1 balances	$ —	$ 1,000	$ 1,000
20X2 activity:			
Proportionate share of ABC's loss ($2,000 × 40%)	—	—	(800)

	Carrying Value of Investment in Common Stock	Carrying Value of Loan	Carrying Value of Preferred Stock
Adjustment to carrying value of loan ($1,000 – $950)	—	(50)	—
Adjustment to carrying value of preferred stock ($1,000 – $800 – $900)	—	—	700
December 31, 20X2 balances	$ -0-	$ 950	$ 900

At December 31, 20X2, the adjusted basis of XYZ Organization's investment in ABC, Inc. is as follows:

Common stock	$ —
Loan ($1,000 – $50)	950
Preferred stock ($1,000 – $800)	200
	$ 1,150

	Carrying Value of Investment in Common Stock	Carrying Value of Loan	Carrying Value of Preferred Stock
December 31, 20X2 balances	$ —	$ 950	$ 900
20X3 activity:			
Proportionate share of ABC's loss ($4,000 × 40%—limited to XYZ's adjusted basis)	—	(950)[a]	(200)
Adjustment to carrying value of preferred stock	—	—	200
December 31, 20X3 balances	$ -0-	$ -0-	$ 900

Note:

[a] Because the adjusted basis of the loan is now zero, there is no adjustment to record the reduction in carrying value under FASB ASC 310-10.

At December 31, 20X3, the adjusted basis of XYZ Organization's investment in ABC Inc. is:

Common stock	$ —
Loan ($950 – $950)	—
Preferred stock ($200 – $200)	—
	$ -0-

	Carrying Value of Investment in Common Stock	Carrying Value of Loan	Carrying Value of Preferred Stock
December 31, 20X3 balances	$ —	$ —	$ 900
20X4 activity:			
Proportionate share of ABC's earnings [($4,000 × 40%) – $450 of previously unreported losses]	—	950	200

	Carrying Value of Investment in Common Stock	Carrying Value of Loan	Carrying Value of Preferred Stock
Adjustment to carrying value of loan ($950 – $600)	—	(350)	—
Adjustment to carrying value of preferred stock ($1,100 – $500)	—	—	(600)
December 31, 20X4 balances	$ -0-	$ 600	$ 500

At December 31, 20X4, the adjusted basis of XYZ's investment in ABC Inc. is:

Common stock	$ —
Loan ($0 + $950 – $350)	600
Preferred stock ($0 + $200)	200
	$ 800

* * *

An organization that has suspended loss recognition in accordance with the equity method may subsequently increase its investment in a way that does not result in increasing its ownership interest from one of significant influence to one of control. In such cases, the organization should recognize previously suspended losses up to the amount of the additional investment that represents funding of prior losses. Determining whether an additional investment represents funding of prior losses is a matter of judgment based on the facts. The organization also should reevaluate whether it has become committed to provide financial support for the investee.

Differences in Fiscal Years

An organization may recognize its share of the for-profit entity's earnings or losses based on the most recent available financial statements of the entity so long as the time lag in reporting periods is consistent from year to year. Thus, for example, if an organization and for-profit entity have different fiscal year ends, the organization generally may compute its share of the for-profit entity's earnings or losses based on the for-profit entity's financial statements for its fiscal year. A change in a previously existing difference in year ends should be reported as a change in accounting principle.

Changing to or from the Equity Method

Changes in its ability to significantly influence a for-profit entity's financial and operating policies may require an organization to change to or from the equity method. For example, an organization (or others) might buy or sell shares of the investee's stock, changing the organization's ownership percentage and ability to exercise influence. In such cases, the following apply:

a. When an organization loses its ability to significantly influence the entity, it should stop accruing its share of the entity's earnings or losses and begin accounting for the investment using the cost method or at fair value. The investment's cost is its carrying amount on the date that it no longer qualifies for equity method accounting.

b. When an investment in a for-profit entity previously accounted for using a method other than the equity method becomes eligible for equity method accounting, an organization should add the cost of acquiring the additional interest to its existing investment and adopt the equity method at the date significant influence is obtained. For example, if ABC Organization purchased none of for-profit DEF Company's voting stock on January 1, 20X4, and another 15% on October 1, 20X5, its change in net assets for 20X5 would include (1) 10% of DEF Company's earnings for the nine months ended September 30, 20X5, and

(2) 25% of DEF Company's earnings for the three months ended December 31, 20X5. In addition, ABC Organization should compare the carrying amount of its investment at October 1 with the underlying net assets of DEF Company and account for any differences as discussed earlier in this section.

Investee Capital Transactions

If an investee accounted for using the equity method issues additional shares, the investor organization should account for the transaction as if it had sold a proportionate share of its investment. Any resulting gain or loss should be recognized in the change in net assets.

DISCLOSURE REQUIREMENTS

A nonprofit organization's financial statements should include the following disclosures about an investment in a for-profit entity that is accounted for using the equity method:

a. Name of each investee

b. Percentage ownership of the entity's common stock

c. Organization's accounting policies with respect to investments in common stock (If an investee is 20% or more owned but not accounted for using the equity method, the disclosure should include the name of the entity and the reasons why the equity method is not appropriate. Conversely, if an entity is less than 20% owned but accounted for using the equity method, the disclosure should include the name of the entity and the reasons why the equity method is used.)

d. Difference, if any, between the carrying amount of the investment and the underlying equity in net assets, and the accounting treatment of the difference

e. If a quoted market price for the investment is available, the aggregate value of the investment based on the quoted price (This disclosure is not required for investments in subsidiaries.)

f. If equity method investments are, in the aggregate, material to the organization's financial position or changes in net assets, summarized information about the investee's assets, liabilities, and results of operations

g. Material effects on the organization of possible conversions of the investee's outstanding convertible securities, exercises of options and warrants, or contingent issuances

When determining the extent of the disclosures, the significance of the investment to the organization's financial position and change in net assets should be considered.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

6. Which of the following examples regarding the accounting for the investee's losses is correct?

   a. ABC's share of XYZ's losses should be determined.

   b. It is not necessary to determine the adjusted basis of ABC's other investments in XYZ.

   c. XYZ's adjusted basis of other investments should only be adjusted for certain applicable accounting principles.

   d. Once ABC's share of investee income is equal to its share of previously unreported investee losses, subsequent investee income should be recorded as adjustments to the adjusted basis of the other investments in chronological order of the application of the organization's share of the investee's losses.

7. Which of the following should be considered when determining the *extent* of the disclosures about an investment in a for-profit entity that is accounted for using the equity method?

   a. The investee's name.

   b. An organization's accounting policies regarding the investments in common stock.

   c. How much of the entity's common stock is owned.

   d. How significant the investment is to the organization's financial position.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

6. Which of the following examples regarding the accounting for the investee's losses is correct? **(Page 23)**

   a. ABC's share of XYZ's losses should be determined. [This answer is correct. According to FASB ASC 323-10-35-26, the organization's share of the investee's losses should be determined.]

   b. It is not necessary to determine the adjusted basis of ABC's other investments in XYZ. [This answer is incorrect. The adjusted basis of the organization's other investments in the investee should be determined. The adjusted basis of the other investments is the cost basis adjusted for any valuation allowances for investments is the cost basis adjusted for any valuation allowances for investments.]

   c. XYZ's adjusted basis of other investments should only be adjusted for certain applicable accounting principles. [This answer is incorrect. The adjusted basis of other investments in the investee should be adjusted for any applicable accounting principles. For example, investee loans should be adjusted for any required valuation allowances and debt and equity securities should be adjusted to fair value.]

   d. Once ABC's share of investee income is equal to its share of previously unreported investee losses, subsequent investee income should be recorded as adjustments to the adjusted basis of the other investments in chronological order of the application of the organization's share of the investee's losses. [This answer is incorrect. After the organization's share of investee income equals its share of previously unreported investee losses, subsequent investee income should be recorded as adjustments to the adjusted basis of the other investments in the reverse order of the application of the organization's share of the investee's losses.]

7. Which of the following should be considered when determining the *extent* of the disclosures about an investment in a for-profit entity that is accounted for using the equity method? **(Page 27)**

   a. The investee's name. [This answer is incorrect. A nonprofit organization's financial statements should disclose the name of each investee about an investment in a for-profit entity that is accounted for using the equity method. However, this is not considered when determining the *extent* of the disclosure.]

   b. An organization's accounting policies regarding the investments in common stock. [This answer is incorrect. A nonprofit organization's financial statements should disclose the organization's percentage ownership of the entity's common stock. However, this is not considered when determining the *extent* of the disclosure.]

   c. How much of the entity's common stock is owned. [This answer is incorrect. A nonprofit organization's financial statements should disclose the percentage ownership of the entity's common stock. This disclosure is not considered when determining the extent of the disclosure.]

   d. How significant the investment is to the organization's financial position. [This answer is correct. When determining the extent of the disclosures, the significance of the investment to the organization's financial position should be considered. A change in net assets should also be considered.]

Lesson 4: Other Investments

INTRODUCTION

This lesson provides guidance on accounting for certain investments held by nonprofit organizations that are categorized as other investments and investments in insurance contracts. The measurement and presentation of other investments depends on the type of asset held and type of nonprofit organization holding the asset.

Gains, losses, dividends, interest, and other investment income generally should be reported on the statement of activities as increases or decreases in the appropriate class of net assets, depending on the existence or absence of donor-imposed restrictions.

Learning Objectives:

Completion of this lesson will enable you to:
- Identify the guidance used for accounting for investments and investments in insurance contracts.

The authoritative literature on accounting for investments in life insurance and life settlement contracts offers the following guidance:

a. The cash surrender value of an investment in life insurance should be reported as an asset. Any change in the cash surrender value during the period should be reported as an adjustment to premiums paid.

b. Investments in life settlement contracts should be accounted for using either the investment or fair value methods.

ACCOUNTING REQUIREMENTS

This lesson presents guidance for reporting other investments of nonprofit organizations both before and after the effective date of ASU 2016-01.

Other Investments Before the Effective Date of ASU 2016-01

Certain investments held by nonprofit organizations are described in FASB ASC 958-325. That subtopic provides guidance for the following types of investments unless other accounting requirements apply:

a. Partnership interests

b. Investments in real estate

c. Mortgage notes that are not debt securities

d. Venture capital funds

e. Oil and gas interests

f. Equity securities that do not have a *readily determinable fair value* and are not accounted for using the equity method (that is, cost method investments)

The guidance discussed in this section should be applied to the investments described earlier in this section unless, because of their characteristics, other accounting requirements apply as follows:

a. Debt securities and equity securities with readily determinable fair values

b. Derivatives

c. Consolidated entities

d. Interests accounted for using the equity method

e. Beneficial interests in investments held by a financially interrelated nonprofit organization

An investment described at the beginning of this section, not otherwise excluded as described above, is called an *other investment* in the accounting literature for nonprofit organizations and the remainder of this lesson.

Recognition and Measurement

Other investments that are purchased should be recorded at their acquisition cost unless the fair value option is elected for eligible investments. Acquisition cost includes brokerage and other transaction fees. Other investments received as contributions should be measured at fair value and recognized as revenues or gains in the period received. The classification of contributions as revenues or gains depends on whether the transaction is part of the organization's ongoing or major activities. The dividends, interest, and other income generated by other investments should be reported in the statement of activities as increases in unrestricted net assets unless use of the assets or investment income is limited by donor-imposed restrictions.

If the organization acquires an other investment as an agent and has little or no discretion in determining how the investment income and realized and unrealized gains and losses will be used, the transaction should be accounted for as an agency transaction. In a typical agency transaction, the receipt of assets is reported as an increase in liabilities rather than as contribution revenue or gain.

Measurement of other investments in subsequent reporting periods depends on both the type of nonprofit organization and the nature of the investment. The following paragraphs discuss the measurement guidance and how different types of organizations are allowed to apply that guidance.

Fair Value Option. Under the fair value option, organizations are allowed to measure at fair value certain eligible financial instruments and specified other items that are not currently required to be measured using fair value. However, the choice is allowed only at defined election dates such as upon initial recognition of the eligible item. For items for which the fair value option has been elected, unrealized gains and losses are reported in the change in net assets at subsequent reporting dates. Any associated upfront costs and fees are recognized in the change in net assets as incurred.

Cost Method Investments. Equity securities that do not have readily determinable fair values, do not qualify for consolidation or the equity method, and are accounted for using the cost method are referred to as *cost method investments*. A cost method investment is originally recorded as an asset at cost and investment income is reflected in the statement of activities as an increase in unrestricted or restricted net assets, depending on the existence of donor-imposed restrictions. Dividends distributed from accumulated earnings of the investee are recorded as revenue in the period received. Dividends in excess of accumulated earnings are considered a return of investment and recorded as a reduction of the cost of the investment.

All organizations that hold equity securities that are reported at cost because they do not have readily determinable fair values should review those investments for impairment in accordance with the following guidance.

Organizations may be required to develop fair value estimates for other investments for disclosure or other purposes. If a fair value estimate for a cost method investment exists, that estimate should be used for determining whether the investment has an impairment that is other than temporary.

However, if no fair value estimate has been developed, the organization should evaluate, at the individual security level, whether events or changes in circumstances have occurred that may have a significant adverse effect on fair value, such as (a) a significant deterioration in the investee's financial or operating performance, (b) a significant adverse change in the investee's regulatory, economic, or technological environment, (c) a significant adverse change in the investee's industry or geographic market conditions, (d) a bona fide offer to purchase or sell that is below cost, or (e) significant concerns about the investee's ability to continue as a going concern. If one or more of those events has occurred, a fair value estimate should be developed and compared to the cost of the investment.

If impairment exists but is considered only temporary, the cost method investment should be evaluated for impairment each reporting period until it is either written down or no longer impaired.

For cost method investments where the fair value is less than cost, an evaluation should be performed to determine if the impairment is other than temporary. The investor should consider all relevant accounting guidance to make this determination. Factors such as the following may indicate that impairment is other than temporary:

- An investee experiences a series of operating losses
- There are adverse changes in the present value of current estimated cash flows related to a beneficial interest
- The length of the time and the extent to which the market value has been less than cost
- The financial condition and near-term prospects of the issuer of the investment, including any specific events that may influence its operations
- The intent and ability of the entity to retain the investment for a sufficient period of time to allow for any anticipated recovery in market value

An organization should recognize an impairment loss when the impairment is deemed other than temporary. If an impaired cost-method investment will be sold shortly after the reporting date and the fair value is not expected to recover prior to the sale date, the investment should be deemed to be other-than-temporarily impaired in the period the decision to sell is made. After an impairment is recognized, the fair value estimate becomes the new cost basis of the other investment and subsequent recoveries in fair value are not recognized.

Institutions of Higher Education. Colleges, universities, and community or junior colleges may report other investments at either (a) carrying value—that is, purchased other investments at cost and contributed other investments at fair value at the date of the gift—or (b) fair value. If other investments are reported at carrying value, they should be adjusted if there has been an impairment that is other than temporary. The organization should apply the same measurement attribute to all of its other investments, excluding other investments that the organization chooses to measure at fair value pursuant to the fair value option or as allowed by FASB ASC 815, *Derivatives and Hedging*.

Institutions of higher education should present the total performance of the other investment portfolio (that is, investment income and realized and unrealized gains and losses) in the statement of activities unless that information is disclosed in the notes to the financial statements.

Voluntary Health and Welfare Organizations. Voluntary health and welfare organizations should report other investments at either (a) carrying value—that is, cost if purchased, and fair value on the date of donation if contributed—or (b) fair value. If other investments are not equity securities and the fair value of the portfolio of those investments falls below the recorded amount, the investments may need to be written down to fair value (or an allowance for the decline in fair value may need to be provided) in the period of the decline. An impairment loss should be recognized in the period the decline occurs if it can reasonably be expected the organization would suffer a loss on disposition of the other investment. The organization should apply the same measurement attribute to all of its other investments, excluding other investments that the organization chooses to measure at fair value pursuant to the fair value option or as allowed by FASB ASC 815.

Other Nonprofit Organizations. Nonprofit organizations other than voluntary health and welfare organizations and institutions of higher learning should measure other investments at either (a) fair value or (b) the lower of cost or fair value. The same measurement attribute should be applied to all of the organization's other investments, except for those other investments measured at fair value pursuant to the fair value option or as allowed by FASB ASC 815. If other investments are not equity securities and are carried at the lower of cost or fair value, declines in value should be recognized if the aggregate fair value of the other investments falls below their carrying amount. Recoveries of aggregate fair value should be recorded in subsequent periods to the extent that carrying value does not exceed the original cost.

OTHER INVESTMENTS AFTER THE EFFECTIVE DATE OF ASU 2016-01

Certain investments held by nonprofit organizations are described in FASB ASC 958-325. That subtopic provides guidance for the following types of investments, among others, unless other accounting requirements apply:

a. Investments in real estate

b. Mortgage notes that are not debt securities

c. Oil and gas interests

The guidance discussed in this section should be applied to the investments described above unless, because of their characteristics, other accounting requirements apply as follows:

a. Debt securities and equity securities

b. Derivatives

c. Consolidated entities

d. Interests accounted for using the equity method

e. Beneficial interests in investments held by a financially interrelated nonprofit organization

Recognition and Measurement

Other investments that are purchased should be recorded at their acquisition cost unless the fair value option is elected for eligible investments. Acquisition cost includes brokerage and other transaction fees. Other investments received as contributions should be measured at fair value and recognized as revenues or gains in the period received. The classification of contributions as revenues or gains depends on whether the transaction is part of the organization's ongoing or major activities.

Recognized gains and losses on other investments, and the dividends, interest, and other income generated by those investments should be reported in the statement of activities as increases in net assets without donor restrictions unless use of the assets or investment income is limited by donor-imposed restrictions.

If the organization acquires an other investment as an agent and has little or no discretion in determining how the investment income and realized and unrealized gains and losses will be used, the transaction should be accounted for as an agency transaction. In a typical agency transaction, the receipt of assets is reported as an increase in liabilities rather than as contribution revenue or gain.

In general, the same measurement attribute (e.g., carrying value or fair value) should be used to measure all other investments held by a nonprofit organization, unless the organization elected to—

a. measure an eligible other investment at fair value in accordance with the fair value option described in FASB ASC 825-10, or

b. measure a financial instrument that contains an embedded derivative at fair value in accordance with FASB ASC 815-15-25.

Unless the organization has elected to report an eligible other investment at fair value in accordance with the options discussed previously, the measurement of other investments in subsequent reporting periods depends on the type of nonprofit organization holding the investment as discussed next.

Institutions of Higher Education. Colleges, universities, and community or junior colleges may report other investments at either (a) carrying value—that is, purchased other investments at cost and contributed other investments at fair value at the date of the gift—or (b) fair value. If other investments are reported at carrying value, they should be adjusted if there has been an impairment that is other than temporary.

Voluntary Health and Welfare Organizations. Voluntary health and welfare organizations should report other investments at either (a) carrying value—that is, cost if purchased, and fair value on the date of donation if contributed—or (b) fair value. If other investments are not equity securities and the fair value of the portfolio of those investments falls below the recorded amount, the investments may need to be written down to fair value (or an allowance for the decline in fair value may need to be provided) in the period of the decline. An impairment loss should be recognized in the period the decline occurs if it can reasonably be expected the organization would suffer a loss on disposition of the other investment.

Other Nonprofit Organizations. Nonprofit organizations other than voluntary health and welfare organizations and institutions of higher learning should measure other investments at either (a) fair value or (b) the lower of cost or fair value. If other investments are not equity securities and are carried at the lower of cost or fair value, declines in value should be recognized if the aggregate fair value of the other investments falls below their carrying amount. Recoveries of aggregate fair value should be recorded in subsequent periods to the extent that carrying value does not exceed the original cost.

LIFE INSURANCE

Under certain life insurance policies, a portion of premium payments go to the insurer for its assumption of risk while the other portion accumulates as cash value. The insured can receive the cash value of the policy by either (a) borrowing money from the insurer and using the cash value as collateral or (b) surrendering the policy. The amount that can be received, referred to as the policy's "cash surrender value," is the policy's cash value reduced by policy loans and surrender charges.

When an organization buys a cash value policy for itself, the amount that it could receive by surrendering the policy at the statement of financial position date should be reported as an asset. Any change in the policy's cash surrender value during the period should be reported as an adjustment of premiums paid. When determining the amount that could be realized under the insurance policy, any additional amounts included in the contractual terms of the policy should be considered.

The following additional guidance applies when determining the amount that could be realized under the insurance policy:

- Amounts recoverable in future periods beyond one year from surrender of the policy should be recorded at their present values. However, when contractual restrictions on the ability to surrender a policy exist, the cash surrender value should not be discounted as long as the policy holder continues to participate in changes in cash surrender value.
- Amounts to be realized should be based on the assumed surrender of individual policies (or individual certificates in a group policy); the amount to be received upon assumed surrender of the final policy (or final certificate) should also be included in the amount that could be realized.
- Amounts in addition to cash surrender value that are based on the contractual terms of the policy should exclude amounts recoverable by the policyholder only at the insurance company's discretion.
- The amount should be determined on a group basis if surrender is only permitted for all individual policies or certificates as a group.

INVESTMENTS IN LIFE SETTLEMENT CONTRACTS

An owner of a life insurance policy may enter into a contract with a third-party investor where the investor receives the face value of the life insurance policy upon the death of the insured. For such contracts (referred to as life settlement contracts), the investor does not have an insurable interest and provides consideration to the policy owner of an amount in excess of the cash surrender value of the insurance policy.

The investor may make an irrevocable election to account for its investments in life settlement contracts, on an instrument-by-instrument basis, using either the investment method or fair value method. Under the investment method the initial investment, plus all initial direct external and subsequent continuing costs to keep the policy in force, are capitalized by the investor. Upon the death of the insured, a gain is recognized in the change in net assets for the difference between the life insurance proceeds and the carrying amount of the contract. The investment

should be tested for impairment if the investor becomes aware of information that indicates that the expected proceeds will be insufficient to recover the carrying amount plus anticipated undiscounted future premiums and capitalizable direct external costs. If an impairment loss is recognized, the investment should be written down to fair value.

Under the fair value method, an investor records the initial investment at the transaction price and remeasures the investment at fair value at each subsequent reporting period. Changes in fair value are reported in the statement of activities in the period in which they occur. Premiums paid and proceeds received are reported in the same financial statement line item as the changes in fair value.

DISCLOSURE REQUIREMENTS

OTHER INVESTMENTS

Nonprofit organizations should disclose the following information related to other investments:

a. For the most recent statement of financial position presented, the nature of and carrying value for each investment or group of investments that represents a significant concentration of market risk.

b. For each statement of financial position presented:

    (1) The aggregate carrying value of each major investments type

    (2) The basis for determining the carrying amount for other investments

    (3) The methods and significant assumptions used to estimate fair values of other investments (other than financial instruments) if reported at fair value

c. The policy for reporting restricted gains and investment income whose restrictions are met in the same reporting period if the organization chooses to show them as unrestricted support

d. If considered useful, information about realized and unrealized gains and losses, and the historical costs of investments (such disclosure is not required or precluded by GAAP)

e. As applicable, the disclosures about fair value measurements required by FASB ASC 820 and the fair value option required by FASB ASC 825-10

Before the effective date of ASU 2016-14, the following presentation and disclosure requirements related to the statement of activities apply:

a. For each statement of activities presented:

    (1) Information about the components of investment return, including investment income, net gains and losses on investments reported at fair value, and net realized gains and losses on investments reported at other than fair value

    (2) If investment return is separated into operating and non-operating amounts, a reconciliation of investment return to amounts reported in the statement of activities and a description of the policy used to determine the amount of investment return included in the operating amount and, if applicable, the reason for any changes to that policy

b. The amount of investment expenses reported on the statement of activities as a reduction of investment income, gains, and losses

c. For institutions of higher education, the amount of investment income and realized and unrealized gains and losses from the other investment portfolio if that information is not presented on the face of the statement of activities

After the effective date of ASU 2016-14, investment return (other than returns from programmatic investments) should be reported net of related external and direct internal investment expenses.

Before the effective date of ASU 2016-01, the following disclosures are required for cost method investments:

a. For cost method investments as of each date for which a statement of financial position is presented:

   (1) The aggregate carrying amount of all cost method investments

   (2) The aggregate carrying amount of cost method investments that the organization did not evaluate for impairment

   (3) If applicable, the fact that the fair value of a cost method investment is not estimated if there are no identified events or changes in circumstances that may have a significant adverse effect on the fair value and the organization does not otherwise estimate fair value either because (a) it is not practicable to estimate fair value or (b) the organization is exempt from estimating fair value under FASB ASC 825

b. If a loss has not been recognized for impaired cost method investments:

   (1) As of each date for which a statement of financial position is presented, quantitative information, aggregated by category of investment, presented in tabular form and segregated by investments that have been in a loss position for less than 12 months and those that have been in a loss position for 12 months or longer, that includes:

      (a) Aggregate amount of unrealized losses

      (b) Aggregate fair value of investments with unrealized losses

   (2) As of the date of the most recent statement of financial position, narrative information that was considered in reaching the conclusion that the impairments are not other-than-temporary, including (a) the nature of the investment, (b) the cause of the impairment, (c) the number of investment positions in an unrealized loss position, (d) the severity and duration of the impairment, and (e) other evidence considered relevant

LIFE INSURANCE

A policyholder should disclose the existence of contractual restrictions on the ability to surrender a life insurance policy.

INVESTMENTS IN LIFE SETTLEMENT CONTRACTS

Life settlement contracts that are remeasured at fair value should be reported separately on the face of the statement of financial position from those accounted for under the investment method. This may be accomplished by either reporting separate line items or reporting an aggregate amount with parenthetical disclosure of the amount of investments accounted for under the fair value method.

Investment income from investments in life settlement contracts remeasured at fair value should be reported separately from investment method income. This may be accomplished by either reporting separate line items or reporting an aggregate amount with parenthetical disclosure of the amount of investment income from investments accounted for under the fair value method.

Cash receipts and payments related to life settlement contracts should be classified in the statement of cash flows based on the nature and purpose for which the life settlements were acquired.

The following information should be disclosed for investments in life settlement contracts:

a. The accounting policy for life settlement contracts, including the classification of cash receipts and disbursements in the statement of cash flows

b. Separately for fair value and investment method contracts, based on the remaining life expectancy for each of the first five succeeding years from the date of the statement of financial position and thereafter, and in the aggregate:

   (1) Number of contracts

   (2) Carrying value of contracts

   (3) Face value (death benefits) of the underlying life insurance policies

c. The nature of information that causes a change in the expected timing of cash proceeds, including disclosing significant changes to the amounts above, item b.

d. For investment method contracts, anticipated life insurance premiums to be paid for each of the five succeeding fiscal years

e. For fair value contracts, the methods and significant assumptions used to estimate the fair value of investments, including any mortality assumptions

The following should be disclosed for each statement of activities:

a. Gains or losses recognized on investments sold during the period

b. Unrealized gains or losses recognized during the period for investments still held at the statement of financial position date

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

8. Accounting for investments in life settlement contracts is characterized by which of the following?

    a. The cash surrender value of an investment in life insurance should be reported as a liability.

    b. Investments in life settlement contracts should be accounted for using the investment method or one other method.

9. Which of the following statements regarding cost method investments is correct?

    a. Dividends distributed from accumulated earnings of the investee are recorded as a cost in the period received.

    b. Dividends in excess of accumulated earnings are considered a return of investment and recorded as a liability.

    c. An evaluation should be performed to determine if impairment is other than temporary for cost method investments that have a fair value less than cost.

    d. When the impairment is deemed temporary, an organization should recognize an impairment loss.

10. Which of the following is **not** a factor that would indicate an impairment that is other than temporary?

    a. The probability that all amounts due, per the contractual terms of a debt security, will not be collected.

    b. The amount of time and the extent to which the market value has exceeded cost.

    c. The investee encounters a string of operating losses.

    d. Negative changes occur in the present value of current estimated cash flows that relate to a beneficial interest.

11. Certain guidance exists when determining the amount that could be realized under a life insurance policy. Which of the followings statements is correct regarding how that guidance is applied?

    a. Amounts recoverable in future periods beyond six months from when the policy was surrendered should be recorded at their present values.

    b. Amounts to be realized should be based on the expected surrender of individual policies.

    c. Amounts, along with cash surrender value that are based on the contractual policy terms should include the amounts the policyholder recovers at the discretion of the insurance company.

    d. Amounts should be determined on a group basis even if surrender is permitted for certain individual policies.

12. Which of the following statements is correct regarding investments in life settlement contracts?

    a. Upon the death of the insured, an owner of a life insurance policy may not enter into a life settlement contract with a third-party investor such that the face value of the policy is received by the investor.

    b. The investor is permitted to make an irrevocable election to account for its investments in life settlement contracts.

    c. The investor has an insurable interest and does not provide consideration to the policy owner of the insurance policy.

13. Before the effective date of ASU 2016-01, if a loss was not recognized for impaired cost method investments, quantitative information, in tabular form and segregated by investments that were in a loss for less than how many months, were presented?

    a. 12 months.

    b. 15 months.

    c. 18 months.

    d. 24 months.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

8. Accounting for investments in life settlement contracts is characterized by which of the following? **(Page 31)**

   a. The cash surrender value of an investment in life insurance should be reported as a liability. [This answer is incorrect. The cash surrender value of an investment in life insurance should be reported as an asset, not a liability.]

   b. Investments in life settlement contracts should be accounted for using the investment method or one other method. [This answer is correct. Investments in life settlement contracts should be accounted for using either the fair value or investment methods.]

9. Which of the following statements regarding cost method investments is correct? **(Page 33)**

   a. Dividends distributed from accumulated earnings of the investee are recorded as a cost in the period received. [This answer is incorrect. Dividends distributed from accumulated earnings of the investee are recorded as revenue in the period received.]

   b. Dividends in excess of accumulated earnings are considered a return of investment and recorded as a liability. [This answer is incorrect. Dividends in excess of accumulated earnings are considered a return of investment and recorded as a reduction of the cost of the investment.]

   c. An evaluation should be performed to determine if impairment is other than temporary for cost method investments that have a fair value less than cost. [This answer is correct. For cost method investments where the fair value is less than cost, an evaluation should be performed to determine if the impairment is other than temporary.]

   d. When the impairment is deemed temporary, an organization should recognize an impairment loss. [This answer is incorrect. An organization should recognize an impairment loss when the impairment is deemed other than temporary.]

10. Which of the following is **not** a factor that would indicate an impairment that is other than temporary? **(Page 33)**

    a. The probability that all amounts due, per the contractual terms of a debt security, will not be collected. [This answer is incorrect. According to FASB ASC 320-10-35-31, one factor that may indicate that impairment is other than temporary is if it is probable that all amounts due according to the contractual terms of a debt security will not be collected.]

    b. The amount of time and the extent to which the market value has exceeded cost. [This answer is correct. The length of the time and the extent to which the market value has been less than cost is one factor that may indicate that impairment is other than temporary.]

    c. The investee encounters a string of operating losses. [This answer is incorrect. FASB ASC 323-10-3531 states that one factor that may indicate that impairment is other than temporary is when an investee experiences a series of operating losses.]

    d. Negative changes occur in the present value of current estimated cash flows that relate to a beneficial interest. [This answer is incorrect. One factor that may indicate that impairment is other than temporary is if there are adverse changes in the present value of current estimated cash flows related to a beneficial interest.]

11. Certain guidance exists when determining the amount that could be realized under a life insurance policy. Which of the followings statements is correct regarding how that guidance is applied? **(Page 35)**

    a. Amounts recoverable in future periods beyond six months from when the policy was surrendered should be recorded at their present values. [This answer is incorrect. Amounts recoverable in future periods beyond one year from surrender of the policy should be recorded at their present values.]

    b. Amounts to be realized should be based on the expected surrender of individual policies. [This answer is correct. Amounts to be realized should be based on the assumed surrender of individual policies (or individual certificates in a group policy); the amount to be received upon assumed surrender of the final policy (or final certificate) should also be included in the amount that could be realized.]

    c. Amounts, along with cash surrender value that are based on the contractual policy terms should include the amounts the policyholder recovers at the discretion of the insurance company. [This answer is incorrect. Amounts in addition to cash surrender value that are based on the contractual terms of the policy should exclude amounts recoverable by the policyholder only at the insurance company's discretion.]

    d. Amounts should be determined on a group basis even if surrender is permitted for certain individual policies. [This answer is incorrect. The amount should be determined on a group basis if surrender is only permitted for all individual policies or certificates as a group.]

12. Which of the following statements is correct regarding investments in life settlement contracts? **(Page 35)**

    a. Upon the death of the insured, an owner of a life insurance policy may not enter into a life settlement contract with a third-party investor such that the face value of the policy is received by the investor. [This answer is incorrect. Per FASB ASC 325-30-20, an owner of a life insurance policy may enter into a contract with a third-party investor where the investor receives the face value of the life insurance policy upon the death of the insured.]

    b. The investor is permitted to make an irrevocable election to account for its investments in life settlement contracts. [This answer is correct. FASB ASC 325-30-20 cites that the investor may make an irrevocable election to account for its investments in life settlement contracts, on an instrument-by-instrument basis, using either the investment method or fair value method.]

    c. The investor has an insurable interest and does not provide consideration to the policy owner of the insurance policy. [This answer is incorrect. For life settlement contracts, the investor does not have an insurable interest and does provide consideration to the policy owner of an amount in excess of the cash surrender value of the insurance policy as indicated in FASB ASC 325-30-20.]

13. Before the effective date of ASU 2016-01, if a loss was not recognized for impaired cost method investments, quantitative information, in tabular form and segregated by investments that were in a loss for less than how many months, were presented? **(Page 37)**

    a. 12 months. [This answer is correct. The period of loss had to be less than 12 months.]

    b. 15 months. [This answer is incorrect. Less than 15 months was not the correct amount of time.]

    c. 18 months. [This answer is incorrect. Less than 18 months was not the correct amount of time.]

    d. 24 months. [This answer is incorrect. Less than 24 months was not the correct amount of time.]

Lesson 5: Related Entities

INTRODUCTION

Nonprofit organizations can hold ownership interests in for-profit entities or be related to other nonprofit entities in a number of ways. Generally, if an organization holds a controlling financial interest in a for-profit entity, the organization should present consolidated financial statements that include the subsidiary. If an organization holds 50% or less of the voting stock in a for-profit entity but exercises significant influence, it should report its interest using the equity method of accounting, or at fair value if permitted. Noncontrolling interests in for-profit real estate entities that are more than minor also should be reported using the equity method, or at fair value if permitted.

Certain disclosures are required for related but separate nonprofit organizations that are not consolidated.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine how nonprofit organizations can hold ownership interests in for-profit entities or be related to other nonprofit entities.

ACCOUNTING REQUIREMENTS

SOURCE: FASB ASC 810-10, 810-20, 958-810

Nonprofit organizations sometimes hold interests in for-profit entities or other nonprofit organizations. The accounting methods used to report the relationships vary. Depending on ownership or economic interest and control, an organization may be required to consolidate the other entity, report its investment at fair value, by using the equity method, or it may only be required to disclose the relationship.

OWNERSHIP INTERESTS IN FOR-PROFIT ENTITIES

How a nonprofit organization reports its ownership interest in a for-profit entity generally depends on whether the organization has a controlling financial interest in the entity. The guidance for reporting investments in for-profit entities is summarized as follows:

a. An organization with a controlling financial interest through direct or indirect ownership of a majority voting interest in a for-profit entity (other than a limited partnership or similar legal entity) generally should consolidate the investee.

b. An organization that holds less than a majority voting interest in the investee (that is, it owns 50% or less of the voting stock), generally uses the equity method to report the investment if it can exercise significant influence over the investee's operating and financial policies. However, an organization may be required or may be permitted to elect to report the investment at fair value.

c. An organization that is a general partner or a limited partner in a limited partnership or similar legal entity generally should consolidate the investee if it controls the partnership. GAAP provides guidance for assessing control. If the organization does not control the partnership as defined in GAAP, it generally should use the equity method to report the investment if it can exercise significant influence over the partnership's operating and financial policies. The organization also may be permitted to elect to report the investment at fair value.

d. An organization with a noncontrolling interest in a real estate partnership, real estate limited liability company, or similar real estate entity that is more than minor should use the equity method to report its investment if it can exercise significant influence over the partnership's operating and financial policies; otherwise the cost method should be used. The organization also may be permitted to elect to report the investment at fair value.

The following paragraphs discuss how the appropriate reporting method is determined. The flowchart in Exhibit 5-1 summarizes that guidance.

Controlling Financial Interest

Generally, a nonprofit organization should consolidate the activities of a for-profit entity in which it directly or indirectly owns a controlling financial interest. A controlling financial interest in entities other than limited partnerships usually is evidenced by ownership of a majority voting interest. Thus, as a general rule, an organization that directly or indirectly owns more than 50% of the outstanding shares of a for-profit entity should account for its investment through consolidation. Consolidation is also required when control exists through other means. For example, control may exist even though there is a smaller percentage of ownership if it is obtained through a contract, a lease, an agreement with other shareholders, or by court decree.

However, a majority-owned subsidiary should *not* be consolidated if—

a. control does not rest with the organization as majority owner (for example, if a subsidiary is in legal reorganization, bankruptcy, or operates under foreign exchange or governmental restrictions so severe that they cast significant doubt on the organization's ability to control the subsidiary).

b. noncontrolling shareholders have certain approval or veto rights that restrict the majority shareholder's powers to control the investee's operations or assets.

c. noncontrolling limited partners have substantive participating rights.

If a controlling financial interest is consolidated, nonprofit organizations should apply the guidance for presenting consolidated financial statements provided in FASB ASC 810-10, *Consolidation—Overall*. (Nonprofit organizations are not subject to the requirements in the Variable Interest Entities subsections of that topic, however.)

Control of Limited Partnerships and Similar Legal Entities.

The guidance for assessing the potential consolidation of interests in limited partnerships and similar legal entities by nonprofit organizations is found in FASB ASC 958-810. There is a general presumption of control by the general partner(s) in a limited partnership regardless of the extent of the general partner's ownership interest. When a limited partnership has multiple general partners, an analysis of the relevant facts and circumstances will need to be made to determine which general partner has control of the partnership and should consolidate it.

However, the general partner does not control a limited partnership if the limited partners possess either substantive kick-out rights or substantive participating rights, in which case, the presumption of control by the general partner is overcome and—

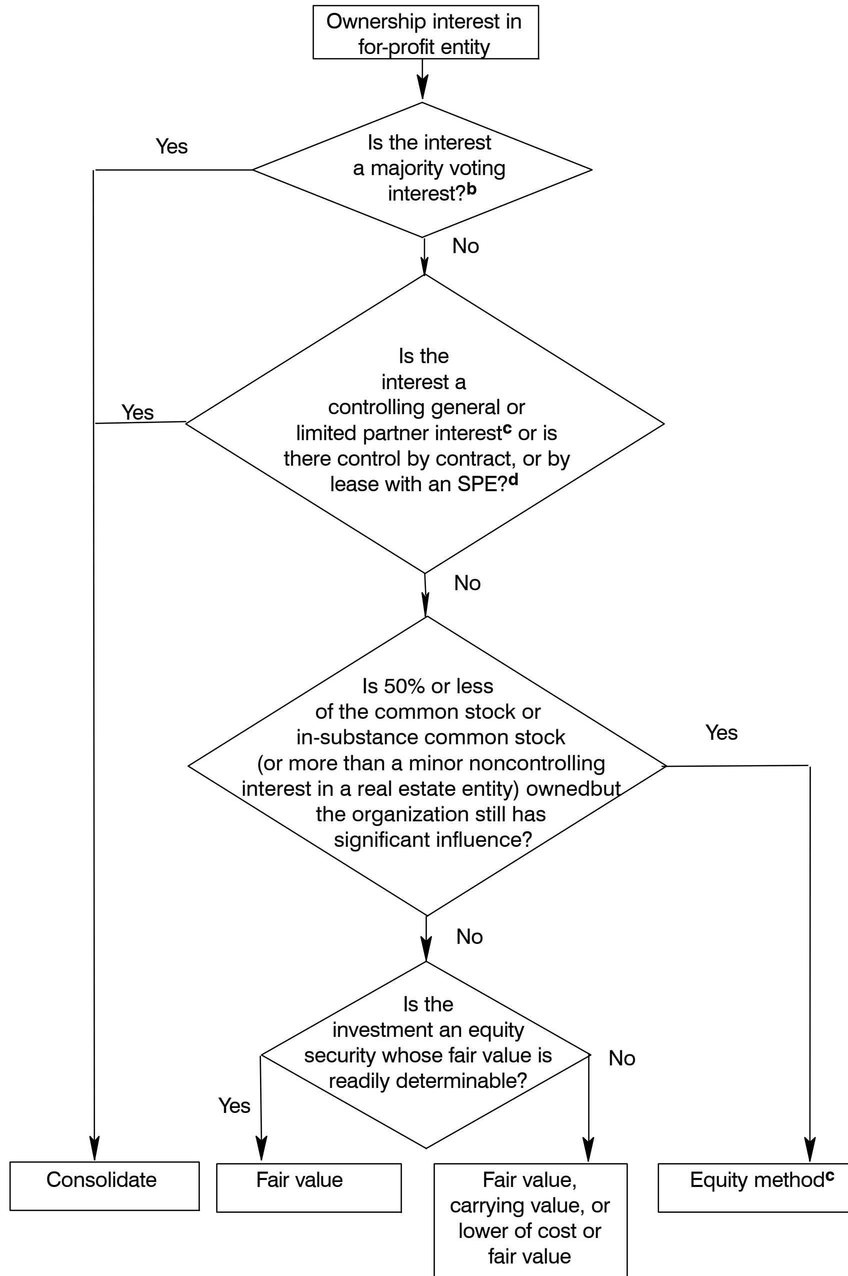
a. The general partner should use the equity method for reporting its noncontrolling interest.

b. The limited partners should assess whether any one of them holds a controlling financial interest in the limited partnership that requires consolidation, as discussed in these materials

A controlling financial interest typically exists when one limited partner owns (directly or indirectly) through voting interests more than 50% of the limited partnership's kick-out rights. However, the presumption regarding the consolidation of a limited partnership by a limited partner with a majority of kick-out rights through voting interests may be overcome when a noncontrolling limited partner (which can refer to one or more limited partners) can effectively participate in certain significant financial and operating decisions made in the ordinary course of business, such as establishing operating and capital decisions of the limited partnership.

Exhibit 5-1

Accounting for Ownership Interests in For-profit Entities[a]



Notes:

[a] This flowchart summarizes the guidance in FASB ASC 958-810-15-4. See also the implementation guidance at FASB ASC 958-810-55-4.

[b] If the majority voting interest does not result in control, the answer should be "No."

[c] GAAP may also allow the organization to report the investment at fair value.

[d] The conditions that require consolidation of an SPE lessor were described elsewhere in this course.

* * *

The effect of limited partner rights on the presumption of control by the general partner and on whether one limited partner has a controlling financial interest should be assessed when an investor first becomes a partner. A reassessment should be made at each subsequent reporting period for the nonprofit organization's financial statements.

Special-purpose-entity Lessors. An organization that has a lease with a special-purpose entity (SPE) lessor should consolidate the lessor if the following conditions exist:

a. Substantially all of the activities of the SPE involve assets leased to a single lessee

b. The expected substantive residual risks and substantially all of the residual rewards of the leased assets and underlying debt reside with the lessee through the lease agreement; a residual value guarantee; a guarantee of the SPE's debt; or an option that allows the lessee to purchase the leased asset at a fixed price, a price other than fair value, or to receive excess sales proceeds

c. The owners of the SPE have not made an initial substantive residual equity capital investment that is at risk during the lease term. (However, if the owner of the SPE is a related party, this condition is met regardless of the size of the capital investment.)

If the SPE was created for both the construction and subsequent lease of an asset, and the conditions described earlier in this section exist, consolidation of the lessee should begin at the date of the lease agreement or commitment (that is, the lease inception) rather than at the beginning of the lease term.

Less Than a Majority Voting Interest

If a nonprofit organization owns 50% or less of the voting stock in an entity but can exercise significant influence over that entity, the organization generally should report its interest using the equity method of accounting unless that investment is reported at fair value as later in this lesson. *Absent evidence to the contrary*, an organization is presumed to have the ability to significantly influence an entity if it directly or indirectly owns 20% or more of the entity's voting stock.

The nonprofit organization should also generally use the equity method if it has a noncontrolling interest in a limited partnership, real estate partnership, limited liability company, or a similar entity that is more than minor unless that investment is reported at fair value as described in the next section on that topic.

If the nonprofit organization's ownership interest in a for-profit entity is minor, it reports the investment as follows:

- Equity securities with readily determinable fair values are reported at fair value.

- Equity securities that do not have readily determinable fair values and other types of ownership interests are reported in accordance with the guidance for other investments.

Reporting Interests at Fair Value. An organization may report certain investments in for-profit entities at fair value when consolidation or the equity method would otherwise be required as follows—

- An organization that holds a noncontrolling equity interest (described in item b. earlier in this section) may report that investment at fair value using the framework provided in FASB ASC 820, even if the equity securities do not have readily determinable fair values. This choice, referred to as the *fair value option*, is described in FASB ASC 825-10, *Financial Instruments—Overall*.

- An organization that holds an investment described earlier in this section in items b.–d. may be allowed to report that investment at fair value in accordance with the provisions in Lesson 4.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

14. Which of the following statements regarding ownership interests in for-profit entities is correct?

    a. How a nonprofit organization reports its ownership interest in a for-profit entity depends on whether or not the organization is the trustee.

    b. If an organization is a general partner in a imited partnership, it should consolidate the investee if it controls the partnership.

    c. The AICPA Audit and Accounting Guide provides guidance for determining if the general partner has control.

    d. If it can exercise significant influence over the partnership's operating and financial policies, an organization with a noncontrolling interest in a real estate partnership that is more than minor should use the cost method to report its investment.

15. OrgA, a nonprofit organization, owns 55% of the voting common stock of Alias Company, a for-profit entity. How should OrgA account for its investment in Alias Company?

    a. Consolidation.

    b. Cost method.

    c. Fair value.

    d. Equity method.

16. Which of the following nonprofit organizations should use the equity method to report its investment in a for-profit entity?

    a. OrgA owns 80% of the voting common stock of Mountain, Inc. OrgA has control over Mountain, Inc.

    b. OrgB owns 10% of the voting common stock of Pacific, Inc. The fair value of Pacific is readily determinable.

    c. OrgC owns 15% of the voting common stock of Eastern, Inc. The fair value of Eastern is not readily determinable.

    d. OrgD owns 25% of the voting common stock of Central, Inc. The fair value of Central is not readily determinable.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

14. Which of the following statements regarding ownership interests in for-profit entities is correct? **(Page 43)**

    a. How a nonprofit organization reports its ownership interest in a for-profit entity depends on whether or not the organization is the trustee. [This answer is incorrect. How a nonprofit organization reports its ownership interest in a for-profit entity generally depends on whether it has a controlling financial interest in the entity.]

    b. If an organization is a general partner in a imited partnership, it should consolidate the investee if it controls the partnership. [This answer is correct. According to FASB ASC 958-81015-4, an organization that is a general partner in a limited partnership or similar entity should consolidate the investee if it controls the partnership.]

    c. The AICPA Audit and Accounting Guide provides guidance for determining if the general partner has control. [This answer is incorrect. GAAP provides guidance for determining whether the general partner has control.]

    d. If it can exercise significant influence over the partnership's operating and financial policies, an organization with a noncontrolling interest in a real estate partnership that is more than minor should use the cost method to report its investment. [This answer is incorrect. An organization with a noncontrolling interest in a real estate partnership, real estate limited liability company, or similar real estate entity that is more than minor should use the equity method to report its investment if it can exercise significant influence over the partnership's operating and financial policies; otherwise the cost method should be used.]

15. OrgA, a nonprofit organization, owns 55% of the voting common stock of Alias Company, a for-profit entity. How should OrgA account for its investment in Alias Company? **(Page 44)**

    a. Consolidation. [This answer is correct. A nonprofit organization should consolidate the activities of a for-profit entity in which it has a controlling financial interest, either directly or indirectly. A controlling financial interest usually is evidenced by ownership of a majority voting interest.]

    b. Cost method. [This answer is incorrect. If OrgA owns less than 50% of Alias Company, does not have a significant influence over Alias Company, and the fair value is not readily determinable, the cost method can be used to account for the investment.]

    c. Fair value. [This answer is incorrect. If OrgA owns less than 50% of Alias Company, does not have a significant influence over Alias Company, but the fair value of Alias Company is readily determinable, the fair value method can be used.]

    d. Equity method. [This answer is incorrect. If OrgA owns less than 50% of Alias Company, but has a significant influence over Alisa Company, the equity method can be used.]

16. Which of the following nonprofit organizations should use the equity method to report its investment in a for-profit entity? **(Page 46)**

    a. OrgA owns 80% of the voting common stock of Mountain, Inc. OrgA has control over Mountain, Inc. [This answer is incorrect. OrgA should consolidate Mountain.]

    b. OrgB owns 10% of the voting common stock of Pacific, Inc. The fair value of Pacific is readily determinable. [This answer is incorrect. OrgB should use the fair value method to report its investment in Pacific.]

    c. OrgC owns 15% of the voting common stock of Eastern, Inc. The fair value of Eastern is not readily determinable. [This answer is incorrect. OrgC should use the cost method to report its investment in Eastern.]

    d. OrgD owns 25% of the voting common stock of Central, Inc. The fair value of Central is not readily determinable. [This answer is correct. If a nonprofit organization owns common stock in a for-profit entity and has 50% or less of the voting interest but can exercise significant influence over that entity, the organization should generally report its interest using the equity method of accounting unless that investment is reported at fair value.]

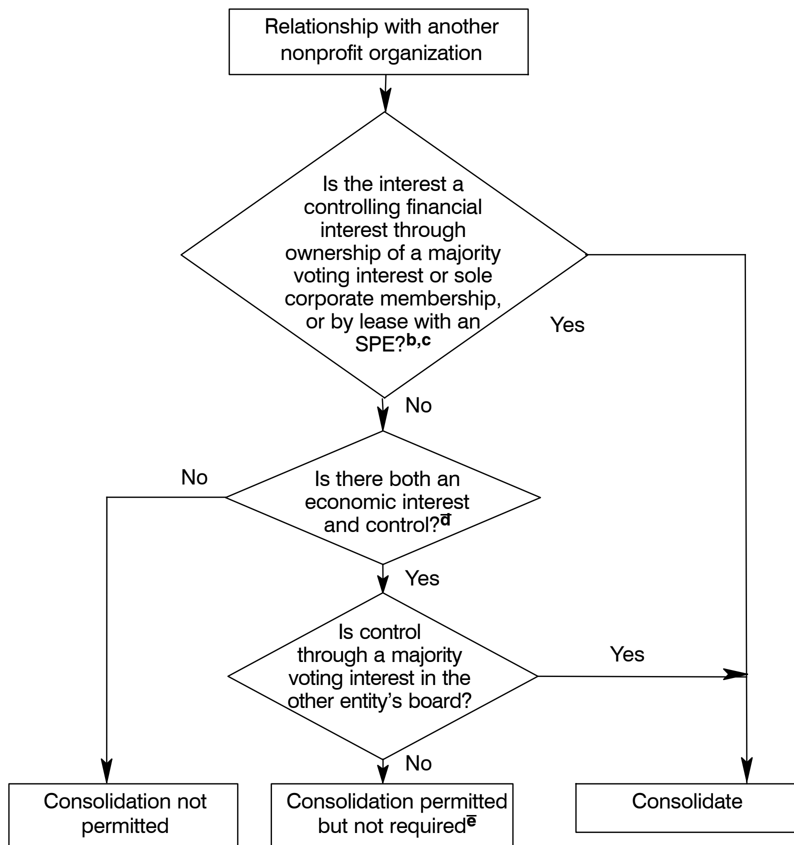
INTERESTS IN NONPROFIT ORGANIZATIONS

A nonprofit organization may be required to consolidate a related nonprofit organization, depending on the nature of its relationship with the entity. Generally, if an organization owns another nonprofit entity or has a controlling financial interest, it should consolidate the organization's activities into its financial statements. If the organization does not have a controlling financial interest in the organization, however, it may still be required (or permitted) to consolidate the related organization's activities.

In determining how to report a relationship with another nonprofit organization, an organization should evaluate whether it has a controlling financial interest or control through other means. Exhibit 5-2 presents a flowchart that summarizes the reporting guidance for different relationships between nonprofit organizations. The following paragraphs discuss the various types of relationships and whether they result in consolidation.

Exhibit 5-2

Accounting for Relationships With Other Nonprofit Organizations[a]



Notes:

[a] This flowchart summarizes the guidance in FASB ASC 958-810-25. See also the implementation guidance at FASB ASC 958-810-55-3.

[b] If the majority voting interest or sole corporate membership does not result in control, the answer should be "No."

[c] The conditions that require consolidation of an SPE lessor were described elsewhere in this lesson.

[d] If there is an economic interest or control but not both, consolidation is not permitted, but the relationship should be disclosed.

[e] If consolidated financial statements are not presented, the disclosures described in FASB ASC 958-810-50-2 are required.

* * *

Controlling Financial Interest

Generally, a nonprofit organization that has either a direct or indirect controlling financial interest in another nonprofit organization through ownership of a majority voting interest or sole corporate membership should consolidate the other organization's activities into its financial statements. An exception to the general rule is if ownership of the majority voting interest or sole corporate membership does not give the organization control (for example, because the related entity is in legal reorganization or bankruptcy).

The existence of supermajority voting requirements by the board of directors to approve certain actions may, however, be sufficient to overcome the presumption of control by the holder of the majority voting interest. Judgment is required to determine if those voting requirements are so restrictive as to call into question whether the investor has a controlling financial interest, or if they have little or no effect on the ability to control the investee's assets or operations.

Economic Interest and Control

An organization has *control* over another entity when it has the direct or indirect ability to determine the direction of the entity's management and policies. An organization has an *economic interest* in another entity when:

a. the other entity holds or uses significant resources to directly or indirectly produce income for or provide services to the organization, or

b. the organization is responsible for the other entity's liabilities.

For example, if another organization solicits funds in the name of the organization or if the organization provides funds to another organization, an economic interest is present. An economic interest is also present if an organization has the right to, or a responsibility for, the operating results of another entity, or if it is entitled to the net assets, or is responsible for any deficit, of another entity upon dissolution.

If an organization has an economic interest without control, or control without an economic interest, it should *not* consolidate the activities of the other entity. When both control and an economic interest are present, reporting the relationship with the other nonprofit organization varies depending on whether there is—

- an economic interest and control in the other entity through a majority voting interest in the board, or
- an economic interest and control by other means.

Economic Interest and Control through Majority Voting Interest in the Board. A nonprofit organization that has both an economic interest and control of another nonprofit organization through a majority voting interest in the other organization's board should consolidate that entity's activities into its financial statements unless the majority voting interest does not give the organization control.

To have control through a majority voting interest in the board, an organization must have the direct or indirect ability to appoint individuals that together constitute a majority of the votes of the fully constituted board, including any vacant board positions. Simply having a majority interest in the related organization's board without the ability to *require* that the majority of the members be appointed by the organization does not meet the criteria for control.

Economic Interest and Control by Other Means. Nonprofit organizations sometimes have control over, and economic interests in, other nonprofit organizations without having a majority ownership interest, sole corporate membership, or majority voting interest in the board of the other entity. This type of control could be obtained as a result of a contract, affiliation agreement, or other means. In such cases, consolidation is permitted but not required. The guidance states, however, that consolidation is encouraged if—

a. The organization controls another nonprofit organization in which it has an economic interest and that control does not result from (1) a controlling financial interest through direct or indirect ownership of a majority voting interest, or (2) a majority voting interest

b. Consolidation would be meaningful

Certain disclosures are required if an organization does not consolidate its interest in another nonprofit organization in which it has an economic interest and control by other than a controlling financial interest or a majority voting interest.

DISCLOSURE REQUIREMENTS

If an organization is permitted to consolidate a financially related nonprofit entity as described earlier in this lesson but chooses *not* to, the following disclosures are required:

a. Identification of the related nonprofit organization and the nature of the relationship that results in control

b. Summary of the related entity's financial information, including total assets, liabilities, net assets, revenue, and expenses

c. Resources held by the related entity for the benefit of (or under the control of) the reporting organization

d. Related party disclosures required by FASB ASC 850-10-50-1 through 50-6.

Upon the initial adoption of ASU 2015-02, Consolidation (Topic 810): Amendments to the Consolidation Analysis, and ASU 2017-02, Not-for-Profit Entities—Consolidation (Subtopic 958-810): Clarifying When a Not-for-Profit Entity That Is a General Partner or a Limited Partner Should Consolidate a For-Profit Limited Partnership or Similar Entity, the following should be disclosed:

a. If the nonprofit organization that is the reporting entity is required to consolidate a legal entity upon the initial adoption of the ASUs:

    (1) A description of the transition method(s) applied to determine the carrying amounts of the newly consolidated legal entity.

    (2) Amount and classification in the statement of financial position of the consolidated assets or liabilities by transition method.

b. If the fair value option is for legal entities that are consolidated as a result of adopting the ASUs:

    (1) The disclosures required for the fair value option.

    (2) Management's reasons for the fair value option election for a particular entity or group of legal entities.

    (3) The reasons for the differing elections when the fair value option is elected for some legal entities and not others.

    (4) Quantitative information by line item in the statement of financial position, indicating the related effect of electing the fair value option on the cumulative-effect adjustment to net assets.

c. If the nonprofit organization that is the reporting entity is required to deconsolidate a legal entity upon adopting the ASUs, the amount of any cumulative-effect adjustment related to the deconsolidation, separate from any cumulative-effect adjustment related to the initial consolidation of other legal entities upon adoption of the ASUs.

d. The applicable disclosures for a change in accounting principle at FASB ASC 250-10-50-1 through 50-2, except the disclosure at FASB ASC 250-10-50-1(b)(2).

If a nonprofit organization has either control of, or an economic interest in, another nonprofit entity (but not both), the organization should provide the related party disclosures required by FASB ASC 850-10-50-1 through 50-6.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

17. When are the disclosures described in FASB ASC 958-810-50-2 required?

    a. When consolidation is not permitted and there is both an economic interest and control.

    b. When consolidated financial statements are not presented.

    c. If sole corporate membership does not result in control, consolidation should be permitted.

18. Which of the following statements regarding economic control is correct?

    a. Merely owning a majority interest in the related organization's board without the ability to require that the majority of the members be assigned by the organization, does not meet the standards for control.

    b. Nonprofit organizations cannot have economic interests in, or control over, other nonprofit organizations without having sole corporate membership.

    c. If an organization is responsible for the operating results of another entity, an economic interest no longer exists.

    d. An organization that has economic interest without control can consolidate the activities of other entities.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

17. When are the disclosures described in FASB ASC 958-810-50-2 required? **(Page 50)**

    a. When consolidation is not permitted and there is both an economic interest and control. [This answer is incorrect. If there is an economic interest or control but not both, consolidation is not permitted, but the relationship should be disclosed.]

    b. When consolidated financial statements are not presented. [This answer is correct. If consolidated financial statements are not presented, the disclosures described in FASB ASC 958-810-50-2 are required.]

    c. If sole corporate membership does not result in control, consolidation should be permitted. [This answer is incorrect. If the majority voting interest or sole corporate membership does not result in control, consolidation is not permitted.]

18. Which of the following statements regarding economic control is correct? **(Page 51)**

    a. Merely owning a majority interest in the related organization's board without the ability to require that the majority of the members be assigned by the organization, does not meet the standards for control. [This answer is correct. Simply having a majority interest in the related organization's board without the ability to *require* that the majority of the members be appointed by the organization does not meet the criteria for control.]

    b. Nonprofit organizations cannot have economic interests in, or control over, other nonprofit organizations without having sole corporate membership. [This answer is incorrect. Nonprofit organizations sometimes have control over, and economic interests in, other nonprofit organizations without having a majority ownership interest, sole corporate membership, or majority voting interest in the board of the other entity.]

    c. If an organization is responsible for the operating results of another entity, an economic interest no longer exists. [This answer is incorrect. An economic interest is present if an organization has the right to, or a responsibility for, the operating results of another entity, or if it is entitled to the net assets, or is responsible for any deficit, of another entity upon dissolution.]

    d. An organization that has economic interest without control can consolidate the activities of other entities. [This answer is incorrect. If an organization has an economic interest without control, or control without an economic interest, it should *not* consolidate the activities of the other entity.]

Lesson 6: Split-interest Agreements

INTRODUCTION

Split-interest agreements allow the benefits of a trust or other arrangement to be shared by the nonprofit organization and other beneficiaries. A split-interest agreement is created when a donor decides to transfer assets directly to a nonprofit organization or place them in a trust for the benefit of the nonprofit organization and another beneficiary.

Split-interest agreements are either revocable or irrevocable. Revocable split-interest agreements are not recognized as contributions, while the benefits to be received by the organization related to irrevocable split-interest agreements are generally recorded as contributions. The accounting treatment varies for irrevocable split-interest agreements, depending on the type of split-interest arrangement created and whether the organization or a third party is trustee for the assets.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize how split-interest agreement contributions are shared by nonprofit organizations and other beneficiaries.

ACCOUNTING REQUIREMENTS

Nonprofit organizations may receive contributions from donors in different forms. Some gifts may be for the sole use of the recipient nonprofit organization, while others are passed on, in whole or in part, to others. Split-interest agreements are agreements in which donors enter into trusts or other arrangements under which the benefits are to be shared by the nonprofit organization and other beneficiaries. The other beneficiaries generally are not other nonprofit organizations.

A typical split-interest agreement has a lead interest and a remainder interest. A *lead interest* is the right to the use or cash flows of assets during the term of the split-interest agreement. The term of the agreement may be expressed in a specified number of years or it may be based on the occurrence of a certain event, such as the death of the donor or the lead beneficiary. The right to receive all or a portion of the assets that remain in a split-interest agreement when the term of the agreement ends is the *remainder interest*.

There are two basic types of split-interest agreements—revocable and irrevocable. A nonprofit organization should determine whether the agreement is revocable or irrevocable when it is notified of or receives assets under a split-interest agreement.

REVOCABLE SPLIT-INTEREST AGREEMENTS

A revocable split-interest agreement (that is, one that can be cancelled by the donor) should be accounted for as an intention to give.

If a nonprofit organization receives assets under a revocable split-interest agreement, they are measured at fair value and recognized by debiting assets and crediting a refundable advance. Changes in the carrying value of assets received under revocable split-interest agreements and income from those assets that is not available for the organization's unconditional use should be recognized as adjustments to the recorded asset and related refundable advance. If income generated by assets is available for the organization's unconditional use, it should be recognized as contribution revenue in the appropriate class of net assets, depending on the existence or absence of donor restrictions. Assets received under a revocable split-interest agreement should be recognized as contribution revenue only when the agreement becomes irrevocable or the assets become available to the organization for its unconditional use, whichever occurs first.

IRREVOCABLE SPLIT-INTEREST AGREEMENTS

The time at which an organization is considered to receive an irrevocable split-interest agreement depends on whether the organization or a third party is trustee for the agreement. If the organization is trustee or fiscal agent of the assets, the gift is considered received when the donor executes the split-interest agreement. If an unrelated third party (such as a bank, trust company, or private individual) is the trustee or fiscal agent of the assets and the nonprofit organization has an unconditional right to receive all or a portion of the specified cash flows from the assets, the organization should record its lead interest in the split-interest agreement when it is notified of the gift's existence. However, if an unrelated third-party trustee has variance power and can redirect the benefits of the assets to another organization, or if the organization's rights to the benefits are conditional, the agreement should be considered an intention to give. The organization should not recognize the contribution until it has an unconditional right to receive benefits under the split-interest agreement.

The following paragraphs describe in general terms the accounting treatment for an irrevocable split-interest agreement when it is created, when changes in value occur during the term of the agreement, and when the agreement is terminated.

Initially Recording the Agreement

When and how a nonprofit organization records a split-interest agreement differs depending on whether the organization or a third party is the trustee or otherwise controls the contributed assets.

a. *Third-party Trustee*. If assets contributed under an irrevocable split-interest agreement are held or controlled by a third party, and the organization has an unconditional right to receive all or a portion of the specified cash flows from the assets, the organization should recognize its beneficial interest in the assets and contribution revenue at fair value.

b. *Organization Is Trustee*. If the organization holds or controls the assets contributed under an irrevocable split-interest agreement, it should:

    (1) Measure the assets received at their fair value.

    (2) Measure the liability for any portion of the assets held for the donor or other beneficiaries at fair value. If a present value technique is used, fair value should generally be measured at the present value of the future payments to be made to the other beneficiaries.

    (3) Measure contribution revenue at fair value.

Depending on whether the trustee nonprofit organization has a lead interest or a remainder interest in the split-interest agreement, either the fair value of contribution revenue or the fair value of the split-interest liability to other beneficiaries can be estimated as follows:

- If the organization has a lead interest (i.e., if payments will be made to other beneficiaries only after the organization receives its benefits), the fair value of the contribution can be estimated directly based on the present value of the future distributions to be received by the organization as a beneficiary. In that case, the fair value of the liability for payments to other beneficiaries can be estimated as the difference between the fair values of the contributed assets and contribution revenue. (If a present value technique is used to measure the fair value of the contribution, it should be based on the present value of the benefits to be received over the expected term of the agreement.)

- If the organization has a remainder interest in the assets (i.e., if it receives assets only when obligations to other beneficiaries are satisfied), the fair value of the liability based on the present value of future payments to be made to other beneficiaries often can be computed directly from the terms of the split-interest agreement. In that case, the fair value of contribution revenue is estimated as the difference between the fair values of the contributed assets and the liability for payments to be made to other beneficiaries.

Net Asset Classification. As a general rule, contributions of assets to be received in the future carry an implied time restriction; accordingly, the contribution revenue recognized under split-interest agreements should be classified as temporarily restricted unless the donor stipulates otherwise. However, explicit donor stipulations may require the contribution revenue to be classified otherwise, as follows:

- If the donor permanently restricts the organizations use of its lead or remainder interest in the assets, the contribution should be classified as an increase in permanently restricted net assets.
- If the donor grants the organization the immediate unrestricted right to use the assets, the contribution should be classified as an increase in unrestricted net assets.

Net Asset Classification After the Effective Date of ASU 2016-14

Contribution revenue recognized under split-interest agreements should be classified as an increase in net assets without donor restrictions if the donor gives the organization the immediate right to use, without restrictions, the assets it receives. Otherwise, the contribution is classified as an increase in net assets with donor restrictions.

Some charitable gift annuity agreements allow the organization to hold the gifted assets as part of its general assets and the assets are available for the organization's general use. In a split-interest agreement that includes a charitable gift annuity, the contribution is without donor restrictions if (1) the donor does not restrict the use of the assets, and (2) neither the agreement nor laws and regulations require the assets to be invested until the death of the annuity beneficiary. (Annuity reserves that are required by state laws do not create donor restrictions.) If either of these conditions are not met, the contribution of the charitable gift annuity is reported as an increase in net assets with donor restrictions. When donor-imposed restrictions or legal requirements are satisfied, net assets with donor restrictions are reclassified as net assets without donor restrictions.

Upon receiving distributions under the terms of the split-interest agreement, the nonprofit organization should reclassify net assets with donor restrictions to net assets without donor restrictions unless those net assets were further restricted by the donor. If there are additional donor-imposed stipulations, the net assets are reclassified to net assets without donor restrictions when all restrictions expire.

Recording Changes in Value during the Agreement Term

After initially recognizing an irrevocable split-interest agreement, an organization will need to recognize transactions and events during the term of the agreement at each financial reporting date. The accounting for the agreement during its term varies depending on whether the nonprofit organization, or a third party, is the trustee or otherwise controls the contributed assets.

a. *Third-party Trustee.* If assets contributed under an irrevocable split-interest agreement are held or controlled by a third party, the organization should recognize changes in the fair value of its beneficial interest using the same valuation technique that it initially used to measure the beneficial interest. When measuring fair value using present value techniques, all of the elements of the present value measurement, including the discount rate, should be revised at each remeasurement date to reflect current market conditions.

b. *Organization Is Trustee.* If the assets held by the nonprofit organization are investments in equity securities with readily determinable fair values or investments in debt securities, the organization should recognize changes in fair value in accordance with the guidance in Lesson 2. If the nonprofit organization holds other assets as trustee for a split-interest agreement, subsequent changes in fair value should be recognized in accordance with the applicable guidance in Lesson 4. The measurement of the liability for future payments to beneficiaries will change as a result of (1) amortization of the discount set up to record the benefits to be received at fair value and (2) revaluations of the future payments to the beneficiaries based on changes in life expectancy and other actuarial assumptions, unless the measurement objective is fair value. Generally, the rate used to determine the discount should not change after initially recognizing the split-interest agreement unless the measurement objective is fair value. Thus, the discount should typically only be adjusted for current period amortization.

The transactions and events that must be recorded during the term of the split-interest agreement should be recorded as increases or decreases to the assets and liabilities recorded under the agreement, with a corresponding amount recorded as "change in value of split-interest agreements'' in the statement of activities. The amount recognized in the statement of activities should be classified in the same net asset classification used when the contribution was initially recorded.

A nonprofit organization serving as trustee or fiscal agent for the assets covered by a split-interest agreement also should recognize in its financial statements income earned on assets, gains and losses on sales of assets, and distributions to other beneficiaries.

Measuring the Split-interest Liability. The measurement objective for the liability for future payments to the donor or other beneficiaries under an irrevocable split-interest agreement in which the organization serves as the trustee for contributed assets is fair value if:

- The organization elects the fair value option available under FASB ASC 825-10.
- The split-interest agreement contains an embedded derivative subject to the measurement requirements of FASB ASC 815.
- The split-interest agreement contains an embedded derivative and the organization has elected to measure obligations containing embedded derivatives in their entirety at fair value in conformity with FASB ASC 815-15-25.

The election to measure the obligation to the noncharitable beneficiary at fair value may be made on an instrument-by-instrument basis and should be supported by concurrent documentation or by a preexisting documented policy for automatic election. If an organization elects to measure the obligation for a split-interest agreement at fair value using present value techniques, the entire split-interest liability should be remeasured at fair value. All assumptions, including discount rate assumptions, should be revised at each measurement date to reflect current market conditions.

When assets of a split-interest agreement are held by the nonprofit organization, the measurement of the liability to the beneficiary depends upon whether (a) payments are of a fixed or a variable amount, and (b) the term of the agreement is period-certain or life-contingent. The obligation must be analyzed to determine whether it is subject to the requirements of FASB ASC 815 either because it meets the definition of a derivative in its entirety or because it contains an embedded derivative instrument that requires separate accounting. However, in accordance with FASB ASC 815-10-15-52 through 15-57, the liability is exempt from the requirements of FASB ASC 815 if the obligation is life-contingent (that is, payments are made only if the beneficiary is alive when payments are due). Split-interest obligations typically will not meet the criterion in FASB ASC 815-10-15-83 for classification as derivative instruments in their entirety. If the payments under the agreement are variable and the agreement is period-certain, the liability to the beneficiary may contain an embedded derivative. The criteria for assessing whether an embedded derivative exists are provided at FASB ASC 815-15-25-1.

To help nonprofit organizations determine if their split-interest agreements contain embedded derivatives that have to be accounted for in accordance with FASB ASC 815, Example 2 in FASB ASC 958-30-55 provides eight cases and explains whether there are embedded derivatives. In general, a split-interest agreement should be examined to see if it has an embedded derivative that must be measured at fair value if it requires a payment or payments to a noncharitable beneficiary in amounts that can vary based on the assets in the trust, and the payments are made for either: (a) a defined period (e.g., ten years), or (b) a defined period plus a life contingency (e.g., life, but no less than ten years).

There are two allowable ways of accounting for an irrevocable split-interest gift that contains an embedded derivative that is within the scope of FASB ASC 815-15.

a. Divide the liability to the beneficiary into two parts: a debt host contract and an embedded derivative. (GAAP refers to this as bifurcating the liability.) The debt host 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. The organization then accounts for the two liabilities as described below.

b. Elect to measure the entire split-interest obligation at fair value in conformity with FASB ASC 815-15-25, or the Fair Value Option Subsections of FASB ASC 825-10.

In circumstances in which the liability for the debt host is initially measured using present value techniques, discount rate assumptions should not be changed after initial recognition. If the fair value of the liability (or contra-liability) for the embedded derivative is measured using present value techniques, all of the elements in the fair value measurement, including the discount rate assumptions, are updated in subsequent periods to reflect current market conditions.

If an organization cannot reliably identify and measure the embedded derivative, the entire liability to the noncharitable beneficiary is measured at fair value. If the fair value of the liability is measured using present value techniques, all of the elements used in that measurement, including discount rate assumptions, should be revised to reflect current market conditions at subsequent measurement dates. Alternatively, the organization can irrevocably elect to measure the entire liability at fair value in accordance with FASB ASC 815-15-25 or the Fair Value Option Subsections of FASB ASC 825-10, even if it can reliably identify and measure the derivative.

Accounting for the Termination of the Agreement

At the end of the split-interest agreement term, an amount necessary to reduce all related assets and liabilities to zero should be recognized in the statement of activities as "change in value of split-interest agreements." A reclassification of net assets should be reported when any donor-restricted assets previously distributed under the terms of the agreement are released from donor-imposed restrictions.

Common Types of Split-interest Agreements

Common types of split-interest agreements are:

- Charitable lead trusts
- Charitable remainder trusts
- Charitable gift annuities
- Pooled income funds

The following paragraphs describe how the general rules listed earlier discussed in the previous paragraphs should be applied to each of those types of split-interest agreements.

Effects of ASU 2016-14 on the Accounting For Split-interest Agreements

In August 2016, the FASB issued ASU 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities,* which significantly amends the standards for the presentation and accompanying disclosures of the financial statements of nonprofit organizations.

As a result of ASU 2016-14, the three classes of net assets in current GAAP are reduced to two. Instead of reporting unrestricted, temporarily restricted, and permanently restricted net assets, nonprofit organizations will report net assets in terms of those *with donor restrictions* and those *without donor restrictions.* To avoid unnecessary complexity in the illustrative examples of accounting for the common types of split-interest agreements discussed in the remainder of this section, the authors combine the net asset descriptions and certain other descriptions that are applicable before and after the adoption of ASU 2016-14. For example, to describe the receipt of assets for a charitable lead trust in, the first illustrative accounting entry for the contribution uses the description: "Contribution revenue—temporarily restricted/with donor restrictions" to indicate the net asset classification both before and after ASU 2016-14 is adopted.

The amendments in ASU 2016-14 are effective for annual financial statements issued for fiscal years beginning after December 15, 2017, and interim periods within fiscal years beginning after December 15, 2018. Early adoption is permitted. ASU 2016-14 is to be applied on a retrospective basis.

Charitable Lead Trusts

Under a charitable lead trust agreement, a donor establishes a trust naming a nonprofit organization as beneficiary. Under the agreement, the nonprofit organization receives distributions from the trust until termination of the agreement, at which time the remaining assets in the trust are paid out to the donor or other beneficiaries named by the donor. The donor may or may not restrict the use of the assets distributed to the organization. Charitable lead trusts generally take the following two forms:

- Charitable lead annuity trusts (CLATs). Under this type of charitable lead trust, the nonprofit organization periodically receives a fixed dollar amount from the trust during the agreement's term.
- Charitable lead unitrusts (CLUTs). Under this type of charitable lead trust, the nonprofit organization periodically receives a distribution of a fixed percentage of the trust's fair value during the agreement's term.

The accounting requirements for recording a charitable lead trust agreement depend on whether the nonprofit organization is the trustee or otherwise controls the assets.

Third Party Is Trustee. Exhibit 6-1 presents an example charitable lead trust with a third party as trustee. As illustrated in the example, an organization should initially measure its beneficial interest in the trust and contribution revenue at fair value. During the term of the agreement, the organization should record distributions as reductions in the beneficial interest rather than as contribution revenue. The organization should recognize changes in the fair value of the beneficial interest at subsequent reporting dates by adjusting that account and recognizing the change in the fair value of the beneficial interest in the statement of activities. If the organization used present value techniques to determine fair value, it should also amortize the discount on the present value of future benefits by increasing its beneficial interest balance and recognizing the change in value of split-interest agreements on its statement of activities (an increase in net assets). When measuring fair value using present value techniques, the discount rate assumptions should be revised to reflect current market conditions. In addition, present value techniques also need to consider all other present value assumptions, including revaluations of expected benefits based on revisions in the life expectancy of the donor (if the trust terminates at the donor's death). When the trust terminates, the organization should adjust its remaining beneficial interest account to zero and record a corresponding debit to the change in value of split-interest agreements account.

Exhibit 6-1

Illustrative Example Charitable Lead Trust
When an Unrelated Third Party Is Trustee

Assumptions

Helen Smith establishes and funds an irrevocable charitable lead annuity trust agreement with assets valued at $500,000, naming Fidelity Bank as trustee and the Hope Organization as lead beneficiary. Under the terms of the agreement, Fidelity Bank will invest the trust assets and the Hope Organization will receive $25,000 from the trust each year. Ms. Smith did not place any restrictions on the annual distributions to the Hope Organization. The trust terminates upon Ms. Smith's death, with the remaining trust assets becoming part of her estate, to be distributed in accordance with her will. The Hope Organization measured fair value using a present value technique to calculate the present value of the dollar amounts to be received annually over the expected life of Ms. Smith. The present value of the future benefits expected to be received by Hope Organization is calculated as $230,000.

Initial Recording

When the trust is established, the Hope Organization would record the following entry:

Beneficial interest in lead trust	230,000	
Contribution revenue—temporarily restricted/with donor restrictions		230,000

Recording Over Term of the Agreement

Annual Distributions. The Hope Organization would make the following entry when the $25,000 annual distribution amount is received:

Cash	25,000	
Beneficial interest in lead trust		25,000

Reclassify Net Assets. In addition, the following entry would be required to reflect the Hope Organization's right to use, without restrictions the distribution:

Net assets released from restrictions— temporarily restricted/with donor restrictions	25,000	
Net assets released from restrictions—unrestricted/without donor restrictions		25,000

Remeasuring Fair Value. In subsequent periods, Hope Organization should recognize changes in the fair value of its beneficial interest using the same valuation technique that it initially used to measure the beneficial interest. Because Hope Organization initially estimated the fair value by calculating the present value of its expected future cash inflows, it would remeasure its beneficial interest using that same method. All assumptions, including the discount rate, should be revised to reflect current market conditions.

Assume for purposes of this example that Hope Organization considered current market conditions the first year, and the discount rate and other assumptions for measuring the fair value of the beneficial interest did not change. Accordingly, Hope Organization would only need to recognize amortization of the discount. Assuming amortization of the discount on the present value of future distributions for the first year is $1,800, discount amortization should be recorded as follows:

Beneficial interest in lead trust	1,800	
Change in value of split-interest agreements—temporarily restricted/with donor restrictions		1,800

Revaluation of Future Distributions. If, in the fifth year, an increase in the life expectancy of Ms. Smith results in a $17,000 increase in the estimated present value of the future benefits expected to be received by Hope Organization, the Hope Organization would record the following revaluation adjustment entry:

Beneficial interest in lead trust	17,000	
Change in value of split-interest agreements—temporarily restricted/with donor restrictions		17,000

Termination of the Agreement

When Ms. Smith dies, the trust terminates. Assuming Ms. Smith dies earlier than actuarial assumptions projected and the remaining beneficial interest balance is $31,000, the Hope Organization would make the following entry to reduce the remaining receivable to zero:

Change in value of split-interest agreements—temporarily restricted/with donor restrictions	31,000	
Beneficial interest in lead trust/with donor restrictions		31,000

* * *

Organization Is Trustee. Exhibit 6-2 presents an example of a charitable lead trust for which the nonprofit organization holds the trust assets. The organization should initially recognize the contribution revenue and related assets and liabilities when the split-interest agreement is executed. When the trust assets are received, the organization measures the assets held in the charitable lead trust at their fair values on the date the split-interest

agreement was recognized. Because the organization has a lead interest, payments to other beneficiaries will be made only after the organization receives its benefits. Accordingly, contribution revenue should be measured at the fair value of the future distributions the organization will receive. If a present value technique is used, the fair value is estimated as the present value of the specified dollar amounts to be received over the expected term of the agreement (the life of the donor). The fair value of the liability for amounts held for other beneficiaries can be estimated as the difference between the fair values of the assets received and the contribution recognized.

Exhibit 6-2

Illustrative Example Charitable Lead Trust
When Organization Is the Trustee

Assumptions

Helen Smith establishes and funds an irrevocable charitable lead annuity trust agreement with assets valued at $500,000, naming the Hope Organization as trustee and lead beneficiary. Under the terms of the agreement, the Hope Organization will invest the trust assets and receive $25,000 from the trust each year. Ms. Smith did not place any restrictions on the annual distributions to Hope Organization. The trust terminates upon Ms. Smith's death, with the remaining trust assets becoming part of her estate, to be distributed in accordance with her will. Hope Organization used present value techniques to determine fair value at initial recognition and did not elect to measure the obligation at fair value in subsequent periods. The present value of the future benefits expected to be received by Hope Organization is calculated as $230,000.

Although the liability for the ultimate payment to Ms. Smith's estate is affected by changes in the value of the trust assets, the obligation is exempt from the requirements of FASB ASC 815 because it represents a single payment whose amount and timing is solely life-contingent.

Initial Recording

When the trust is established, the Hope Organization would record the following entry:

Assets held in charitable lead trust	500,000	
Contribution revenue—temporarily restricted/with donor restrictions		230,000
Liability for amounts held for others		270,000

Recording Over Term of the Agreement

At each reporting period, the assets held in trust under the split-interest agreement should be reported in accordance with the applicable guidance discussed in *PPC's Guide to Nonprofit GAAP*. Income, gains, and losses are reflected as changes in the trust assets and split-interest liability accounts. Over the term of the agreement, the liability for amounts held for others is adjusted for the amortization of the discount initially recognized to estimate the fair value of the contribution. The liability would also need to be adjusted for any reevaluations of future cash flows due to changes in the donor's life expectancy.

Income Earned on Assets. Assuming the Trust has investment earnings of $20,000 during the first year, the following entry would be necessary:

Assets held in charitable lead trust	20,000	
Liability for amounts held for others		20,000

Annual Distributions. The Hope Organization would make the following entry when the $25,000 annual distribution amount is received:

Cash	25,000	
Assets held in charitable lead trust		25,000

Reclassify Net Assets. In addition, the following entry would be required to reflect the Hope Organization's right to use, without restrictions, the distribution:

Net assets released from restrictions— temporarily restricted/with donor restrictions	25,000	
Net assets released from restrictions—unrestricted/without donor restrictions		25,000

Amortization of Discount. Assuming amortization of the discount on the present value of future distributions for the first year is $1,800, discount amortization should be recorded as follows:

Liability for amounts held for others	1,800	
Change in value of split-interest agreements—temporarily restricted/with donor restrictions		1,800

Revaluation of Future Distributions. Revaluations of the liability for amounts held for others may be necessary to account for the change in future cash outflows when the donor's life expectancy changes, or for other changes in actuarial assumptions. The nonprofit organization should use the same technique and the same discount rate to measure its obligation as it used when it initially recognized the split-interest agreement. After the revaluation, the liability account is adjusted to the new estimate and the offset is a change in the value of split-interest agreements recognized in the statement of activities. The change should be classified in the same class of net assets initially determined when the contribution was recorded. If, in the fifth year, an increase in the life expectancy of Ms. Smith results in a $17,000 increase in the present value of the future benefits expected to be received by Hope Organization, the Hope Organization would record the following revaluation adjustment entry:

Liability for amounts held for others	17,000	
Change in value of split-interest agreements—temporarily restricted/with donor restrictions		17,000

Termination of the Agreement

When Ms. Smith dies, the trust terminates and the remaining assets are distributed to her estate. Assuming Ms. Smith dies earlier than actuarial assumptions projected, and the liability for amounts held for others was $367,000 rather than equal to the $398,000 value of the remaining trust assets, the Hope Organization would record the termination of this agreement as follows:

Liability for amounts held for others	367,000	
Change in value of split-interest agreements—temporarily restricted	31,000	
Assets held in charitable lead trust		398,000

* * *

Charitable Remainder Trust

Charitable remainder trusts are split-interest agreements in which a nonprofit beneficiary receives its interest in the donated assets after the donor or another beneficiary has received benefits for a specified time period. The donor establishes and funds the trust and specifies beneficiaries to receive distributions over the life of the split-interest agreement. At the termination of the agreement, the remaining assets in the trust pass to the nonprofit organization for its use. The donor may place temporary or permanent restrictions on the assets transferred to the nonprofit organization.

Charitable remainder trusts generally take the following two forms:

- *Charitable Remainder Annuity Trusts (CRATs).* Under this type of charitable remainder trust, distributions to the beneficiary are for a specified dollar amount.

- *Charitable Remainder Unitrusts (CRUTs).* Under this type of charitable remainder trust, the beneficiary receives a stated percentage of the fair value of the trust, determined annually. In some cases, the donor limits the CRUT distributions to the lesser of the actual amount earned or the stated distribution percentage.

The accounting requirements for recording a charitable remainder trust agreement depend on whether the nonprofit organization is the trustee or otherwise controls the assets.

Third Party Is Trustee. Exhibit 6-3 presents an example charitable remainder unitrust for which a third party is the trustee. As the example illustrates, the organization should initially measure its beneficial interest in the trust and the contribution revenue at fair value. 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 trust would be measured as the present value of the estimated future distributions the organization expects to receive over the term or upon termination of the agreement. The organization should recognize changes in the fair value of the beneficial interest (using the same measurement technique initially used to record the assets) by adjusting that account and recording either a debit or credit to the change in value of the split-interest agreements account on its statement of activities, as appropriate. When subsequently measuring fair value using a present value technique, all of the elements used in that measurement, including the discount rate, revaluations of the expected benefits to be received, and changes in other actuarial assumptions should be revised to reflect current market conditions. When the trust terminates, the organization should record the assets when received and adjust the remaining beneficial interest account to zero. Any difference should be recorded as a debit or credit to the change in value of split-interest agreements account.

Exhibit 6-3

Illustrative Example
Charitable Remainder Trust When an Unrelated Third Party Is Trustee

<u>Assumptions</u>

Jeremy Anderson establishes and funds a $1,000,000 charitable remainder unitrust, naming Financial Advisor as trustee. Under the charitable remainder unitrust agreement, Mr. Anderson's spouse receives an annual distribution equal to 10% of the fair value of the assets in the trust until her death. Income earned on the assets in the trust remains in the trust until the death of Mrs. Anderson. When Mrs. Anderson dies, the assets in the trust are to be distributed to the Multiple Sclerosis Society and permanently restricted as an endowment. The Society measures the fair value of its beneficial interest by calculating the present value of its expected future benefits. The present value of the future benefits to be received by the Society is calculated as $473,000.

<u>Initial Recording</u>

When the trust is established, the Multiple Sclerosis Society should record the following entry:

Beneficial interest in remainder trust	473,000	
Contribution revenue—permanently restricted		473,000

<u>Recording Over Term of the Agreement</u>

Remeasuring Fair Value. Each year, the Multiple Sclerosis Society should recognize changes in the fair value of its beneficial interest using the same valuation technique that it initially used to measure the beneficial interest. Because the Society initially measured the fair value of the beneficial interest by calculating the present value of its expected future cash inflows, it would remeasure its beneficial interest using that same method. All elements of the present value measurement, including the discount rate, should be revised to reflect current market conditions.

Assume for purposes of this example that the Society considered current market conditions at the end of the first year, and the discount rate and other assumptions for measuring the fair value of the beneficial interest did not change. Accordingly, the Society would only need to recognize amortization of the discount. Assuming the

amortization of the discount on the benefits expected to be received by the Society during the first year is $60,000, the following entry would be made:

Beneficial interest in remainder trust	60,000	
Change in value of split-interest agreements—permanently restricted/with donor restrictions		60,000

Revaluation of Future Distributions. Assuming changes in actuarial assumptions in the fourth year results in a $52,000 revaluation adjustment and decrease in the fair value of the benefits expected to received by the Society, the following entry would be required:

Change in value of split-interest agreements—permanently restricted/with donor restrictions	52,000	
Beneficial interest in remainder trust		52,000

Termination of the Agreement

When Mrs. Anderson dies, the trust terminates. Assuming the Trust holds $842,000 in assets at that time and the amount to be received by the Society is $49,000 in excess of the remaining beneficial interest on the Society's books, the Society would make the following entry to reduce its beneficial interest to zero and to recognize the assets received from the trust at their fair value:

Endowment assets	842,000	
Beneficial interest in remainder trust	793,000	
Change in value of split-interest agreements—permanently restricted/with donor restrictions		49,000

* * *

Organization Is Trustee. Exhibit 6-4 presents an example of a charitable remainder unitrust agreement in which the nonprofit organization acts as trustee and holds the trust assets. The organization should initially recognize the contribution revenue and related assets and liabilities when the split-interest agreement is executed. When the trust assets are received, they are measured at their fair values on the date the split-interest agreement was recognized. The liability for the obligation to other beneficiaries under the unitrust agreement also is measured at fair value. Because the organization has a remainder interest, it will receive payments only after obligations to other beneficiaries are satisfied. Accordingly, if a present value technique is used, the fair value of the liability can be estimated directly based on the present value of the future payments to be distributed over the beneficiary's expected life. The fair value of contribution revenue is estimated based on the difference between the fair values of the split-interest assets and the liability to other beneficiaries.

Exhibit 6-4

Illustrative Example Charitable Remainder Trust When Organization Is the Trustee

Assumptions

Jeremy Anderson establishes and funds a $1,000,000 charitable remainder unitrust, naming the Multiple Sclerosis Society as trustee. Under the agreement, Mr. Anderson's spouse receives an annual distribution equal to 10% of the fair value of the assets in the trust until her death. Income earned on the assets in the trust remains in the trust until the death of Mrs. Anderson. When Mrs. Anderson dies, the trust assets are to be distributed to the Multiple Sclerosis Society and retained as a permanently restricted endowment. The Multiple Sclerosis Society used present value techniques to measure the liability at initial recognition and did not elect the fair value option available

under FASB ASC 825-10 to report the liability at fair value at subsequent reporting dates. The present value of the future payments to be made over Mrs. Anderson's life is calculated as $527,000.

Although the liability for the payments to Mrs. Anderson is affected by changes in the value of the trust assets, the obligation is exempt from the requirements of FASB ASC 815 because each payment is solely life-contingent.

Initial Recording

When the trust is established, the Multiple Sclerosis Society would record the following entry:

Assets held in charitable remainder trust	1,000,000	
Liability under unitrust agreement		527,000
Contribution revenue—permanently restricted/with donor restrictions		473,000

Recording Over Term of the Agreement

At each reporting period, the assets held in trust under the split-interest agreement should be reported in accordance with the applicable guidance discussed in *PPC's Guide to Nonprofit GAAP*. Income, gains, and losses are reflected as changes in the trust assets and split-interest liability accounts. Over the term of the agreement, the liability for amounts held for others is adjusted for the amortization of discount initially recognized to estimate the fair value of the obligation. The liability would also need to be adjusted for any revaluations of projected future payments to the lead beneficiaries.

Income Earned on Assets. Assuming the Trust has investment earnings of $70,000 during the first year, the Society would make the following entry:

Assets held in charitable remainder trust	70,000	
Liability under unitrust agreement		70,000

Annual Distributions. If distributions of $109,000 are made to Mrs. Anderson in the second year, the Society would make the following entry:

Liability under unitrust agreement	109,000	
Assets held in charitable remainder trust		109,000

Amortization of Discount. Assuming amortization of the discount on the liability under unitrust agreement is $50,000 in the first year, the Society would make the following entry:

Change in value of split-interest agreements—permanently restricted/with donor restrictions	50,000	
Liability under unitrust agreement		50,000

Revaluation of Future Distributions. Revaluations of the liability for amounts held for others may be necessary to account for the change in future cash outflows when the donor's life expectancy changes, or for other changes in actuarial assumptions. The nonprofit organization should use the same technique and the same discount rate to measure its obligation as it used when it initially recognized the split-interest agreement. (FASB ASC 958-30-35-6) After the revaluation, the liability account is adjusted to the new estimate and the offset is a change in the value of split-interest agreements recognized in the statement of activities. The change should be classified in the same class of net assets initially determined when the contribution was recorded. If changes in actuarial assumptions in the fourth year results in a $52,000 revaluation increase to the liability under unitrust agreement, the change would be recorded as follows:

Change in value of split-interest agreements—permanently restricted/with donor restrictions	52,000	
Liability under unitrust agreement		52,000

Termination of the Agreement

Adjust Liability to Zero. When Mrs. Anderson dies, the agreement terminates and the remaining assets are distributed to the organization. Assuming a $49,000 liability under the unitrust agreement remains at that time, the Multiple Sclerosis Society would make the following entry to reduce the remaining liability to zero:

Liability under unitrust agreement	49,000	
Change in value of split-interest agreement—permanently restricted		49,000

Reclassify Assets. If, at the termination of the agreement, the trust assets had a fair value of $842,000, the Society would make the following entry to reclassify the remaining assets in the trust to a permanently restricted/perpetual endowment:

Endowment assets	842,000	
Assets held in charitable remainder trust		842,000

* * *

Charitable Gift Annuity

A charitable gift annuity is very similar to a charitable remainder annuity trust in that a donor contributes assets in exchange for distributions of a fixed amount for a specified period of time to the donor or other beneficiaries. Unlike a charitable remainder annuity trust, however, no trust is established under a charitable gift annuity arrangement. Instead, the assets are transferred directly to the nonprofit organization and are held as general assets of the organization, and the related annuity liability is also recorded as a general obligation of the organization. (FASB ASC 958-30-05-11) As a result, investment income earned and changes in the fair value of the investments are recognized in the same manner as the income, gains, and losses of the organization's other investments. That is, the income, gains, and losses are recognized in the statement of activities rather than as increases and decreases in the liability to the lead beneficiary.

Exhibit 6-5 presents an example a charitable gift annuity arrangement. The organization should initially recognize the contribution revenue and related assets and liabilities when the split-interest agreement is executed. When the assets are received, the organization measures the assets at their fair values on the date the split-interest agreement was recognized. Present value techniques are one valuation technique for measuring the fair value of the annuity payment liability; other valuation techniques also are available, as described in FASB ASC 820. If a present value technique is used, the fair value of the liability should be measured at the present value of the future payments to be distributed over the beneficiary's expected life. The difference between the fair values of the assets received and the liability to other beneficiaries is recognized as contribution revenue.

Exhibit 6-5

Illustrative Example
Charitable Gift Annuity

Assumptions

Justin Allen transfers assets having a fair value of $400,000 to Treepoint Private School under an arrangement whereby the School agrees to pay annual distributions of $20,000 to Mr. Allen's spouse until her death. The transferred assets are available for the School's general use. The School used present value techniques to measure the annuity payment liability at initial recognition and did not elect to measure the annuity obligation at fair value in subsequent periods. The present value of future distributions to be made to Mrs. Allen is calculated to be $134,000.

Initial Recording

Upon execution of the contract, Treepoint Private School should record the agreement through the following entry:

	Debit	Credit
Assets	400,000	
Annuity payment liability		134,000
Contribution revenue—unrestricted/without donor restrictions		266,000

Recording Over Term of the Agreement

During the term of the agreement, distributions to beneficiaries decrease the School's cash and the annuity payment liability. Also, the School should recognize amortization of the discount on the annuity payment liability.

Annual Distributions. Annual distributions to Mrs. Allen should be recorded by the School in the following manner:

	Debit	Credit
Annuity payment liability	20,000	
Cash		20,000

Amortization of Discount. If first year amortization of the discount on the annuity payment liability is $1,500, the following entry would be recorded:

	Debit	Credit
Change in the value of split-interest agreements—unrestricted/without donor restrictions	1,500	
Annuity payment liability		1,500

Revaluation of Future Distributions. If the value of future benefits to be paid to the annuitant changes because of a change in the beneficiary's life expectancy, the School should adjust the annuity payment liability account to reflect the change, and record either a debit or credit to the change in value of split-interest agreements account, as appropriate. If, in the third year, the estimated life expectancy of Mrs. Allen changes from 10 years to 12 years, resulting in a $17,000 increase in the present value of future distributions to Mrs. Allen, the School would record the following entry:

	Debit	Credit
Change in the value of split-interest agreements—unrestricted	17,000	
Annuity payment liability		17,000

Termination of the Agreement

When, under the conditions of the arrangement, payments to others must cease (upon death of the beneficiary, or if the specified time has passed or the specified amount of distributions have been made), the School should reduce its annuity payment liability account to zero, with a corresponding debit to the change in value of split-interest agreements account. Assuming Mrs. Allen dies after 11 years, leaving an annuity payment liability of $8,000 on the School's books, the School would make the following entry to record the termination of the agreement and reduce the remaining liability to zero:

	Debit	Credit
Annuity payment liability	8,000	
Change in the value of split-interest agreements—unrestricted/without donor restrictions		8,000

* * *

Pooled Income Fund

Pooled income funds are trusts for which a nonprofit organization pools, invests, and manages gifts from many different donors. The funds are unitized and donors are assigned a specific number of units based on the relationship of the fair value of their contribution to the fair value of the pool as a whole at the time the donor enters

the pool. The donor, or beneficiary specified by the donor, receives the income earned on the donor's units in the pool. "Income" is defined under the split-interest agreement covering the arrangement. When the donor dies, the donor's units revert to the nonprofit organization. (Net income unitrusts are similar to pooled income funds, and, accordingly, are accounted for similarly.)

Exhibit 6-6 provides an example of a pooled income fund. As the example illustrates, when donor assets are received by an organization, they should be measured at their fair value. Contribution revenue, representing the organization's remainder interest in the assets, should also be recognized at fair value. The present value of the assets to be received by the organization upon the death of the donor is one possible valuation technique to measure the fair value of the contribution. The difference between the fair values of the assets received and the contribution recognized should be recorded as deferred revenue, which represents the discount for future interest.

Exhibit 6-6

Illustrative Example
Pooled Income Fund

Assumptions

Doris White makes a $600,000 life income gift to the Arts Council, which is pooled with other donor pooled income gifts. Ms. White's gift is assigned a specific number of units in the pool. Ms. White will receive the income (defined in the split-interest agreement as cash distributions) earned from the units until her death, at which time the Arts Council will receive the units for its unrestricted use. Changes in the fair value of the units in the fund accrue to the benefit of the organization. The Arts Council used present value techniques to measure the initial contribution. The present value of the assets expected to be received by the Arts Council is calculated to be $350,000.

Initial Recording

Upon receiving the assets, the Arts Council should record the following entry:

Assets of pooled income fund	600,000	
Contribution revenue—temporarily restricted/with donor restrictions		350,000
Discount for future interest (deferred revenue)		250,000

Recording Over Term of the Agreement

At each reporting period, the assets held in the pooled income fund should be reported in accordance with the applicable guidance discussed in *PPC's Guide to Nonprofit GAAP*. Income, gains, and losses are reflected as changes in the trust assets. During the term of the split-interest agreement, dividend income on the donor's units and payment of that income to the donor should be recorded by the organization. Changes in the fair value of the donor's units are recognized as a change in value of split-interest agreements. (However, if the split-interest agreement stipulated changes in the fair value of the units accrue to the benefit of the donor, the change in fair value would be recognized in the liability to the beneficiary.) The organization should also amortize the deferred revenue account that represents the discount for future interest and credit the change in the value of split-interest agreements account.

Income Earned on Assets. If dividends received in the first year by Ms. White's units in the pool is $40,000, the Arts Council would make the following entry:

Assets of pooled income fund	40,000	
Liability to life beneficiary		40,000

Distributions. Payment of Ms. White's income to her in the first year would then be recorded as follows:

Liability to life beneficiary	40,000	
Assets of pooled income fund		40,000

Change in Fair Value. Assuming the fair value of Mrs. White's units in the pool increased by $5,000, the Arts Council would record the gain on investments as follows:

Assets of pooled income fund	5,000	
Change in value of split-interest agreements— temporarily restricted/with donor restrictions		5,000

Amortization of Discount. Assuming amortization of the discount on the estimated future interest to be received by the Arts Council during the first year was $44,000, the Arts Council would make the following entry:

Discount for future interest	44,000	
Change in the value of split-interest agreements—temporarily restricted/with donor restrictions		44,000

Termination of the Agreement

Adjust Discount to Zero. If, at Ms. White's death, a discount for future interest of $28,000 remains to be amortized, the Arts Council would record the following entry to adjust the deferred revenue account to zero:

Discount for future interest	28,000	
Change in the value of split-interest agreements—unrestricted/without donor restrictions		28,000

Reclassify Assets. If, at Ms. White's death, her units in the fund had a fair value of $660,000, the Arts Council would reclassify the pooled income fund assets to general use assets, as follows:

Cash or investment assets	660,000	
Assets of pooled income fund		660,000

Release Restrictions. The Arts Council would also make the following entry to reclassify net assets to reflect the expiration of the time restriction on the contributed assets:

Net assets released from restrictions— temporarily restricted/with donor restrictions	660,000	
Net assets released from restrictions—unrestricted/without donor restrictions		660,000

* * *

DISCLOSURE REQUIREMENTS

FINANCIAL STATEMENT PRESENTATION

Assets and liabilities from split-interest agreements should be reported separately from other assets and liabilities in the statement of financial position or disclosed in the notes to the financial statements. Contribution revenue and changes in the value of split-interest agreements also should be reported as separate line items on the statement of activities or disclosed in the notes to the financial statements.

DISCLOSURES

The following disclosures about split-interest agreements should be made:

a. A description of the general terms of the split-interest agreements

b. The basis used for recognizing assets related to the split-interest agreements (that is, cost, lower of cost or fair value, or fair value)

c. The discount rates and actuarial assumptions used, if present value techniques are used in reporting the assets and liabilities related to split-interest agreements

d. Legally mandated reserves arising from split-interest agreements

e. Any limitations imposed by state law, such as limitations on the manner in which some net assets are invested

Before the effective date of ASU 2016-14, reserves set aside voluntarily as a cushion against unexpected actuarial losses should be included with unrestricted net assets. The organization may disclose such reserves as a separate component of unrestricted net assets, such as board-designated unrestricted net assets.

After the adoption of ASU 2016-14, if the organization has set aside voluntary reserves for unexpected actuarial losses:

a. The reserves should be included with net assets without donor restrictions on the statement of financial position

b. Information about the amounts and purposes of the reserves should be provided by either of the following:

   (1) presenting the voluntary reserves as a separate component of board-designated net assets on the face of the statement of financial position, or

   (2) providing the relevant information about the amounts and purposes of board designations in the notes to the financial statements

If the assets and liabilities under split-interest agreements are measured at fair value on a recurring bases after initial recognition, additional disclosures about fair value measurement are required by FASB ASC 820-10-50.

Additional disclosures are required by the Fair Value Option Subsections of Subtopic 825-10 if an organization elects to measure an obligation recognized under a split-interest agreement pursuant to paragraph 958-30-35-2.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

19. How should a third-party trustee contribute assets under an irrevocable split-interest agreement when the organization has an unconditional right to receive all or a part of the specified cash flows from the assets?

    a. Evaluate the assets received at their fair value.

    b. The liability should be measured for any percentage of the assets held for the donor at fair value.

    c. Recognize its beneficial interest in the contribution revenue and assets at fair value.

    d. The contribution revenue should be measured at fair value.

20. Which of the following split-interest agreements establishes a trust that names the nonprofit organization as a beneficiary?

    a. Charitable lead trust.

    b. Charitable remainder trust.

    c. Charitable gift annuity.

21. Which of the following statements is true regarding net asset classification?

    a. Asset contributions to be received in the future generally carry an indirect time restriction.

    b. Unless the donor specifies otherwise, contribution revenue recognized under split-interest agreements should be classified as permanently restricted.

    c. Contributions should be classified as a decrease in permanently restricted net assets only if the donor permanently restricts the organization's use of its lead interest in assets.

    d. Contributions should be classified as a decrease in restricted net assets if the donor grants the organization immediate unrestricted right to use the assets.

22. Which of the following statements is correct regarding how charitable gift annuity agreements allow organizations to hold gifted assets as part of its general assets?

    a. Contributions of the charitable gift annuity are recorded as an increase in net assets, if certain conditions are not met.

    b. In a split-interest agreement that includes a charitable gift annuity, the contribution is unrestricted if both the state law and the agreement require the assets to be invested until the annuity beneficiary dies.

23. In which of the following ways are distributions to the beneficiary are for a specific dollar amount?

    a. Charitable Remainder Annuity Trusts (CRATs).

    b. Charitable Remainder Unitrusts (CRUTs).

    c. Charitable lead annuity trusts (CLATs).

    d. Charitable lead unitrusts (CLUTs).

24. Recording the charitable remainder trust agreement is dependent upon which of the following?

    a. Whether the nonprofit organization is the trustee or otherwise controls the assets.

    b. Whether the organization or a third party is trustee for the agreement.

    c. Whether payments to the noncharitable beneficiary are period certain and variable in amount.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

19. How should a third-party trustee contribute assets under an irrevocable split-interest agreement when the organization has an unconditional right to receive all or a part of the specified cash flows from the assets? **(Page 58)**

    a. Evaluate the assets received at their fair value. [This answer is incorrect. If the organization is a trustee and holds or controls the assets contributed under an irrevocable split-interest agreement, it should measure the assets received at their fair value.]

    b. The liability should be measured for any percentage of the assets held for the donor at fair value. [This answer is incorrect. If the organization is a trustee and holds or controls the assets contributed under an irrevocable split-interest agreement, it should measure the liability for any portion of the assets held for the donor or other beneficiaries at fair value.]

    c. Recognize its beneficial interest in the contribution revenue and assets at fair value. [This answer is correct. If assets contributed under an irrevocable split-interest agreement are held or controlled by a third party, and the organization has an unconditional right to receive all or a portion of the specified cash flows from the assets, the organization should recognize its beneficial interest in the assets and contribution revenue at fair value.]

    d. The contribution revenue should be measured at fair value. [This answer is incorrect. Contribution revenue should be measured at fair value when the organization is a trustee and holds or controls the assets contributed under an irrevocable split-interest agreement.]

20. Which of the following split-interest agreements establishes a trust that names the nonprofit organization as a beneficiary? **(Page 62)**

    a. Charitable lead trust. [This answer is correct. Under a charitable lead trust agreement, a donor establishes a trust naming a nonprofit organization as beneficiary, as stated in FASB ASC 958-30-20.]

    b. Charitable remainder trust. [This answer is incorrect. Charitable remainder trusts are split-interest agreements in which a nonprofit beneficiary receives its interest in the donated assets after the donor or another beneficiary has received benefits for a certain time period.]

    c. Charitable gift annuity. [This answer is incorrect. A donor contributes assets in exchange for distributions of a fixed amount for a certain period of time to the donor or other beneficiaries under a charitable gift annuity.]

21. Which of the following statements is true regarding net asset classification? **(Page 59)**

    a. Asset contributions to be received in the future generally carry an indirect time restriction. [This answer is correct. As a general rule, contributions of assets to be received in the future carry an implied time restriction.]

    b. Unless the donor specifies otherwise, contribution revenue recognized under split-interest agreements should be classified as permanently restricted. [This answer is incorrect. The contribution revenue recognized under split-interest agreements should be classified as temporarily restricted unless the donor stipulates otherwise.]

    c. Contributions should be classified as a decrease in permanently restricted net assets only if the donor permanently restricts the organization's use of its lead interest in assets. [This answer is incorrect. If the donor permanently restricts the organizations use of its lead or remainder interest in the assets, the contribution should be classified as an increase in permanently restricted net assets.]

d. Contributions should be classified as a decrease in restricted net assets if the donor grants the organization immediate unrestricted right to use the assets. [This answer is incorrect. If the donor grants the organization the immediate unrestricted right to use the assets, the contribution should be classified as an increase in unrestricted net assets.]

22. Which of the following statements is correct regarding how charitable gift annuity agreements allow organizations to hold gifted assets as part of its general assets? **(Page 59)**

a. Contributions of the charitable gift annuity are recorded as an increase in net assets, if certain conditions are not met. [This answer is correct. If certain conditions are not met, the contribution of the charitable gift annuity is reported as an increase in net assets.]

b. The state law and the agreement require the assets to be invested until the annuity beneficiary dies. [This answer is incorrect. In a split-interest agreement that includes a charitable gift annuity, the contribution is unrestricted if neither the agreement nor state law require the assets to be invested until the death of the annuity beneficiary.]

23. In which of the following ways are distributions to the beneficiary are for a specific dollar amount? **(Page 65)**

a. Charitable Remainder Annuity Trusts (CRATs). [This answer is correct. Under CRATs distributions to the beneficiary are for a specified dollar amount, as stated in FASB ASC 958-30-20; 958-30-05-10.]

b. Charitable Remainder Unitrusts (CRUTs). [This answer is incorrect. Under CRUTs, the beneficiary receives a stated percentage of the fair value of the trust, that is determined annually.]

c. Charitable lead annuity trusts (CLATs). [This answer is incorrect. Under CLATs, the nonprofit organization periodically receives a fixed dollar amount from the trust.]

d. Charitable lead unitrusts (CLUTs). [This answer is incorrect. Under CLUTs, the nonprofit organization periodically receives a distribution of a fixed percentage of the trust's fair value during the agreement's term.]

24. Recording the charitable remainder trust agreement is dependent upon which of the following? **(Page 65)**

a. Whether the nonprofit organization is the trustee or otherwise controls the assets. [This answer is correct. The recording of the charitable remainder trust agreement depends on whether or not the nonprofit organization is the trustee or otherwise controls the assets.]

b. Whether the organization or a third party is trustee for the agreement. [This answer is incorrect. The time at which an organization is considered to receive an irrevocable split-interest agreement depends on whether the organization or a third party is trustee for the agreement. If the organization is trustee or fiscal agent of the assets, the gift is considered received when the donor executes the split-interest agreement.]

c. Whether payments to the noncharitable beneficiary are period certain and variable in amount. [This answer is incorrect. According to FASBASC958-30-55-6 through 55-8, the measurement of the liability to the noncharitable beneficiary of a remainder trust during the life of the agreement depends upon whether the payments to the noncharitable beneficiary are variable in amount and whether they are period certain.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Nonprofit GAAP—Course 1—Selected Topics Specific to Nonprofit Organizations (NPGTG171)

Testing Instructions

1. Following these instructions is an **EXAMINATION FOR CPE CREDIT** consisting of multiple choice questions. You may print and use the **EXAMINATION FOR CPE CREDIT ANSWER SHEET** to complete the examination. This course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of the course, the participant then answers the examination questions and records answers to the examination questions on either the printed **Examination for CPE Credit Answer Sheet** or by logging onto the Online Grading System. The **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation Form** for each course are located at the end of all course materials.

   ONLINE GRADING. Log onto our Online Grading Center at **cl.thomsonreuters.com/ogs** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam of $89 is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   PRINT GRADING. If you prefer, you may email, mail, or fax your completed answer sheet, as described below ($89 for email or fax; $99 for regular mail). The answer sheets are found at the end of the course PDFs. Answer sheets may be printed from the PDFs; they can also be scanned for email grading, if desired. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number. You may submit your answer sheet for grading three times. After the third unsuccessful attempt, another payment is required to continue.

   You may submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

   - Email to: *CPLGrading@thomsonreuters.com*
   - Fax to: **(888) 286-9070**
   - Mail to:

     Thomson Reuters
     Tax & Accounting—Checkpoint Learning
     NPGTG171 Self-study CPE
     36786 Treasury Center
     Chicago, IL 60694-6700

   Note: The answer sheet has four bubbles for each question. However, if there is an exam question with only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Each answer sheet sent for print grading must be accompanied by the appropriate payment ($89 for answer sheets sent by email or fax; $99 for answer sheets sent by regular mail). Discounts apply for three or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price

for grading all three is $254 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $320 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $378 (a 15% discount on all five courses). The 15% discount also applies if more than five courses are submitted at the same time by the same participant. The $10 charge for sending answer sheets in the regular mail is waived when a discount for multiple courses applies.

4. To receive CPE credit, completed answer sheets must be postmarked or entered into the Online Grading Center by **December 31, 2018**. CPE credit will be given for examination scores of 70% or higher.

5. When using our print grading services, only the **Examination for CPE Credit Answer Sheet** should be submitted. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Nonprofit GAAP—Course 1—Selected Topics Specific to Nonprofit Organizations (NPGTG171)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet. The answer sheet can be printed out from the back of this PDF or accessed by logging onto the Online Grading System.

1. Which of the following defines an agency fund?

   a. A fund that is used to account for resources that an organization holds on behalf of others.

   b. A fund that is used to account for resources that donors provide when the organization, that is not the sole beneficiary, has a beneficial interest.

   c. A fund that records equipment and resources and property held to acquire them.

   d. Funds that are used to record activities that resources support over which the organization board has discretionary control.

2. Plant funds may be comprised of several individual components. Which one of those components includes resources held to service debt related to equipment or plant acquisitions?

   a. Plant funds that are unexpended.

   b. Replacement and renewals funds.

   c. Retirement-of-indebtedness fund.

   d. Funds that are investment-in-plant.

3. The portion of the fund balance in a revolving loan fund that is restricted by donors in perpetuity for use in making loans should be classified as which of the following?

   a. Restricted.

   b. Unrestricted.

   c. Temporarily restricted.

   d. Permanently restricted.

4. Investments in equity securities that have readily determinable fair values and debt securities initially should be reported at which of the following if purchased?

   a. Fair value.

   b. Acquisition cost.

   c. Carrying value.

   d. Other than fair value.

5. Which of the following provides the most reliable fair value evidence and generally should be used to measure fair value when available?

   a. Quoted prices in active markets.

   b. Sales price.

   c. Over-the-counter market.

   d. Bid-and-asked quotations.

6. Which of the following type of funds is formed when a donor stipulates that the contributed assets be invested in perpetuity or for a specific time period?

   a. Quasi endowment.

   b. Donor-restricted endowment.

   c. Split-interest.

   d. Current restricted.

7. When using the equity method, investments initially are recorded under which of the following?

   a. Present value.

   b. Acquisition cost.

   c. Cost.

   d. Other than fair value.

8. Unless the entity is required or chooses to report investment at fair value, it should use which of the following methods to account for its noncontrolling interest in the common stock of a for-profit entity if it is able to significantly influence the entity's financial and operating policies?

   a. Present value.

   b. Acquisition cost.

   c. Cost.

   d. Equity.

9. Unless their use is restricted by explicit donor stipulations or by law, gains, dividends, losses, interest, and other investment income generally should be reported as increases or decreases on which of the following?

   a. Statement of activities.

   b. Notes to the financial statements.

   c. Statement of financial position.

   d. Statement of cash flows.

10. How should *other* investments that are purchased be recorded if the fair value option is **not** elected for eligible investments?

    a. Present values

    b. Other than fair value.

    c. Cost.

    d. Acquisition cost.

11. OrgA acquires XYZ, an other investment, as an agent and has no discretion in determining how the investment income and realized and unrealized gains will be used. OrgA should account for that transaction as which of the following type of transaction?

    a. Agency.

    b. Capital.

    c. Exchange.

    d. Intra-entity.

12. Which of the following statements is correct regarding cost method investments?

    a. Equity securities qualify for the equity method even if they do not have readily determinable fair values.

    b. Equity securities that do not have readily determinable values can be accounted for using the consolidation method.

    c. An estimate should be used when determining if the investment has an impairment that is other than temporary if a fair value estimate for a cost method investment exists.

    d. Organizations are not required to develop fair value estimates for the disclosure of other investments.

13. Org B has no fair value estimate and evaluates, at the security level, all changes in circumstances that may have a significant adverse effect on fair value. During the evaluation, Org B discovers that impairment exists, but is it only temporary. Which of the following investments should be evaluated for impairment for each reporting period until it is written down or no longer impaired?

    a. Cost method investments.

    b. Fair value investments.

    c. Donor-restricted investments.

    d. Equity method investments.

14. For institutions of higher learning, if an other than temporary impairment exists, other investments reported at which of the following should be adjusted?

    a. Carrying value.

    b. Fair value.

    c. Cost.

    d. Acquisition cost.

15. Charles Shabb, an investor in life settlement contracts, records the initial investment at the transaction price and remeasures the investment at fair value at each subsequent reporting period. Which reporting method is Charles using?

    a. Fair value.

    b. Equity.

    c. Cost.

    d. Consolidation.

16. Before the effective date of ASU 2016-01, nonprofit organizations should disclose specific information related to other investments. Which of the following should be disclosed for cost investments as of each date for which a statement of financial position is presented?

    a. Aggregate fair value of investments with unrealized losses.

    b. Aggregate amount of unrealized losses.

    c. Aggregate carrying amount of all cost method investments.

    d. All major investment types' aggregate carrying value.

17. All of the following should be disclosed for investments in life settlement contracts **except:**

    a. Anticipated life insurance premiums to be paid for each of the three succeeding fiscal years for investment method contracts.

    b. Life settlement contract accounting policy.

    c. The nature of information that creates a change in the anticipated timing of cash proceeds.

    d. Significant assumptions and methods used to calculate the fair value of investments for fair value contracts.

18. An organization that holds less than a majority voting interest in the investee generally uses which of the following methods to report the investment?

    a. Fair value method.

    b. Consolidation.

    c. Cost method.

    d. Equity method.

19. OrgA is presumed to directly or indirectly own what percentage or more of Entity B's voting stock if it has significant influence over Entity B (absent evidence to the contrary)?

    a. 5%.

    b. 10%.

    c. 15%.

    d. 20%.

20. If a nonprofit organization has a noncontrolling interest in an LLC, real estate partnership, or a similar entity that is more than minor, it should generally use which of the following methods?

    a. Equity.

    b. Cost.

    c. Consolidation.

    d. Fair value.

21. What is required for a nonprofit organization to use or have knowledge of to determine if supermajority voting requirements are too restrictive and question if the investor has a controlling financial interest, or have little or no effect on the ability to control the investee's assets or operations?

    a. FASB ASC 825-10, *Financial Instruments—Overall.*

    b. FASB ASC 958-325, *Not-for-Profit Entities—Investments—Other.*

    c. GAAP.

    d. Judgment.

22. OrgA is permitted to consolidate GreenE, a financially related nonprofit entity, but chooses not to do so. OrgA is required to disclose all of the following **except:**

    a. Detailed financial information of GreenE for the past three fiscal years.

    b. Identification of GreenE and the nature of the relationship that results in control.

    c. Overview of GreenE's financial information.

    d. GreenE's resources held for the benefit of OrgA.

23. Which of the following statements is true regarding a typical split-interest agreement?

    a. A remainder interest is the right to the use or cash flow assets during the term of the split-interest agreement.

    b. The split-interest agreement term cannot be based on the occurrence of an event like the donor's death.

    c. The split-interest agreement term may be for a certain number of years.

    d. Other beneficiaries are exempt from receiving contributions from split-interest agreements.

24. Which of the following is true regarding irrevocable split-interest agreements?

    a. They are measured at fair value.

    b. They are accounted for as an intention to give.

    c. Assets are recognized as contribution revenue when they are available for unconditional use.

    d. A gift is considered received when the organization is trustee and the donor executes the split-interest agreement.

25. All of the following are permissible ways of accounting for an irrevocable split-interest gift that includes an embedded derivative that is within the scope of FASB ASC 815-15 **except:**

    a. Choosing to measure the entire split-interest obligation at fair value in conformity with FASB ASC 815-15-25.

    b. Bifurcating the split-interest obligation into a debt host contract and an embedded derivative in accordance with FASB ASC 815-15-25-1.

    c. Choosing to measure the entire split-interest obligation at fair value in conformity with the Fair Value Option Subsection of FASB ASC 825-10.

    d. Electing to defer recognition of the split-interest gift for two years.

26. Once the split-interest agreement term has ended, an amount necessary to decrease all related activities and liabilities to zero should be recognized in which of the following as *change in value of split-interest agreements*?

    a. Notes to the financial statement.

    b. Statement of financial position.

    c. Statement of activities.

    d. Statement of cash flows.

27. Which of the following is **not** a common type of split-interest agreement?

    a. Charitable expense trusts.

    b. Charitable gift annuities.

    c. Pooled (life) income funds.

    d. Charitable remainder trusts.

28. Which of the following generally takes the form of CLUTs and CLATS?

    a. Charitable remainder trusts.

    b. Charitable gift annuities.

    c. Pooled (life) income funds.

    d. Charitable lead unitrusts.

29. Which of the following occurs when an organization has a charitable lead interest with a third party as a trustee?

    a. The trust assets received should be initially measured at present value.

    b. Distributions during the term of the agreement should be recorded as contribution revenue.

    c. Distributions during the term of the agreement should be recorded as reductions in the beneficial interest.

    d. Do not select this answer choice.

30. Which of the following occurs when an organization has a charitable lead interest with a nonprofit organization as a trustee?

    a. The organization should initially recognize the contribution revenue after the split-interest agreement is carried out.

    b. The organization measure the assets held in the charitable lead trust at their fair values 30 days after the date the split-interest agreement was recognized when the trust assets are received.

    c. Payments made to other beneficiaries will be made only after the organization receives its benefits since the organization has a lead interest.

    d. Do not select this answer choice.

31. Under which of the following does the nonprofit organization receive distributions from the trust until the agreement is terminated?

    a. Charitable lead trusts.

    b. Pooled (life) income funds.

    c. Charitable gift annuities.

    d. Charitable remainder trusts.

32. In which of the following does the donor establish and fund a trust, and specify beneficiaries who will receive distributions over the life of the split-interest agreement?

    a. Charitable remainder trust.

    b. Charitable lead trust.

    c. Charitable gift annuities.

    d. Pooled (life) income funds.

33. Which of the following generally takes the form of CRUTs or CRATs?

    a. Pooled (life) income funds.

    b. Charitable gift annuities.

    c. Charitable lead trust.

    d. Charitable remainder trust.

34. Which of the following statements regarding a charitable gift annuity is correct?

    a. It is very similar to a pooled (life) income fund.

    b. It is established under a charitable gift annuity arrangement.

    c. Income losses and gains are recognized in the statement of activities.

    d. Annuity payment liabilities should be measured at present value.

35. Which of the following are accounted for in similar ways to net income unitrusts?

    a. Charitable gift annuities.

    b. Pooled life income trusts.

    c. Charitable remainder trusts.

    d. Charitable lead trusts.

36. In regards to the pooled income fund, how should the difference between the fair values of the assets received and the contribution recognized be recorded?

    a. Discount for future interest.

    b. Debit or credit to the change in value.

    c. Adjustment.

    d. Contribution.

37. Dividend income on the donor's units and payments of that income to the donor should be recorded by the organization during the term of the split-interest agreement. How should changes in the fair value of the donor's units related to pooled income fund be recognized?

    a. As a change in split-interest agreements value.

    b. In the beneficiary's liability.

    c. As increases and decreases in the liability to the lead beneficiary.

    d. Do not select this answer choice.

38. Which of the following statements regarding financial statement presentation for disclosures is correct?

    a. Split-interest agreement liabilities and assets should be reported on the statement of activities.

    b. Assets and liabilities from split interest agreements should be reported separately from other assets and liabilities.

    c. Changes in the value of split interest agreements should be reported as a separate line item on the statement of cash flows.

    d. Contribution revenue should be reported as a separate line item on the statement of cash flows.

39. All of the following disclosures should be made regarding a split-interest agreement **except:**

    a. Description of the split-interest agreement general terms.

    b. Related party disclosures.

    c. Legally mandated reserves that occur from split-interest agreements.

    d. State law-imposed limitations.

40. If an organization elects to measure an obligation recognized under a split-interest agreement pursuant to FASB paragraph 958-30-35-2, additional disclosures are required by which of the following?

    a. IASB.

    b. FASB.

    c. Audit Guide.

    d. Internal Revenue Code.

GLOSSARY

Agency or custodian funds: Are used to account for resources held by the organization on behalf of others.

Annuity and life-income (split-interest) funds: Are used to account for resources provided by donors when the organization has a beneficial interest but is not the sole beneficiary.

Cost method investments: Equity securities that do not have readily determinable fair values, do not qualify for consolidation or the equity method, and are accounted for using the cost method.

Donor-restricted: A donor-restricted endowment fund is created when a donor stipulates that the contributed assets be invested for a specific period of time on in perpetiuity.

Endowment funds: Are used to account for assets held to provide income for the maintenance of the organization and may include endowments, term endowments, and quasi-endowments.

Fund accounting: A system of recording resources whose use may be limited by donors, granting agencies, governing boards, other individuals or entities, or by law.

In-substance common stock: An investment for which the risk and reward characteristics are similar to an investment in common stock.

Lead interest: The right to the use or cash flows of assets during the term of the split-interest agreement.

Loan funds: Are used to account for loans made to students, employees, or other constituents, and resources available to make loans.

Plant fund: Is used to record property and equipment and resources held to acquire them.

Quasi endowments: Board-designated resources to be held and invested for specified purposes for a long but unspecified period of time.

Remainder interest: The right to receive all or a portion of the assets that remains in a split-interest agreement when the term of the agreement ends.

Restricted current funds: Are used to record activities supported by resources limited by external parties to specific operating purposes.

Spending rate: The portion of the total return on investments used in the current period—usually as a budgetary method of reporting investment return.

Total return: A concept that focuses on the overall return on investments and includes both investment income and net appreciation.

Unrestricted current (operating or general) funds: Are used to record activities supported by resources over which the organization board has discretionary control.

INDEX

A

ACCOUNTING POLICIES
- Equity method investments 27

C

CONSOLIDATED FINANCIAL STATEMENTS
- Criteria for applying 44, 50, 51

E

EQUITY METHOD INVESTMENTS
- Criteria for applying 43

F

FUND ACCOUNTING
- Common funds 3
- Definition 3
- Disclosure requirements 8
- Illustrative net asset presentation 5

I

INVESTMENTS—DEBT AND EQUITY SECURITIES
- Disclosure requirements 16
- Other investments
  - Disclosure requirements 16
- Recognition and measurement 11

INVESTMENTS—EQUITY METHOD AND JOINT VENTURES
- Accounting changes 26
- Applying the equity method 22
- Capital transactions by for-profit entity 22
- Changes in ability to significantly influence 26
- Criteria for applying 21
- Difference between cost and underlying equity 22
- Differences in fiscal years 23
- Disclosure requirements 27
- Earnings, losses of for-profit entity 22
- Goodwill 22
- Impairment of value 22
- In-substance common stock 21
- Interorganization transactions 22
- Investee capital transactions 27
- Investee losses when organization has other investments 23
- Investment less than zero 22
- Investments in common stock 21
- Other than temporary declines in investment 22
- Preferred stock of entity 22
- Prior period adjustments 22
- Sale of investment 22
- When should equity method be used? 21

INVESTMENTS—OTHER
- Life insurance 35, 37
- Life settlement contracts 35, 37
- Other investments before the effective date of ASU 2016-01
  - Cost method 32
  - Equity securities that do not have a readily determinable fair value 31, 32
  - Fair value option 32
  - Impairment 32
  - Institutions of higher education 33
  - Other nonprofit organizations 33
  - Recognition and measurement 32
  - Voluntary health and welfare organizations 33

R

RELATED ENTITIES
- Consolidation, criteria for applying 43, 44, 51
- Disclosure requirements 52
- Economic interest and control
  - By other means 52
  - Through majority voting interest in the board 51
- Equity method, criteria for applying 46
- Financially related nonprofit organizations
  - Controlling financial interest 50
  - Economic interest and control 51
- Ownership interest in for-profit entities
  - Controlling financial interest 44
  - Less than a majority voting interest 46
- Reporting interests at fair value 46
- Special-purpose-entity lessors 46

S

SPLIT-INTEREST AGREEMENTS
- Charitable gift annuity 69
- Charitable lead trusts
  - Organization is trustee 63
  - Third party is trustee 62
  - Types 62
- Charitable remainder trust
  - Organization is trustee 67
  - Third party is trustee 66
  - Types 65
- Common types
  - Charitable gift annuity 69
  - Charitable lead trusts 62
  - Charitable remainder trust 65
  - Pooled income fund 70
- Definition 57
- Disclosure requirements
  - Disclosures 73
  - Financial statement presentation 73
- Irrevocable split-interest agreements 58
  - Accounting for termination 61
  - Initially recording 58
  - Recording changes in value during the term 59
- Pooled income fund 70
- Revocable split-interest agreements 57
- Types 61

COMPANION TO PPC'S GUIDE TO NONPROFIT GAAP

COURSE 2

SELECTED TOPICS SPECIFIC TO NONPROFIT ORGANIZATIONS (NPGTG172)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course discusses a selection of topics related to generally accepted accounting principles for nonprofit organizations. Lesson 1 covers asset retirement and environmental obligations. Lesson 2 looks at commitments and contingencies. Lesson 3 examines issues related to debt. Lesson 4 discusses derivatives and hedging. Lesson 5 looks at exit or disposal cost obligations and guarantees. Lesson 6 discusses considerations related to inventory. Lesson 7 takes a look at receivables, such as loan impairment. Finally, the course concludes with Lesson 8, which discusses transfers of financial assets.
PUBLICATION/REVISION DATE:	December 2017
RECOMMENDED FOR:	Users of *PPC's Guide to Nonprofit GAAP*
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of accounting
CPE CREDIT:	8 NASBA Registry "QAS Self-Study" Hours This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*.
FIELD OF STUDY:	Accounting
EXPIRATION DATE:	Postmark by **December 31, 2018**
KNOWLEDGE LEVEL:	Basic

Learning Objectives:

Lesson 1—Asset Retirement and Environmental Obligations

Completion of this lesson will enable you to:
- Identify the GAAP accounting and disclosure requirements that apply when a nonprofit organization has asset retirement obligations or environmental remediation liabilities.

Lesson 2—Commitments and Contingencies

Completion of this lesson will enable you to:
- Recognize how nonprofit organizations should address commitments and contingencies under GAAP.

Lesson 3—Debt

Completion of this lesson will enable you to:

- Determine what GAAP requires of nonprofit organizations when they account for debt.
- Recognize the disclosures that nonprofit organizations must make in relation to debt.

Lesson 4—Derivatives and Hedging

Completion of this lesson will enable you to:

- Identify the GAAP accounting and disclosure requirements that nonprofit organizations must uphold in relation to derivatives and hedging.

Lesson 5—Exit or Disposal Cost Obligations and Guarantees

Completion of this lesson will enable you to:

- Recognize the accounting and disclosure requirements that nonprofit organizations must adhere to when dealing with exit or disposal cost obligations and guarantees.

Lesson 6—Inventory

Completion of this lesson will enable you to:

- Identify the accounting and disclosure requirements that apply when a nonprofit organization maintains inventory.

Lesson 7—Receivables—Other

Completion of this lesson will enable you to:

- Determine the GAAP accounting and disclosure requirements for specific receivables that nonprofit organizations may have, such as loan impairment.

Lesson 8—Transfers of Financial Assets

Completion of this lesson will enable you to:

- Recognize the GAAP requirements that apply when nonprofit organizations account for and make disclosures about transfers of financial assets.

TO COMPLETE THIS LEARNING PROCESS:

Log onto our Online Grading Center at **cl.thomsonreuters.com/ogs.** Online grading allows you to get instant CPE credit for your exam.

Alternatively, you can submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

- Email to: *CPLGrading@thomsonreuters.com*
- Fax to: **(888) 286-9070**
- Mail to:

Thomson Reuters
Tax & Accounting—Checkpoint Learning
NPGTG172 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

See the test instructions included with the course materials for additional instructions and payment information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 431-9025 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Asset Retirement and Environmental Obligations

INTRODUCTION

SOURCE: FASB ASC 410

The fair value of a liability for an asset retirement obligation should be recorded in the period in which it is incurred if it can be reasonably estimated. If an obligation is not recognized because fair value cannot be reasonably estimated, that fact and the reasons for it should be disclosed. When the liability is initially recorded, the carrying amount of the related asset is increased by a corresponding amount that is depreciated over the asset's useful life. The liability is subsequently adjusted for changes due to the passage of time or revisions in the timing or amount of expected future cash flows.

Generally, environmental remediation liabilities arising from improper or other than normal operations should be accrued on a site-by-site basis when it is probable that a loss has been incurred and the amount of the loss can be reasonably estimated. It is probable that a loss has been incurred when (a) the entity's obligation for environmental remediation has been asserted or is probable of assertion through litigation, claim, or assessment and (b) it is probable that the result will be unfavorable. The amount of an environmental remediation liability should be determined independently of any potential claim for recovery from other potentially responsible parties.

Learning Objectives:

Completion of this lesson will enable you to:
- Identify the GAAP accounting and disclosure requirements that apply when a nonprofit organization has asset retirement obligations or environmental remediation liabilities.

ACCOUNTING REQUIREMENTS

ASSET RETIREMENT OBLIGATIONS

Initial Recognition and Measurement of the Liability

If an organization has a legal obligation for the retirement of a long-lived asset, the entity should record the fair value of the liability for the obligation in the period in which it is incurred if the fair value can be reasonably estimated. If the fair value cannot be reasonably estimated when the asset retirement obligation is incurred, the liability should be recognized when the fair value can be reasonably estimated. (FASB ASC 410-20-25-4)

If an organization has a *conditional asset retirement obligation*, a liability should be recognized when the fair value of the obligation can be reasonably estimated. A conditional asset retirement obligation is a legal obligation to perform an asset retirement activity where the timing and (or) method of settlement are conditional on a future event. However, the obligation to perform the retirement activity is unconditional despite the uncertainty over timing or method of settlement. The uncertainty should be incorporated into the fair value measurement. (FASB ASC 410-20-20; 410-20-25-7)

A *legal obligation* is an obligation that a party must settle as a result of existing or enacted laws, statutes, ordinances, written or oral contracts, or by legal construction of a contract under the promissory estoppel doctrine. (FASB ASC 410-20-20)

If the liability is incurred over more than one reporting period, the incremental liability in the subsequent period should be initially measured at fair value and added to the original liability. (FASB ASC 410-20-35-1)

Recognizing and Allocating Asset Retirement Cost

When the liability is initially recorded, the entity should capitalize the asset retirement cost by increasing the carrying amount of the related asset for the same amount as the liability. The entity should subsequently expense such costs using a systematic and rational method over its useful life. (FASB ASC 410-20-25-5; 410-20-35-2)

Subsequent Recognition and Measurement

After initial measurement, the asset retirement obligation liability should be adjusted for changes that may result from the passage of time or revisions to the timing or amount of the original estimate of undiscounted cash flows. The carrying amount of the liability should be adjusted for changes due to the passage of time before adjusting for changes in the timing or amounts of estimated cash flows. (FASB ASC 410-20-35-3 and 35-4)

Changes due to the passage of time should be measured by applying an interest method of allocation to the amount of the liability at the beginning of the period and by using the credit-adjusted risk-free rate that existed when the liability was initially measured. The amount of the change increases the carrying amount of the liability in the statement of financial position and is shown as accretion expense in the statement of activities. (FASB ASC 410-20-20; 410-20-35-5)

Changes resulting from revisions to the timing or amount of estimated undiscounted cash flows increase or decrease the carrying amount of the asset retirement liability and the related capitalized asset retirement cost. Upward revisions to the cash flows are discounted using the current credit-adjusted risk-free rate, and downward revisions are discounted using the credit-adjusted risk-free rate that existed when the liability was originally recognized. If it is not possible to identify the period to which the downward revision relates, a weighted-average credit-adjusted risk-free rate may be used. The amount of asset retirement cost expensed is adjusted either in the period of the change, if the change only affects that period, or in the period of the change and future periods if the change affects multiple periods. (FASB ASC 410-20-35-8)

Funding and Assurance Provisions

An entity may provide assurance that it will be able to satisfy its asset retirement obligations through surety bonds, insurance policies, letters of credit, and other methods. While such assurance will not satisfy or extinguish the asset retirement liability, it may affect the credit-adjusted risk-free rate. Changes in funding and assurance have no effect on a previously recognized initial liability but may affect the rate used to discount upward revisions in undiscounted cash flows. Compliance costs for funding and assurance provisions should be accounted for separately from the asset retirement obligation. (FASB ASC 410-20-15-3; 410-20-35-9)

ENVIRONMENTAL REMEDIATION LIABILITIES

Environmental remediation liabilities should be accrued on a site-by-site basis when it is probable that a loss has been incurred at the financial statement date and the amount of the loss can be reasonably estimated.

When to Accrue a Liability

An entity has incurred an environmental liability when the following two elements are met on or before the date the financial statements are issued or available to be issued: (FASB ASC 410-30-25-4)

a. It has been asserted or it is probable that it will be asserted (through litigation, claim, or regulatory assessment) that the entity is responsible for participating in an environmental remediation process as a result of a past event (which occurred on or before the statement of financial position date).

b. It is probable that the result of the litigation, claim, or assessment will be unfavorable and the entity will be held responsible.

Estimating Environmental Remediation Costs

The following costs should be considered when estimating an entity's environmental remediation liability: (FASB ASC 410-30-30-10)

a. Incremental direct costs

b. Costs of compensation and benefits for employees who devote significant time to remediation activities

If the entity cannot estimate a single loss amount, a range of loss should be defined and an amount within that range should be accrued. (If no amount in the range is a better estimate than any other amount, the lowest amount in the range should be accrued.) (FASB ASC 410-30-25-8; 410-30-25-10 and 25-11)

Discounting Environmental Liabilities

Environmental liabilities may be discounted (but are not required to be discounted) only if both of the following are fixed or reliably determinable for each specific clean-up site: (FASB ASC 410-30-35-12)

a. Aggregate amount of the obligation

b. Amount and timing of cash payments

If only a range of loss can be estimated and no amount within the range is a better estimate of the liability than other amounts, discounting is not appropriate because the aggregate obligation is not fixed or reliably determinable.

Allocating Shared Costs among Responsible Parties

To record an environmental remediation liability, an entity must determine its share of the total remediation liability. That is a subjective estimate based on many factors, including the following: (FASB ASC 410-30-30-1)

- *Who are the PRPs for the site?* Generally, the EPA will notify the entity that it is a potentially responsible party (PRP), along with other PRPs identified by the EPA. However, depending on the available information, the EPA may not be aware of all PRPs. In that case, the entity, along with other identified PRPs, should consider investigating to find other parties who may be liable for a portion of the remediation costs.

- *What is the percentage of the total liability that will be allocated to the entity?* Several factors can be considered in allocating liability among PRPs, such as volume measures, the type of waste, whether the PRP was a site operator or owner, the degree of care exercised by the PRP, and any statutory or regulatory limitations on contributions from some PRPs. As a practical matter, the allocation often is determined by agreement among the parties, by hiring an allocation consultant, or by requesting that the EPA determine an allocation. The percentage for the entire remediation effort, not just a portion, should be used to determine the entity's allocable share of the total remediation liability. (FASB ASC 410-30-55-4 and 55-5)

- *What is the likelihood the other PRPs will pay their full share of the liability?* The entity should assess the likelihood that the other PRPs will pay their allocable portion of the total remediation liability. That assessment generally is based on the financial condition of the other PRPs and must be monitored as the remediation progresses. Any amounts that will not be paid by other PRPs must be allocated among the remaining PRPs and included in the remaining PRPs' liabilities. (FASB ASC 410-30-30-7)

Claims for Recovery

The amount of an environmental remediation liability should be determined independently from any potential claim for recovery. Furthermore, an asset related to a potential claim for recovery should be recognized only when realization of the claim is considered probable. (If a claim for recovery is being litigated, realization of the claim generally is not considered probable.) A potential claim for recovery should be measured based on available information and the specific situation. Measurement of the potential recovery should consider the related transaction costs and, when appropriate, the time value of money. The time value of money should not be considered if the

related liability is not discounted and timing of the recovery depends on the timing of paying the liability. In most cases, a legal right of offset does not exist for environmental liabilities and related claims for recovery. Thus, presentation of the gross liability and related claim for recovery in the statement of financial position generally is appropriate. (FASB ASC 410-30-35-8 through 35-11; 410-30-45-1 and 45-2)

DISCLOSURE REQUIREMENTS

ASSET RETIREMENT OBLIGATIONS

The following information should be disclosed about asset retirement obligations: (FASB ASC 410-20-50-1)

a. A general description of the asset retirement obligations and the associated long-lived assets

b. The fair value of the assets that are legally restricted for the purpose of settling asset retirement obligations

c. A reconciliation of the beginning and ending aggregate carrying amounts of asset retirement obligations separately showing the changes attributable to the following whenever there is a significant change in one or more of these components during the reporting period:

    (1) liabilities incurred in the current period

    (2) liabilities settled in the current period

    (3) accretion expense

    (4) revisions in estimated cash flows

If a reasonable estimate of the fair value of an asset retirement obligation cannot be made, that fact and the reasons for the inability to make an estimate should be disclosed. (FASB ASC 410-20-50-2)

ENVIRONMENTAL REMEDIATION LIABILITIES

An entity should make the following specific disclosures related to environmental remediation liabilities.

Accounting Policies

An entity should disclose whether environmental remediation liabilities are measured on a discounted basis. (FASB ASC 410-30-50-4)

Accrued Liabilities

The following information should be disclosed related to recorded accruals for environmental remediation loss contingencies:

a. The nature and the amount of the accrual (if necessary for the financial statements not to be misleading) (FASB ASC 410-30-50-5; 450-20-50-1)

b. If any part of the accrued obligation is discounted, the discount rate used and the undiscounted amount of the obligation (FASB ASC 410-30-50-7)

c. An indication that it is at least reasonably possible that the estimate of the accrued obligation (or any related third-party recoveries) will change in the near term if the criteria of FASB ASC 275 for significant estimates are met (FASB ASC 275-10-50-9; 410-30-50-6)

Unaccrued Contingencies

For reasonably possible loss contingencies (including losses in excess of accrued amounts), the following disclosures should be made:

a. A description of the contingency and an estimate of the possible loss (or the fact that such an estimate cannot be made) (FASB ASC 410-30-50-5; 450-20-50-4)

b. An indication that it is at least reasonably possible that the estimate will change in the near term if the criteria of FASB ASC 275 for certain significant estimates are met (FASB ASC 275-10-50-9; 410-30-50-6)

For probable but not reasonably estimable loss contingencies that may be material, the following disclosures should be made: (FASB ASC 450-20-50-4 and 50-5)

a. A description of the remediation obligation

b. The fact that a reasonable estimate cannot currently be made

Unasserted Claims

If assertion of a claim is probable or if existing laws require the entity to report the release of hazardous substances and begin a remediation study, a loss contingency should be disclosed. (FASB ASC 410-30-50-13)

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. What element of a *conditional asset retirement obligation* is conditional?

   a. Whether the retirement will occur.

   b. The occurrence of a future event.

   c. The fair value of the retired asset.

   d. The passage of a particular law or ordinance.

2. Why might an environmental liability for a clean-up site be discounted?

   a. The loss amount is a range in which no single amount is better than the others.

   b. There is more than one potentially responsible party (PRP) for the site.

   c. The aggregate amount of the obligation can be reliably determined.

   d. The amount and timing of cash payments will vary.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. What element of a *conditional asset retirement obligation* is conditional? **(Page 97)**

   a. Whether the retirement will occur. [This answer is incorrect. Though there is uncertainty in a *conditional asset retirement obligation,* the obligation to perform the retirement activity is unconditional.]

   b. The occurrence of a future event. [This answer is correct. As described in FASB ASC 410-20-20 and 410-20-25-7, a *conditional asset retirement obligation* is a legal obligation to perform an asset retirement activity where the timing and (or) method of settlement are conditional on a future event.]

   c. The fair value of the retired asset. [This answer is incorrect. The uncertainty inherent in a *conditional asset retirement obligation* should be incorporated into the fair value measurement for the retirement obligation; however, uncertainty about an asset's fair value is not the conditional element in this type of obligation.]

   d. The passage of a particular law or ordinance. [This answer is incorrect. A *legal obligation* is an obligation that a party must settle as a result of existing or enacted laws, statutes, ordinances, written or oral contracts, or by legal construction of a contract under the promissory estoppel doctrine. However, passage of a particular law or ordinance is not a specific reason called out in the definition of a *conditional asset retirement obligation.* Such an obligation is conditional for other, broader reasons.]

2. Why might an environmental liability for a clean-up site be discounted? **(Page 99)**

   a. The loss amount is a range in which no single amount is better than the others. [This answer is incorrect. If only a range of loss can be estimated and no amount within the range is a better estimate of the liability than other amounts, discounting is not appropriate under FASB ASC 410-30-35-12.]

   b. There is more than one potentially responsible party (PRP) for the site. [This answer is incorrect. The amount of PRPs figures into estimating an organization's total share of a remediation liability; however, this is not a reason for a possible discount.]

   c. The aggregate amount of the obligation can be reliably determined. [This answer is correct. Per FASB ASC 410-30-35-12, environmental liabilities may be discounted (but are not required to be discounted) only if two items are fixed or reliably determinable for each specific clean-up site. One of these items is the aggregate amount of the obligation.]

   d. The amount and timing of cash payments will vary. [This answer is incorrect. Under FASB ASC 410-30-35-12, the amount and timing of cash payments for a clean-up site must be fixed or reliably determinable to qualify for a discount.]

Lesson 2: Commitments and Contingencies

INTRODUCTION

SOURCE: FASB ASC 440-10 and FASB ASC 450; 855; and 958-450

Nonprofit organizations may have commitments, contingencies, or both. This lesson discusses the accounting and disclosure requirements for commitments and contingencies under GAAP and how they will apply to nonprofit organizations.

This lesson does not discuss accounting for long-term obligations. Its guidance does not apply to leases or financial instruments with characteristics of both liabilities and equity. The guidance in this lesson also generally does not apply to pension costs, employment related costs (e.g., deferred compensation contracts), uncertainty in income taxes, contingent assets or liabilities recognized at the acquisition date in a business combination, or insurance policies that do not transfer risk to the insurer. More information on these topics can be found in *PPC's Guide to Nonprofit GAAP.*

Commitments related to product financing arrangements and long-term borrowings, as well as contingencies related to environmental remediation liabilities, exit or disposal cost obligations, guarantees, and uncollectible receivables are all discussed elsewhere in this course.

Learning Objectives:

Completion of this lesson will enable you to:
- Recognize how nonprofit organizations should address commitments and contingencies under GAAP.

COMMITMENTS

An organization should disclose certain information about its commitments, including commitments under unconditional purchase obligations. Unconditional purchase obligations may be recorded or unrecorded. For unrecorded obligations, the disclosures include the nature of the obligations, the amount of the obligations that are determinable (for the latest statement of financial position presented and for the next five years), a description of any variable portion of the obligations, and actual purchases under the contracts during the year. For recorded unconditional purchase commitments, the required payments for each of the next five years should be disclosed.

DISCLOSURE REQUIREMENTS

GENERAL

GAAP specifically requires the following commitments to be disclosed: (FASB ASC 440-10-50-1)

a. Unused letters of credit

b. Commitments such as obligations to reduce debt or maintain working capital

c. Long term leases

d. Pledged assets securing loans

e. Pension plans

UNCONDITIONAL PURCHASE OBLIGATIONS

An unconditional purchase obligation requires one party to transfer funds to another party in the future in return for specified quantities of goods or services at specified prices. Certain disclosures are required about unconditional purchase obligations that have the following characteristics: (FASB ASC 440-10-20; 440-10-50-2)

a. The obligation is noncancelable, or cancelable only—

   (1) upon the occurrence of a remote contingency;

   (2) with the other party's permission;

   (3) if a replacement agreement is signed between the same parties; or

   (4) upon payment of a penalty in an amount that reasonably assures that the agreement will be continued.

b. The obligation is associated with financing arrangements for (1) the facilities that will provide the specified goods or services or (2) the costs related to the goods or services (for example, carrying costs).

c. The obligation's remaining term is for more than one year.

Under current accounting practices, assets and liabilities created by purchase obligations may or may not be recorded. Often, unfulfilled purchase obligations are not recorded until at least part of the commitment is fulfilled. Authoritative literature does not address the issue of when purchase obligation assets and liabilities should be recorded. Instead, it merely requires that the obligations be disclosed. The required disclosures vary depending on whether the unconditional purchase obligation is recorded or not. In addition, although obligations to pay future minimum lease payments under leases may possess all of the characteristics listed above, some lease obligations with specific disclosure requirements are excluded from the unconditional purchase obligation disclosure requirements. (FASB ASC 440-10-50-3) More information about such lease obligations is beyond the scope of this course but can be found in *PPC's Guide to Nonprofit GAAP*.

Unrecorded Unconditional Purchase Obligations

The following information should be disclosed about unconditional purchase obligations that meet the criteria listed previously and have not been recognized in the statement of financial position: (FASB ASC 440-10-50-4)

a. Nature and term of the obligations

b. Total amount of the fixed and determinable portion of the obligations as of the date of the latest statement of financial position presented and, if determinable, for each of the five succeeding fiscal years

c. Nature of any variable components of the obligations

d. Amounts actually purchased under the obligations for each period for which a statement of activities is presented

These disclosures may be omitted if the aggregate amount of required payments is immaterial.

Disclosure of the imputed interest that reduces the fixed and determinable portion of the obligations (item b. in the preceding paragraph) to present value is encouraged but not required. The discount rate used to compute the obligations' present value should be the initial effective interest rate of the borrowings used to finance the facilities that will provide the contracted goods or services. If that rate is not known, the purchaser's incremental borrowing rate should be used. (FASB ASC 440-10-50-5) The purchaser's incremental borrowing rate is the rate the purchaser would have incurred at the inception of the unconditional purchase obligation to borrow funds, on similar terms, to discharge the obligation. (FASB ASC 440-10-20)

Recorded Unconditional Purchase Obligations

If an unconditional purchase obligation that meets the previously listed criteria has been recorded, the aggregate amount of payments required for each of the five years following the date of the latest statement of financial position date presented should be disclosed. (FASB ASC 440-10-50-6)

CONTINGENCIES

An estimated loss from a loss contingency should be accrued and disclosed if (a) it is probable that a loss has been incurred at the financial statement date and (b) the amount of the loss can be reasonably estimated. Loss contingencies that do not meet those conditions should be disclosed if there is a reasonable possibility that a loss may have been incurred.

Gains from gain contingencies should not be accrued since doing so might recognize revenue before it is realized.

Subsequent events that provide evidence about conditions that existed at the financial statement date should be recognized in the financial statements. Subsequent events that provide evidence about conditions that did not exist at the financial statement date should not be recognized in the financial statements. For nonrecognized subsequent events, disclosure may be necessary to keep the financial statements from being misleading.

ACCOUNTING REQUIREMENTS

A contingency is an existing condition, situation, or set of circumstances involving an uncertainty that, when resolved, may result in a gain or loss. Contingencies that may result in the loss or impairment of an asset or the incurrence of a liability are called "loss contingencies" while those that may result in the acquisition of an asset or the reduction of a liability are called "gain contingencies." (FASB ASC Master Glossary; 450-10-05-1) The following paragraphs discuss accounting for gain and loss contingencies.

LOSS CONTINGENCIES

A loss contingency will not develop into an actual loss until a particular future event occurs. Thus, accounting for a loss contingency is based on whether the likelihood of the future event occurring is *probable* (likely to occur), *reasonably possible* (more than slight but less than likely) or *remote* (slight). (FASB ASC 450-20-25-1; Master Glossary) Depending on whether it is probable, reasonably possible, or remote, a loss contingency may be required to be accrued, disclosed, or neither.

The estimated loss from a loss contingency should be accrued when both of the following conditions are met: (FASB ASC 450-20-25-2)

a. Information available before the financial statements are available to be issued indicates that it is probable that a loss has been incurred at the financial statement date.

b. The amount of loss can be reasonably estimated. (A loss that is not accrued in the period it becomes probable because its amount cannot be reasonably estimated should be accrued in the period its amount can be reasonably estimated. Prior periods should not be adjusted.) (FASB ASC 450-20-25-7)

If a loss is probable but only a range of loss can be reasonably estimated, conditions a and b are still met and a loss should be accrued. In such cases, the minimum amount of the range should be accrued unless another amount is a better estimate. (FASB ASC 450-20-30-1) Adjustment in subsequent periods of the amount accrued is a change in estimate.

It is preferable for a loss contingency to be disclosed instead of accrued if— (FASB ASC 450-20-50-5)

a. it is probable that a loss has occurred but the amount of the loss cannot be reasonably estimated or

b. it is reasonably possible (but not probable) that a loss has occurred.

In addition, a guarantee should be disclosed even if the likelihood of loss is remote. Guarantees are discussed in Lesson 5.

Required disclosures are discussed later in this lesson. Exhibit 2-1 summarizes the accounting requirements for loss contingencies.

Exhibit 2-1

Accounting for Loss Contingencies

Likelihood of Loss	Loss Can Be Reasonably Estimated	Loss Cannot Be Reasonably Estimated
Probable	Accrue the loss and disclose the contingency.	Do not accrue the loss but disclose the contingency.
Reasonably possible	Do not accrue the loss but disclose the contingency.	Do not accrue the loss but disclose the contingency.
Remote	Do not accrue the loss. Disclose the contingency if it involves a guarantee. Otherwise, disclosure is permitted, but not required.	Do not accrue the loss. Disclose the contingency if it involves a guarantee. Otherwise, disclosure is permitted, but not required.

* * *

Contingencies Arising after the Financial Statement Date

A loss contingency may arise after the financial statement date but before the financial statements are available to be issued. Because the contingency arose after the financial statement date, a loss should not be accrued. However, the contingency may need to be disclosed to keep the financial statements from being misleading. (FASB ASC 450-20-25-6; 450-20-50-9)

Applying the Rules to Specific Loss Contingencies

The following paragraphs discuss considerations for applying the accrual requirements to specific contingencies. In addition, Exhibit 2-2 illustrates applying the recognition and disclosure requirements to specific situations.

Noncompliance with Donor Restrictions. Donors may impose restrictions, such as maintenance of an appropriate composition of assets (i.e., cash and marketable securities), on contributions to nonprofit organizations. Noncompliance may cause the organization to lose future revenues or support or even require the organization to reimburse the donor for previous donations. If it is probable that a restricted donation will have to be reimbursed to the donor and the amount of the reimbursement can be reasonably estimated, a contingent liability should be accrued. (FASB ASC 958-450-25-1)

Potential Loss of or Pending Determination of Tax-exempt Status. A nonprofit organization may have a loss contingency that requires accrual or disclosure if there is a problem with its tax-exempt status or if it has applied for tax-exempt status but a determination letter regarding that status has not been received. (FASB ASC 958-450-25-1)

Uninsured Risks. The fact that an organization is not adequately insured against losses that may result from damage to its property, injury to others, or interruption of its activities is a contingency. The absence of adequate insurance does not mean that an asset has been impaired or a liability has been incurred at the financial statement date, however. Losses from uninsured risks are probable only when future events occur, such as a fire or explosion, and thus relate to the future period in which the events occur rather than the current period. Consequently, contingencies arising from uninsured or underinsured risks should not be accrued. (FASB ASC 450-20-25-6; 450-20-55-5)

Exhibit 2-2

Examples of Applying the Loss Contingency Recognition and Disclosure Requirements in Specific Situations

Facts	Recognition	Disclosure
After the date of the financial statements but before they are available to be issued, a fire destroys an organization's operating facilities, which results in a substantial loss because the facilities were underinsured.	No. The assets were underinsured at the financial statement date, but the event that impaired them did not occur until after the financial statement date.	Yes. A loss occurred, and disclosure is required to keep the financial statements from being misleading. Disclosure should include an estimate of the possible loss or range of loss (or a statement that an estimate cannot be made) and, if applicable, an indication that it is at least reasonably possible that a change in estimate will occur in the near term.
After the date of the financial statements but before they are available to be issued, a fire destroys an organization's operating facilities. Their replacement was fully insured.	No. The assets were not impaired at the financial statement date, and there was no loss.	No. There was no loss.
An organization is sued prior to the financial statement date. Before the financial statements are available to be issued, the suit is settled at a material loss to the organization.	Yes. A liability was incurred at the financial statement date, and the amount of the liability is known.	Yes, if disclosure is required to keep the financial statements from being misleading.
An organization is sued after the financial statement date and settles at a material loss before the financial statements are available to be issued. The event that caused the suit occurred after the financial statement date.	No. The liability was not incurred at the financial statement date.	Yes. A loss occurred, and disclosure is required to keep the financial statements from being misleading.

Facts	Recognition	Disclosure
After the date of the financial statements but before they are available to be issued, a federal agency grantor requires an organization to repay a material grant amount recognized during the year because the grant funds were expended for purposes deemed unallowable for federal cost reimbursement.	Yes. A liability was incurred at the financial statement date, and the amount is known.	Yes, if disclosure is required to keep the financial statements from being misleading.
After the date of the financial statements but before they are available to be issued, a federal agency grantor requires an organization to repay a material grant amount recognized during the year because the grant funds were expended for purposes deemed unallowable for federal cost reimbursement.	Yes. A liability was incurred at the financial statement date, and the amount is known.	Yes, if disclosure is required to keep the financial statements from being misleading.
After the date of the financial statements but before they are available to be issued, a federal agency grantor requires an organization to repay a material grant amount recognized during the year because the grant funds were expended for purposes deemed unallowable for federal cost reimbursement.	Yes. A liability was incurred at the financial statement date, and the amount is known.	Yes, if disclosure is required to keep the financial statements from being misleading.
Before year end, an organization's van driver is involved in a wreck. Although the driver did not cause it, one of the injured passengers in a separate vehicle is suing everyone involved. The organization is sued for $1 million, but its driver is not charged by the police, and the organization's lawyers say that the plaintiff has no chance of winning damages.	No. The chance of loss is remote.	No. The chance of loss is remote.

Facts	Recognition	Disclosure
Before year end, an organization is sued for $250,000. Any settlement would be covered by its $1 million liability policy, and the $10,000 deductible under the policy is not material. Although settlement has not been reached before the financial statements are available to be issued, the organization believes that it will eventually have to settle on the suit.	No. Any loss under the suit would not be material.	No. The loss would not be material.

* * *

Expropriation of Assets. The threat of expropriation of an organization's assets is a contingency. Consequently, a loss should be accrued if (a) expropriation is imminent and a loss is expected and (b) the amount of the loss can be reasonably estimated. An expropriation's imminence may be indicated by a government's public or private declarations of intent or its actual expropriation of another organization's assets. (FASB ASC 450-20-55-9)

Litigation, Claims, and Assessments. A loss due to pending or threatened litigation or actual or possible claims and assessments should be accrued if all of the following conditions are met:

a. *The underlying cause of the litigation, claim, or assessment occurred on or before the financial statement date.* The condition is met even if the organization does not become aware of the existence or possibility of the litigation, claim, or assessment until after the financial statement date. (FASB ASC 450-20-55-10 and 55-11)

b. *The likelihood of an unfavorable outcome is probable.* Factors that should be considered include the nature of the litigation, claim, or assessment; the progress of the case (including its progress after the financial statement date but before the financial statements are available to be issued); the opinions of legal counsel; similar experiences; and the organization's intended response to the litigation, claim, or assessment. (FASB ASC 450-20-55-12)

c. *The amount of the loss can be reasonably estimated.* If the estimated loss is expressed in a range, the lowest amount in the range should be accrued unless another amount within the range is a better estimate. If it is reasonably possible that the actual loss will exceed the amount accrued, the additional exposure to loss should be disclosed. (FASB ASC 450-20-55-16 and 55-18 through 55-21)

When a claim or assessment is *unasserted* (for example, because either the claimant is unaware of its existence or has elected not to assert it), the criteria for accruing the contingency differ slightly. In such cases, the organization must first determine whether it is probable that a suit will be filed or a claim or assessment asserted and the possibility of an unfavorable outcome. Based on its assessment, accrual is required if (a) it is probable that a claim will be asserted, (b) it is probable that the outcome will be unfavorable, and (c) the amount of loss can be reasonably estimated. (FASB ASC 450-20-55-14 and 55-15)

Preacquisition Contingencies. An organization may have contingent assets, contingent liabilities, or contingent impairments of assets on the date it is acquired in a business combination accounted for as an acquisition. Certain

assets or liabilities arising from contingencies should be recognized at the acquisition date. If a contingent gain or loss acquired in a acquisition meets the criteria for recognition as an asset or liability at that date, it is subject to specific initial and subsequent measurement. (An in-depth discussion of this measurement and these types of assets/liabilities is beyond the scope of this course, but more information is available in *PPC's Guide to Nonprofit GAAP*.) If the contingent gain or loss does not meet the criteria for recognition at the acquisition date, it should be accounted for following the guidance in this lesson.

GAIN CONTINGENCIES

Contingencies that might result in gains should not be accrued since doing so might recognize revenue before it is realized. Gain contingencies should be adequately disclosed in the notes to the financial statements, however. (FASB ASC 450-30-25-1; 450-30-50-1)

SUBSEQUENT EVENTS

Subsequent events represent events or transactions that occur after the date of the statement of financial position, but before the financial statements are available to be issued. Two types of events or transactions may occur after the financial statement date but before the financial statements are available to be issued: (FASB ASC 855-10-20)

a. Events or transactions that provide additional evidence about conditions that existed at the financial statement date, including the estimates that are inherent in preparing the financial statements

b. Events that provide evidence about conditions that did not exist at the financial statement date but arose subsequent to that date

Subsequent events that provide additional evidence about conditions that existed at the financial statement date, including estimates that are inherent in preparing financial statements, should be recognized in the financial statements. Subsequent events that provide evidence about conditions that did not exist at the financial statement date should not be recognized in the financial statements. (FASB ASC 855-10-25-1 and 25-3) Nonprofit organizations should evaluate subsequent events until their financial statements are available to be issued. (FASB ASC 855-10-25-2)

Sometimes, the reporting entity may reissue its financial statements. Events or transactions occurring between the original issuance and reissuance of the financial statements should not be recognized unless required by GAAP or regulatory requirements, for example, to correct an error. However, disclosure of subsequent events may be needed to keep the reissued financial statements from being misleading. (FASB ASC 855-10-25-4)

DISCLOSURE REQUIREMENTS

LOSS CONTINGENCIES

When an accrual has been made for a contingency, disclosure of the nature and the amount may be necessary to keep the financial statements from being misleading. The term *reserve* should not be used when an accrual has been made for a loss contingency. (FASB ASC 450-20-50-1)

When there is at least a reasonable possibility that a loss or additional exposure to a loss has been incurred, but (a) an accrual has not been made or (b) exposure exists in excess of the amount accrued, the following information should be disclosed: (FASB ASC 450-20-50-3; 50-4 and 50-9; 958-450-50-1)

a. The nature of the contingency

b. An estimate of the possible loss or range of loss (or a statement that such an estimate cannot be made)

In some cases, contingencies arising after the financial statement date may best be disclosed by supplementing the financial statements with pro forma information that reports the loss as if it occurred at the financial statement date. (FASB ASC 450-20-50-10)

Disclosure of uninsured or underinsured risks is not required (FASB ASC 450-20-50-7); however, it is a best practice to make disclosures when (a) an event that would make the likelihood of loss probable occurs subsequent to the financial statement date but before the financial statements are available to be issued and (b) disclosure is necessary to prevent the financial statements from being misleading.

Disclosure of unasserted claims and assessments that do not meet the criteria for accrual provided earlier in this lesson should be made if (a) it is probable that a claim will be asserted and that its outcome will be unfavorable but the amount of loss cannot be reasonably estimated or (b) it is probable that a claim will be asserted and reasonably possible (but not probable) that its outcome will be unfavorable. (FASB ASC 450-20-50-6)

Noncompliance with Donor Restrictions

As previously discussed, donors may impose restrictions on contributions to an organization, and the organization may not be in compliance with those restrictions. The notes to financial statements should disclose noncompliance with donor-imposed restrictions if either (a) there is a reasonable possibility that a material contingent liability was 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 cause the organization to be unable to continue as a going concern. (FASB ASC 958-450-50-2)

In addition, if an organization fails to maintain an appropriate composition of assets in amounts needed to comply with donor restrictions, the amount and circumstances of the noncompliance should be disclosed. (FASB ASC 958-450-50-3)

GAIN CONTINGENCIES

Adequate disclosure should be made when a contingency might result in a gain, although care should be taken to avoid misleading implications about the likelihood of realization. (FASB ASC 450-30-50-1)

SUBSEQUENT EVENTS

The following disclosures are required for subsequent events: (FASB ASC 450-20-50-9 and 50-10; 855-10-50-1 through 50-3)

a. The date through which subsequent events have been evaluated representing the date financial statements were available to be issued

b. For nonrecognized subsequent events that need to be disclosed to keep the financial statements from being misleading—

    (1) The nature of the event

    (2) An estimate of the effect (or range) or a statement that an estimate cannot be made

In some cases, nonrecognized subsequent events may best be disclosed by supplementing the financial statements with pro forma information that reports the event as if it occurred at the financial statement date.

For revised (reissued) financial statements, disclosure should be made of the date through which subsequent events have been evaluated for both the available-to-be issued and revised financial statements. (FASB ASC 855-10-50-4 and 50-5)

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

3. Which of the following is a characteristic that must exist for unconditional purchase arrangements to need certain specific disclosures?

   a. The obligation has one year or less remaining on its term.

   b. The obligation has no associated financing arrangements.

   c. If the obligation is cancelled, no penalty is required.

   d. The obligation is noncancelable.

4. Helping Hands, a nonprofit organization, has a reasonably possible loss contingency that can be estimated. How should the organization account for this loss contingency?

   a. Accrue and disclose.

   b. Do not accrue, but disclose.

   c. Accrue, but do not disclose.

   d. Do not accrue and only disclose if it involves a guarantee.

5. Which of the following disclosures is necessary specifically for a nonrecognized subsequent event?

   a. A specific estimate of the applicable amount.

   b. The date through which subsequent events have been evaluated.

   c. Whether there was related noncompliance with donor restrictions.

   d. The nature of the subsequent event.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

3. Which of the following is a characteristic that must exist for unconditional purchase arrangements to need certain specific disclosures? **(Page 106)**

   a. The obligation has one year or less remaining on its term. [This answer is incorrect. For such disclosures to be required, the obligation's remaining term must be for *more* than one year.]

   b. The obligation has no associated financing arrangements. [This answer is incorrect. For such disclosures to be required, the obligation must be associated with financing arrangements for (1) the facilities that will provide the specified goods and services or (2) the costs related to the goods or services.]

   c. If the obligation is cancelled, no penalty is required. [This answer is incorrect. Such disclosures are required when one of the few ways such an obligation is cancelable is upon payment of a penalty in an amount that reasonably assures that the agreement will be continued.]

   d. The obligation is noncancelable. [This answer is correct. Per FASB ASC 440-10-20 and 440-10-50-2, certain disclosures are required about unconditional purchase obligations that have specific characteristics. One such characteristic is that the obligation is noncancelable or cancelable only in very few instances.]

4. Helping Hands, a nonprofit organization, has a reasonably possible loss contingency that can be estimated. How should the organization account for this loss contingency? **(Page 108)**

   a. Accrue and disclose. [This answer is incorrect. The loss should be accrued and the contingency disclosed if the likelihood of the loss is probable. Since that is not the case in this scenario, both accruing and disclosing would be more work than required by GAAP for Helping Hands.]

   b. Do not accrue, but disclose. [This answer is correct. Whether or not the loss can be reasonably estimated, if the loss is reasonably possible GAAP requires it to be disclosed, but not accrued. Therefore, this is the type of accounting Helping Hands should use in this scenario.]

   c. Accrue, but do not disclose. [This answer is incorrect. Accounting for loss contingencies is based on the likelihood of the loss and whether the amount can be reasonably estimated. However, with none of those variables does GAAP require accrual without disclosure. Therefore, Helping Hands should not account for its loss contingency in this way.]

   d. Do not accrue and only disclose if it involves a guarantee. [This answer is incorrect. If the likelihood of loss is remote, whether or not the amount can be reasonably estimated, GAAP does not require accrual of the loss. In both instances, GAAP requires disclosure if it involves a guarantee. If not, disclosure is permitted, but not required. However, since Helping Hands' loss contingency has a higher likelihood, this accounting would not meet GAAP requirements.]

5. Which of the following disclosures is necessary specifically for a nonrecognized subsequent event? **(Page 113)**

   a. A specific estimate of the applicable amount. [This answer is incorrect. The organization needs to disclose an estimate of the effect (or range) or a statement that an estimate cannot be made. The disclosure should not, per this guidance, be limited to a single amount, but should be a range.]

   b. The date through which subsequent events have been evaluated. [This answer is incorrect. One required disclosure for subsequent events in general is the date through which subsequent events have been evaluated representing the date financial statements were available to be issued. However, this disclosure is more general in nature, and is not specifically limited to nonrecognized subsequent events. Therefore, there is a better answer to this question.]

c. Whether there was related noncompliance with donor restrictions. [This answer is incorrect. Donors may impose restrictions on contributions to an organization, and the organization might not be in compliance with those restrictions. The notes to the financial statements should disclose noncompliance with donor-imposed restrictions if either (1) there is a reasonable possibility that a material contingent liability was incurred at the date of the financial statements and (2) there is at least a reasonable possibility that the noncompliance could lead to a material loss of revenue or cause the organization to be unable to continue as a going concern. However, this disclosure is specifically related to noncompliance, which has different disclosures than those for subsequent events.]

d. The nature of the subsequent event. [This answer is correct. Per FASB ASC 450-20-50-9 and 50-10, as well as FASB ASC 855-10-50-1 through 50-3, two specific disclosures are needed related to nonrecognized subsequent events to keep the financial statements from being misleading. One such disclosure relates to the amount associated with the event. The other is disclosing the nature of the event.]

Lesson 3: Debt

INTRODUCTION

SOURCE: FASB ASC 310-40; 405-20; 405-30; 405-40; and 470

This lesson takes a look at the GAAP requirements a nonprofit organization will need to adhere to in relation to its debt. It begins with a discussion of various types of debt, and then it goes into more detail on specific accounting and disclosure requirements.

Learning Objectives:

Completion of this lesson will enable you to:
- Determine what GAAP requires of nonprofit organizations when they account for debt.
- Recognize the disclosures that nonprofit organizations must make in relation to debt.

TYPES OF DEBT

OBLIGATIONS EXPECTED TO BE REFINANCED

A current liability that is expected to be refinanced on a long-term basis may be classified as noncurrent if the debtor intends to refinance the liability on a long-term basis and has demonstrated the ability to do so.

CALLABLE OBLIGATIONS

Noncurrent obligations that are callable by the creditor because (a) the debtor is in violation of a provision of the debt agreement at the statement of financial position date or (b) a violation has occurred at the statement of financial position date that, if not cured within a specified grace period, will make the obligation callable. (Callable obligations may be classified as noncurrent if certain conditions are met, however.)

PARTICIPATING MORTGAGE LOANS

If a loan agreement allows the lender to participate in the appreciation of mortgaged real estate, the borrower should record a liability for the fair value of the participation feature at the origination of the loan. The offsetting debit to debt discount should be amortized under the interest method using the effective interest rate. Amounts should be adjusted to current fair value at the end of each reporting period. The borrower's interest expense consists of stated interest, amounts related to the lender's participation, and amortization of debt discount.

PRODUCT FINANCING ARRANGEMENTS

A product financing arrangement should be accounted for as a borrowing rather than a sale. Consequently, a sponsoring organization that sells products to a financing company and, in a related transaction, agrees to repurchase the products over a specified period at a specified price, should (a) continue to carry the products in its statement of financial position as assets and (b) record a liability for any amounts received from the financing company. Similarly, if a financing company purchases products on the sponsoring organization's behalf and, in a related transaction, the sponsoring organization agrees to purchase the products from the financing company, the sponsoring organization should record an asset and liability for the products when the financing company purchases them.

A sponsoring organization should record financing and holding costs as they are incurred by the financing company. The sponsoring organization should account for the costs in accordance with its accounting policies for other financing and holding costs.

MODIFICATIONS AND EXTINGUISHMENTS

When debt is modified in other than a troubled debt restructuring, accounting for unamortized deferred costs depends on whether the borrowing capacity of the new arrangement is greater or less than the borrowing capacity

of the old arrangement. If the new borrowing capacity is greater than or equal to the old capacity, unamortized deferred costs are deferred and amortized over the term of the new arrangement. If the new borrowing capacity is less than the old capacity, unamortized deferred costs are reduced in proportion to the reduced capacity and the remainder is amortized over the term of the new arrangement. When debt is extinguished, whether early or not, a gain or loss may occur equal to the difference between the amount paid to extinguish the debt and the net carrying amount of the debt. A gain or loss on extinguishment should be recognized in the period the extinguishment occurs rather than amortized to future periods.

TROUBLED DEBT RESTRUCTURINGS

How a debtor or creditor accounts for a troubled debt restructuring depends on the type of restructuring. The following are the primary types:

a. *Transfer of assets in full settlement of the debt.* Generally, the debtor should recognize a gain on restructuring equal to the difference between the fair values of the assets transferred and the carrying value of the debt. In addition, a gain or loss should be recognized for the difference between the transferred assets' fair values and carrying amounts.

   A creditor that receives assets (or an equity interest) in full settlement of debt should record the assets (or equity interest) received at their fair values and recognize an ordinary loss for the difference between its recorded investment in the receivable and the fair value of the assets (or equity interest) received. Subsequently, the assets received should be accounted for the same as if they were acquired for cash.

b. *Modification of debt terms.* A restructuring that only involves the modification of terms generally should be accounted for prospectively. The debtor should not adjust the carrying amount of the debt unless it exceeds the future cash payments specified by the new debt terms. Interest should be determined by applying a constant effective interest rate to the outstanding debt.

   A creditor should account for a restructuring involving the modification of terms as it would an impaired loan.

If the restructuring involves a combination of the above types, the debtor and creditor generally should account for the transfer of assets or equity interest first and treat the remainder of the restructuring as a modification of terms. Thus, in a restructuring involving a combination of types, a debtor organization should (a) recognize a gain or loss by reducing the carrying amount of the debt by the fair value of the assets, and (b) account for the remainder of the restructuring as a modification of debt terms. Similarly, a creditor organization should reduce its recorded investment in the receivable by the fair value of the assets or equity interest received and account for the remainder of the restructuring as a modification of debt terms.

INSURANCE-RELATED ASSESSMENTS

A liability for insurance-related assessments should be recognized when (a) an assessment has been made or information available before the financial statements are issued or available to be issued indicates it is probable that an assessment will be made; (b) an event that obligates the organization to pay the assessment has occurred on or before the date of the financial statements; and (c) the assessment can be reasonably estimated.

An asset should be recognized when it is probable that a paid or accrued assessment will be recovered through a premium tax offset or policy surcharge.

JOINT AND SEVERAL LIABILITY ARRANGEMENTS

An obligation for a joint and several liability arrangement for which the total amount of the obligation is fixed at the reporting date should be recognized and measured as the sum of (a) the amount the nonprofit organization agreed to pay under the arrangement among the co-obligors and (b) any additional amount the organization expects to pay on behalf of the co-obligors.

ACCOUNTING REQUIREMENTS

OBLIGATIONS EXPECTED TO BE REFINANCED

Obligations scheduled to mature within one year (or operating cycle, if longer) normally must be included in current liabilities. They may be included in noncurrent liabilities, however, if *both* of the following conditions are met:

a. *The organization intends to refinance the obligation on a long-term basis.*

b. *The organization has the ability to consummate the refinancing.* The organization's ability may be demonstrated in either of the following ways:

   (1) After the statement of financial position date but before the financial statements are available to be issued, a long-term obligation has been issued for the refinancing.

   (2) Before the financial statements are available to be issued, the organization enters into a financing agreement that clearly permits refinancing on terms that are readily determinable, and *all* of the following conditions are met:

      (a) The agreement does not expire within one year (or operating cycle, if longer) from the statement of financial position date and the agreement is not cancelable or callable by the lender except for violation of a provision with which compliance is objectively determinable or measurable.

      (b) No violation of any provision in the agreement exists at the statement of financial position date, and no available information indicates that a violation has occurred before financial statements are issued (or available to be issued). (If there has been a violation, this condition is met if an unconditional waiver of the lender's right to cancel or call the agreement has been obtained.)

      (c) The lender is expected to be financially capable of honoring the agreement. (FASB ASC 470-10-45-13 and 45-14)

A short-term obligation that is repaid *before* long-term financing is obtained may not be excluded from current liabilities, however. A fundamental concept behind excluding a short-term obligation from current liabilities is that it will not require the use of current assets within the coming year. Repaying a short-term obligation *before* long-term financing is obtained requires the use of current assets. (In effect, the refinancing is viewed as a replacement of the current assets used to repay the current liability rather than as a refinancing of the current obligation.) (FASB ASC 470-10-45-15)

Replacing a short-term obligation with another short-term obligation does not, by itself, demonstrate the organization's ability to refinance the obligation on a long-term basis. Thus, for example, replacing a short-term obligation under the terms of a revolving credit agreement would not allow the organization to classify the short-term obligation as noncurrent unless the revolving credit agreement meets the conditions listed previously. (FASB ASC 470-10-45-21)

CALLABLE OBLIGATIONS

An obligation that, by its terms, is due on demand at the statement of financial position date is a current liability. Factors such as an assessment of whether the creditor will actually call the note do not affect the classification decision. In addition, if violations of a long-term debt agreement exist that make the debt callable within one year from the statement of financial position date (or callable within one year from the statement of financial position date if the violation is not cured within a specified grace period), the long-term debt should be classified as a current liability unless— (FASB ASC 470-10-45-10 and 45-11)

- the creditor has specifically waived (or lost) the right to demand payment for more than one year from the statement of financial position date,
- the violation is cured after the statement of financial position date but before financial statements are available to be issued, or

- the organization demonstrates that it is probable it will be able to cure the violation within the grace period.

Subjective Acceleration Clauses

A loan agreement may contain a subjective acceleration clause allowing the creditor to accelerate the maturity of long-term debt based on subjective criteria such as "occurrence of material adverse changes" or "failure to maintain satisfactory operations." In such cases, all facts and circumstances should be evaluated to determine whether (a) the long-term debt should be classified as current, (b) the subjective acceleration clause should be disclosed, or (c) neither disclosure nor reclassification is necessary because the likelihood of acceleration is remote, for example, the organization is in good financial condition and the lender has historically not accelerated due dates. (FASB ASC 470-10-20; 470-10-45-11)

PARTICIPATING MORTGAGE LOANS

Real estate transactions may result in the mortgage lender participating in the appreciation in the fair value of the mortgaged property, the results of operations of the mortgaged real estate project, or both.

Accounting for Participation in the Mortgaged Asset's Appreciation

If the loan agreement allows the lender to participate in the appreciation of the mortgaged real estate's fair value, the borrower should determine the fair value of the participation feature and record a participation liability for that amount at the loan's origination. The offsetting debit to a debt discount account should be amortized under the interest method using the effective interest rate. (FASB ASC 470-30-25-1; 470-30-30-1; 470-30-35-1) At the end of each period, the current fair value of the participation feature should be estimated and the participation liability account should be adjusted accordingly. The offsetting debit or credit should be recorded to the debt discount, with the resulting balance in the debt discount account amortized prospectively under the interest method. (FASB ASC 470-30-35-4 and 35-5)

Interest Expense

The borrower's interest expense on a participating mortgage loan consists of: (FASB ASC 470-30-35-2 through 35-4; 470-30-45-1)

a. *Interest stated in the mortgage agreement.* Such amounts should be charged to interest expense in the period the interest is incurred.

b. *Amounts related to the lender's participation in the results of operations of the real estate project.* Such amounts should be charged to interest expense (in the borrower's corresponding financial reporting period) with an offsetting credit to the participation liability.

c. *Amortization of the debt discount related to the lender's participation in the appreciation of the mortgaged real estate.*

Extinguishment of Participating Mortgage Loans

The difference between the recorded amount of the debt (including any unamortized debt discount and the participation liability) and the amount exchanged to extinguish the debt for a participating mortgage loan extinguished prior to its due date should be treated as a debt extinguishment gain or loss. (FASB ASC 470-30-40-1)

PRODUCT FINANCING ARRANGEMENTS

Characteristics of Product Financing Arrangements

As its name implies, a product financing arrangement is a transaction in which an organization (the sponsor) seeks to finance the purchase of products or inventory. Generally, a product financing arrangement requires one company to purchase inventory for the sponsor who, in a related transaction, agrees to purchase the inventory at

specific prices over a specific period. The following are common examples of product financing arrangements: (FASB ASC 470-40-05-2 and 05-3; 470-40-20)

a. A sponsor sells inventory to another company (the financing company) and, in a related transaction, agrees to repurchase the same or substantially identical inventory.

b. A sponsor arranges for the financing company to purchase the inventory and, in a related transaction, agrees to purchase the inventory from the financing company.

c. A sponsor controls the inventory of another company in accordance with the arrangements in a. or b. above.

All product financing arrangements exhibit a common characteristic—the sponsor agrees to purchase the inventory (or processed goods of which the inventory is a component) at specified prices over specified periods or guarantees the inventory's sale to third parties. (FASB ASC 470-40-05-3) The following are other characteristics that may be present in some product financing arrangements: (FASB ASC 470-40-05-4)

- The financing company is an existing trust, nonbusiness organization, credit grantor, or was established specifically to provide the financing arrangement.
- The majority of the product will be used or sold by the sponsor rather than sold directly to third parties.
- The products are stored on the sponsor's premises.
- The debt incurred by the financing company to purchase the inventory is guaranteed by the sponsor.

Criteria for Treatment as a Product Financing Arrangement

A transaction is considered a product financing arrangement if it meets the following criteria: (FASB ASC 470-40-15-2)

a. The arrangement requires the sponsor to purchase the inventory at specified prices that are not subject to change except for fluctuations due to finance and holding costs. That criteria is considered met in the following circumstances even though, in each case, the sponsor may not actually purchase the products:

   (1) The specified prices are in the form of resale price guarantees under which the sponsor agrees to make up any difference between the specified price and the price received in sales to third parties.

   (2) The sponsor is not required to purchase the product but has an option that, in substance, compels it to purchase the product.

   (3) The sponsor is not required to purchase the product but the other company has an option under which it can require the sponsor to purchase the product.

b. Under the terms of the financing agreement, the amounts paid by the sponsor will be adjusted, if necessary, to cover substantially all costs incurred by the other company to purchase and hold the product.

Accounting for Product Financing Arrangements

In a product financing arrangement, the sponsor is, in effect, the owner of the inventory or products; the arrangement is merely a means to finance the product's purchase or production. (FASB ASC 470-40-25-1) Consequently, a sponsor should account for a product financing transaction as follows: (FASB ASC 470-40-25-2)

a. If the sponsor sells product to another company and, in a related transaction, agrees to repurchase the product (or processed goods containing the product), no sale should be recorded. Instead, the sponsor should (1) continue to recognize the product as an asset and (2) record a liability for any proceeds it receives from the other company under the arrangement.

Upon the adoption of ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, arrangements described in item a. will fall under the scope of FASB ASC 606.

b. If another company purchases a product on the sponsor's behalf and, in a related transaction, the sponsor agrees to purchase the product from the company, the sponsor should record an asset and related liability when the other company purchases the product.

The difference between (a) the cost of the product under the product financing arrangement (excluding processing costs) and (b) the sponsor's original purchase or production costs (or the other company's purchase costs) represents financing and holding costs. The sponsor should account for those costs in accordance with its accounting policies for financing and holding costs as the costs are incurred by the other company. For example, if the sponsor's policy is to account for insurance as a period cost, insurance costs associated with the product financing arrangement should be expensed as they are incurred by the other company. (FASB ASC 470-40-25-3)

Upon the adoption of ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, the difference between (a) the cost of the product under the product financing arrangement (excluding processing costs) and (b) the other company's purchase costs represents financing and holding costs.

MODIFICATIONS AND EXTINGUISHMENTS

Modifications to Line-of-credit Arrangements

When changes are made to a line-of-credit or revolving-debt arrangement (for example, a change in the interest rate, the terms for drawing down funds, covenants, maturity date, or the maximum available credit) in other than a troubled debt restructuring, the unamortized deferred costs related to the old debt arrangement should be accounted for as follows: (FASB ASC 470-50-40-21 and 40-22)

- If the borrowing capacity of the new arrangement is greater than or equal to the borrowing capacity of the old arrangement, any unamortized deferred costs relating to the old arrangement, fees paid to the creditor, or third-party costs should be deferred and amortized over the term of the new arrangement. Borrowing capacity is the product of the remaining debt term and the maximum available credit.

- If the borrowing capacity of the old arrangement is greater than the borrowing capacity of the new arrangement, fees paid to the creditor or third-party costs associated with the new arrangement should be deferred and amortized over the term of the new arrangement. Unamortized deferred costs related to the old arrangement should be reduced in proportion to the decrease in borrowing capacity. Remaining unamortized deferred costs should be amortized over the term of the new arrangement.

Debt Extinguishments

A liability is considered to be extinguished for financial accounting purposes if either of the following conditions is met: (FASB ASC 405-20-40-1)

- The debtor pays the creditor and is relieved of its obligation for the liability.

- The debtor is legally released from primary obligation under the liability.

If a creditor releases a debtor from primary obligation on the condition that a third party assumes the debt and the original debtor becomes secondarily liable, the release extinguishes the original debtor's liability. In that case, however, the original debtor becomes a guarantor, and should recognize a guarantee obligation at fair value if it is likely the third party will not pay the debt. (FASB ASC 405-20-40-2)

All debt extinguishments are fundamentally alike and produce the same result—the debtor is relieved of its obligations under the debt. Consequently, accounting for debt extinguishments is the same regardless of the manner in which the extinguishment is achieved. An extinguishment is accounted for by recognizing a gain or loss

in the period the extinguishment occurs equal to the difference between the following amounts: (FASB ASC 470-50-40-2)

a. *Net carrying amount.* The net carrying amount is the amount recorded for the extinguished debt in the financial statements. It represents the amount due at maturity, adjusted for any unamortized premium, discount, or issuance costs. (FASB ASC 470-50-20)

b. *Reacquisition price.* The debt's reacquisition price is the amount paid on extinguishment, including call premiums and other miscellaneous reacquisition costs. If extinguishment is achieved by a direct exchange of new securities, the reacquisition price is the total present value of the new securities. For an exchange of debt instruments with substantially different terms, or an extinguishment resulting from a substantial modification of terms, the new debt is recorded at fair value, which is used as the reacquisition price for determining the debt extinguishment gain or loss. (FASB ASC Master Glossary; 470-50-40-13)

TROUBLED DEBT RESTRUCTURINGS

A troubled debt restructuring occurs when a creditor, for economic or legal reasons related to the debtor's financial difficulties, makes concessions to a debtor that it would not otherwise consider.

A concession results when the creditor does not expect to collect all amounts due, including interest accrued at the original contract rate. If the creditor restructures debt that includes additional collateral or guarantees from the debtor, a concession exists if the nature and amount of the additional collateral or guarantees received do not serve as adequate compensation for other terms of the restructuring. If a debtor does not have access to similar debt at the same market rate as the restructured debt, the restructuring is considered to be at a below-market rate and may indicate that a concession has been granted. A temporary or permanent increase in the restructured contract interest rate does not prevent the restructuring from being considered as a concession because the rate could still be below market interest rates for other similar debt. A restructuring that results in an insignificant delay in payment is not a concession. (FASB ASC 310-40-15-13 through 15-17)

The concessions may stem from an agreement between the two parties (e.g., a creditor might modify the debt's terms to reduce or defer required payments to help the debtor improve its financial condition and eventually repay the debt) or be imposed by law or a court. (FASB ASC 470-60-15-5 and 15-6) In a troubled debt restructuring, either of the following occurs: (FASB ASC 470-60-15-9)

a. Settlement of debt for less than its carrying value

    (1) The debtor transfers third-party receivables or other assets to the creditor to fully or partially satisfy the debt.

    (2) The creditor accepts an equity interest in the debtor to fully or partially satisfy the debt.

b. The creditor agrees to modify the debt terms. For example, the creditor might—

    (1) reduce the debt's stated interest rate.

    (2) extend the maturity date at a favorable interest rate.

    (3) reduce the debt's face or maturity amount.

    (4) reduce the interest accrued on the debt.

Whatever the concession, the creditor's primary objective is to increase its chances of collecting the debt. (FASB ASC 470-60-15-7)

When effective, ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, will supersede the requirements in FASB ASC 605, *Revenue Recognition*, and most industry-specific revenue recognition guidance throughout the Industry Topics of the FASB ASC, including FASB ASC 958. However, the guidance for contributions

received by nonprofit organizations will remain in FASB ASC 958-605, which will be re-titled, *Not-for-Profit Entities—Revenue Recognition—Contributions*.

A creditor must also determine whether the debtor is experiencing financial difficulties when evaluating whether a troubled debt restructuring has occurred. The following factors may indicate financial difficulty: (FASB ASC 310-40-15-20)

- The debtor is currently in default on any of its debt.
- The debtor is not currently in default, but it is probable that default would occur on any debt in the foreseeable future without the modification.
- Bankruptcy has been declared or the debtor is in the process of declaring bankruptcy.
- Substantial doubt exists about whether the debtor will continue to be a going concern.
- The creditor forecasts that debtor cash flows will be insufficient to service the contractual terms of its debt for the foreseeable future.
- The debtor cannot obtain financing from new sources at an effective interest rate equal to current market interest rates for similar debt for a non-troubled debtor.

A debt restructuring is not necessarily a troubled debt restructuring merely because the debtor is in financial difficulty, however. For example, the following situations do not involve a troubled debt restructuring: (FASB ASC 470-60-15-12)

- The fair value of the assets or equity interest accepted by the creditor in full satisfaction of its receivable is at least equal to (a) the creditor's recorded investment in the receivable or (b) the debtor's carrying amount of the payable.
- The creditor reduces the interest rate to reflect decreases in market rates.
- The debtor issues new marketable debt at current market rates in exchange for the old debt. (The fact that the debtor can obtain new financing at market rates indicates that the restructuring is not troubled.)

Debtors and creditors should individually apply the guidance for troubled debt restructurings to their specific facts and circumstances to determine whether a troubled debt restructuring has occurred. It is possible for a debtor to have a troubled debt restructuring while the related creditor does not. (FASB ASC 470-60-15-3)

Accounting for a troubled debt restructuring depends on its type, which generally is one of the following:

a. Transfer of assets in full settlement

b. Grant of an equity interest in full settlement

c. Modification of debt terms

d. Combination of the above types

The following paragraphs discuss how creditors and debtors should account for each type of restructuring.

Transfers of Assets in Full Settlement

When assets are transferred in full settlement of debt, the debtor generally should recognize two gains (or a gain and a loss) as follows: (FASB ASC 470-60-35-2 and 35-3)

a. A gain on the restructuring should be recognized equal to the difference between the fair value of the assets given up and the carrying amount of the debt. The gain should be included in the current period statement of activities and accounted for as a gain on extinguishment of debt.

b. A gain or loss on transfer of assets should be recognized equal to the difference between the fair value and carrying amount of the assets given up. The gain or loss should be included in the change in net assets in the period the transfer occurs.

The creditor should record the restructuring by (a) recording the assets received at their fair values and (b) recognizing a loss for the difference between the recorded investment in the receivable and the fair values of the assets received. The loss should be recognized in the current period change in net assets to the extent it is not offset by an allowance for uncollectible accounts. (FASB ASC 310-40-40-2 and 40-3)

To illustrate, assume the following:

- A debtor owes a creditor $100,000, including interest.
- The carrying amount of the creditor's receivable is $85,000 since it previously recorded a $15,000 allowance for expected losses on the receivable.
- The creditor accepts real estate with a fair value of $80,000 and carried on the debtor's books at $90,000 in full settlement of its receivable.

The debtor would recognize the following on settlement of the debt:

Gain on extinguishment of debt:	
Carrying amount of the debt	$ 100,000
Fair value of assets given up	80,000
	$ 20,000
Loss on transfer of assets:	
Fair value of assets given up	$ 80,000
Carrying amount of the assets given up	90,000
	$ (10,000)

The creditor would record the real estate received at $80,000 and recognize a $20,000 loss on the restructuring ($100,000 recorded investment in the receivable $80,000 fair value of real estate received). The loss would be recorded by reducing the $15,000 loss allowance to zero and including the remaining loss ($5,000) in the current period change in net assets.

Receipt of Equity Interest in Full Settlement

A nonprofit organization creditor should record the receipt of an equity interest in a debtor for-profit entity as it would record the receipt of any asset. That is, it should record the investment at its fair value and recognize a loss equal to the difference between the fair value of the equity interest and the recorded investment in the receivable. (FASB ASC 310-40-40-2 and 40-3)

To illustrate accounting for a debt restructuring that involves the granting of an equity interest, assume that a for-profit debtor settles a $15,000 debt by issuing 1,000 shares of its $10 par value stock. If the fair value of the stock is $13,000, the nonprofit organization creditor would record an investment of $13,000 for the fair value of the equity interest it received and recognize a $2,000 loss on the transaction ($15,000 recorded investment in the receivable $13,000 fair value of the equity interest received).

Modification of Terms

A troubled debt restructuring may involve the modification of debt terms rather than the transfer of assets. In such cases, the debtor generally should account for the restructuring as follows: (FASB ASC 470-60-35-5 through 35-7)

a. The restructuring should be accounted for prospectively. The carrying amount of the debt should not be changed unless it exceeds the future cash payments specified by the new debt terms. (See item c.) Future

cash payments include all payments of principal and interest, including any accrued interest at the time of restructuring that will be paid under the new debt terms. Estimates of future cash payments should assume that all indeterminate or contingent payments will be paid and the debt will be outstanding for the maximum number of periods possible under the new debt terms.

b. Interest expense should be determined by applying a constant effective interest rate to the outstanding debt. The effective interest rate is the discount rate at which the present value of future cash payments is equal to the carrying amount of the debt. (That method of computing interest expense is commonly referred to as the interest method.)

c. If the total future cash payments specified by the new debt terms (including indeterminate or contingent payments) are less than the carrying amount of the debt, the debtor should (1) reduce the carrying amount of the debt to an amount equal to the total future cash payments and (2) recognize the reduction as a gain. Thereafter, all payments made should be accounted for as a reduction of the carrying amount of the debt, and no interest expense should be recorded.

   Future interest payments may be expected to fluctuate (for example, because they are tied to the prime interest rate). In such cases, estimates of future payments should be based on the interest rate in effect at the time of restructuring. Subsequent changes in interest payments should be accounted for as a change in accounting estimate. If subsequent declines in interest rates result in expected future cash flows that are less than the carrying amount of the debt, no gain should be immediately recognized, however. (To do so might result in the premature recognition of a gain since the gain might be offset by future increases in interest payments.) Instead, actual cash payments should reduce the carrying amount of the debt, and any carrying amount remaining after the debt has been satisfied should be recognized as a gain. (FASB ASC 470-60-35-11)

A nonprofit organization creditor should account for a troubled debt restructuring that involves the modification of debt terms as it would an impaired loan. (FASB ASC 310-40-35-10) That is, it generally should—

a. measure the loan based on the present value of expected future cash flows specified by the new contractual terms at the loan's effective interest rate (or, if more practical, the loan's market price or the fair value of the collateral) and

b. record a loss and allowance for loan losses equal to the difference between the carrying amount of the loan and its measured amount.

Lesson 7 provides further guidance on a creditor's accounting for impaired loans.

To illustrate, assume that a debtor owes $15,400 of principal and interest to a creditor. As a result of a troubled debt restructuring, the debt's terms were modified so that the future cash payments of principal and interest will be $13,000. At the time of the restructuring, the present value of the future cash payments was $12,000. The debtor and creditor should account for the restructuring as follows:

a. Since the total future cash payments are less than the carrying amount of the debt, the debtor should reduce the debt's carrying amount to $13,000 and recognize a gain of $2,400 ($15,400 $13,000) on the restructuring. Thereafter, the debtor should record all payments as a reduction of the debt's carrying amount. No portion of the payments should be recorded as interest expense.

b. The creditor should record an allowance for loan losses of $3,400 ($15,400 $12,000).

Combination of Types

A restructuring may involve a combination of asset transfers and the modification of debt terms. In such cases, the debtor should (a) reduce the carrying amount of the debt by the fair value of the assets transferred, (b) recognize a gain or loss equal to the difference between the carrying amount of the assets transferred and their fair values, and (c) account for the remainder of the restructuring as a modification of debt terms as discussed in the "Modification of Terms" paragraph above. (FASB ASC 470-60-35-8) Similarly, the creditor nonprofit organization

should reduce its recorded investment in the receivable by the fair value of the assets or equity interest received and account for the remainder of the restructuring as a modification of debt terms as discussed in FASB ASC 310-40-35-10 and outlined above. (FASB ASC 310-40-35-7)

Related Issues

Restructuring Costs. A debtor should record legal fees and other direct costs it incurs as a reduction in the gain on restructuring or as expense for the period if no gain on restructuring is realized. (FASB ASC 470-60-35-12)

A creditor should expense legal fees and other direct costs related to a restructuring as they are incurred. (FASB ASC 310-40-25-1)

Contingently Payable Amounts. Amounts contingently payable in future periods should be accounted for similarly to other contingencies. That is, they should be accrued and recorded as interest expense when they are reasonably estimable and it is probable that they must be paid. When a liability for contingent payments is accrued, contingent amounts that were included in estimated future cash payments at the time of the restructuring should be deducted from the carrying amount of the debt to the extent they prevented recognizing a gain at that time. (FASB ASC 470-60-35-10)

For example, assume a debtor owes $100,000 of principal and interest and enters into a troubled debt restructuring agreement to extend the debt's repayment period. As part of the restructuring agreement, the debtor agrees to make future cash payments of $90,000 and, if certain conditions are met, additional payments of $15,000. As discussed in the "Modification of Terms"paragraph, the carrying amount of the debt should not be changed since it is less than the expected future cash payments including contingent payments. When it becomes probable that the $15,000 contingent payments must be made, the debtor should accrue the additional payments by—

a. reducing the carrying amount of the debt by $10,000 (i.e., the portion of the contingent payments that prevented a gain on restructuring from being recorded);

b. accruing a $15,000 liability for the additional payments; and

c. recognizing interest expense of $5,000 (i.e., the portion of the contingent payments that did not prevent a gain on restructuring from being recorded).

Accounting by creditors for amounts contingently receivable is discussed in Lesson 7.

INSURANCE-RELATED ASSESSMENTS

Insurance and noninsurance entities may be subject to guaranty-fund or other insurance-related assessments, mandated by statute or regulatory authority, that relate directly or indirectly to underwriting activities. A state guaranty fund may assess entities licensed to sell insurance for costs related to insolvent insurance entities. Assessments might also occur for noninsurance entities that self-insure against loss or liability. The primary methods of guaranty-fund or other insurance-related assessment are as follows: (FASB ASC 405-30-05-1 through 05-6; 405-30-15-1 and 15-2)

- Retrospective-premium-based.
- Prospective-premium-based.
- Prefunded-premium-based.
- Other premium-based.
- Loss-based.
- Flat fee (administrative-type).

Recognizing Insurance-related Assessments

A liability for insurance-related assessments should be recognized when the following conditions are met: (FASB ASC 405-30-25-1)

a. An assessment has been made or information available before the financial statements are issued or available to be issued indicates it is probable that an assessment will be made.

b. An event that obligates the entity to pay the assessment has occurred on or before the date of the financial statements.

c. The assessment can be reasonably estimated.

Retrospective-premium-based Guaranty Fund Assessments. Assessments by guaranty funds may be based on premiums written or received in one or more years before the insolvency of another insurance entity. If the amount can be reasonably estimated, a liability should be recognized for the entire amount of future assessments related to an insolvency when a formal determination of insolvency is made. (FASB ASC 405-30-05-3; 405-30-25-6)

Prospective-premium-based Guaranty Fund Assessments. Assessments might be made based on premiums written by an entity in one or more years after an insolvency. When law or regulatory practice stipulates that payment of an assessment cannot be avoided, a liability should be recognized for the entire amount of future assessments that cannot be avoided when a formal determination of insolvency occurs (assuming the amount can be reasonably estimated). When there is no such law or regulatory practice, a liability should be recognized when the premiums on which assessments will be based are written or obligated to be written (assuming the amount can be reasonably estimated). (FASB ASC 405-30-05-3; 405-30-25-6)

Prefunded-premium-based Guaranty Fund Assessments and Other Premium-based Assessments. An assessment might be imposed before any particular insolvency occurs based on the current level of written premiums. If the amount can be reasonably estimated, a liability for the assessments should be recognized as the related premiums are written. (FASB ASC 405-30-05-3; 405-30-25-6)

Loss-based Assessments. For assessments based on incurred or paid losses, a liability should be recognized as the related losses are incurred. (FASB ASC 405-30-25-6)

Administrative-type Assessments. Administrative-type assessments, which are ordinarily a flat fee per entity regardless of the existence of an insolvency, are generally expensed in the period assessed. (FASB ASC 405-30-25-7)

Estimating Liabilities

There is no requirement to be able to compute the exact amount of an assessment or to be formally notified of an assessment to make a reasonable estimate of the liability. The best available information about market share or premiums by state and premiums by line of business should be used when estimating future assessments for insurance entities. (FASB ASC 405-30-30-2 and 30-3)

For noninsurance entities: (FASB ASC 405-30-30-4 and 30-6)

a. If the assessments are based on premiums, it may be necessary to consider the premiums the self-insurer would have paid if it had insured the liability with an insurer.

b. If the assessments are based on losses, the losses incurred should be considered when determining the liability. Estimates of loss-based assessments should be consistent with estimates of underlying incurred losses, based on enacted laws and regulations and expected assessment rates.

The range of an assessment liability may need to be reevaluated during the assessment process due to uncertainties. The recorded liability should represent the best estimate within a range of estimates. If there is no best estimate, the recorded liability should be the minimum amount in the range. (FASB ASC 405-30-30-8)

Premium Tax Offsets and Policy Surcharges

An asset should be recognized when it is probable that a paid or accrued assessment will be recovered through a premium tax offset or policy surcharge. A valuation allowance should be provided for any portion of the asset that subsequently becomes less than probable of realization. (FASB ASC 405-30-25-8; 405-30-35-1)

JOINT AND SEVERAL LIABILITY ARRANGEMENTS

Typically, a joint and several liability arrangement allows a claimant to pursue an obligation against any of the parties subject to the arrangement. Such obligations may include debt arrangements, other contractual obligations, settled litigation and judicial rulings. The recognition and measurement guidance in this section only applies, however, to joint and several liability arrangements where the total amount of the obligation is fixed at the reporting date. In other words, there can be no uncertainty in the measurement of the total amount of the obligation. Also, the guidance does not apply to the following: (FASB ASC 405-40-15-1)

- Asset retirement and environmental obligations
- Contingencies
- Guarantees
- Income taxes
- Retirement benefits

An obligation from a joint and several liability arrangement might be recognized at the inception of an arrangement; for example, in a debt arrangement where the amount is fixed at inception. In other situations, an obligation might be recognized after an arrangement's inception; for example, at the date the obligation becomes fixed. An organization should measure its obligation under a joint and several liability arrangement, both initially and in subsequent reporting periods, as the sum of the following: (FASB ASC 405-40-25-1; 405-40-30-1; 405-40-35-1)

a. The amount the organization agreed to pay under the arrangement among its co-obligors.

b. Any additional amount the organization expects to pay on behalf of its co-obligors. (If the expected amount falls within a range, the best estimate should be used. If no amount in the range is better than others, the minimum amount should be used.)

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

6. Which of the following statements most accurately describes GAAP for debt?

   a. Once a liability is classified as current, it cannot be reclassified as noncurrent.

   b. If a lender participates in mortgage loans, the borrower records its fair value the date the loan is paid.

   c. Product financing arrangements are accounted for like borrowings, not like sales.

   d. Noncurrent obligations cannot be callable by the creditor after a specific grace period.

7. What is the common characteristic exhibited by all product financing arrangements?

   a. The sponsor agrees to purchase inventory at specified prices over specified periods or guarantees the sale to third parties.

   b. The financing company is a nonbusiness organization, an existing trust, or was established to provide the financing arrangement.

   c. The majority of the product or inventory will be sold directly to third parties rather than used or sold by the sponsor.

   d. The associated products or inventory are stored on the premises of the financing company.

8. When determining whether a troubled debt restructuring has occurred, which of the following factors might indicate an entity is undergoing financial difficulty?

   a. They debtor will be able to continue as a going concern for at least one year.

   b. The creditor believes that the debtor's cash flows will be able to service its debt.

   c. The debtor obtains new financing at current market interest rates.

   d. It is probable that the debtor will default on debt in the foreseeable future.

9. Assuming all other conditions are met, when would an organization recognize a liability for insurance-related assessments?

   a. The amount of the assessment is unclear.

   b. It is possible that an assessment will be made.

   c. The inciting event occurred before the financial statement date.

   d. The assessment must be made by guaranty funds.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

6. Which of the following statements most accurately describes GAAP for debt? **(Page 119)**

   a. Once a liability is classified as current, it cannot be reclassified as noncurrent. [This answer is incorrect. A current liability that is expected to be refinanced on a long-term basis may be classified as noncurrent if the debtor intends to refinance the liability on a long-term basis and has demonstrated the ability to do so.]

   b. If a lender participates in mortgage loans, the borrower records its fair value the date the loan is paid. [This answer is incorrect. If a loan agreement allows the lender to participate in the appreciation of mortgaged real estate, the borrower should record a liability for the fair value of the participation feature at the origination of the loan.]

   c. Product financing arrangements are accounted for like borrowings, not like sales. [This answer is correct. Under GAAP, a product financing arrangement should be accounted for as a borrowing rather than a sale.]

   d. Noncurrent obligations cannot be callable by the creditor after a specific grace period. [This answer is incorrect. Noncurrent obligations that are callable by the creditor because (1) the debtor is in violation of a provision of the debt agreement at the statement of financial position date or (2) a violation has occurred at the statement of financial position date that, if not cured within a specified grace period, will make the obligation callable.]

7. What is the common characteristic exhibited by all product financing arrangements? **(Page 123)**

   a. The sponsor agrees to purchase inventory at specified prices over specified periods or guarantees the sale to third parties. [This answer is correct. As discussed in FASB ASC 470-40-05-3, all product financing arrangements exhibit a common characteristic—the sponsor agrees to purchase the inventory (or processed goods of which the inventory is a component) at specified prices over specified periods or guarantees the inventory's sale to third parties.]

   b. The financing company is a nonbusiness organization, an existing trust, or was established to provide the financing arrangement. [This answer is incorrect. According to FASB ASC 470-40-05-4, this may be true of some product financing arrangements, but it is not necessarily true of all of them.]

   c. The majority of the product or inventory will be sold directly to third parties rather than used or sold by the sponsor. [This answer is incorrect. As described in FASB ASC 470-40-05-4, in some product financing arrangements, the majority of the product will be used or sold by the sponsor rather than sold directly to third parties.]

   d. The associated products or inventory are stored on the premises of the financing company. [This answer is incorrect. In many product financing arrangements, the products are stored on the sponsor's premises, per FASB ASC 470-40-05-4.]

8. When determining whether a troubled debt restructuring has occurred, which of the following factors might indicate an entity is undergoing financial difficulty? **(Page 126)**

   a. They debtor will be able to continue as a going concern for at least one year. [This answer is incorrect. An indication of financial difficulty is when *substantial doubt* exists over the debtor's ability to continue to be a going concern.]

   b. The creditor believes that the debtor's cash flows will be able to service its debt. [This answer is incorrect. Financial difficulty is indicated if the creditor forecasts that debtor cash flows will be *insufficient* to service the contractual terms of its debt for the foreseeable future.]

c. The debtor obtains new financing at current market interest rates. [This answer is incorrect. Financial difficulty is indicated if the debtor *cannot* obtain financing from new sources at an effective interest rate equal to current market interest rates for similar debt for a non-troubled debtor.]

d. It is probable that the debtor will default on debt in the foreseeable future. [This answer is correct. As described in FASB ASC 310-40-15-20, financial difficulty may be indicated if, though the debtor is not currently in default, it is probable that default would occur on any debt in the foreseeable future without the modification.]

9. Assuming all other conditions are met, when would an organization recognize a liability for insurance-related assessments? **(Page 130)**

a. The amount of the assessment is unclear. [This answer is incorrect. Per FASB ASC 405-30-25-1, for the liability to be recognized, the assessment amount must be able to be reasonably estimated.]

b. It is possible that an assessment will be made. [This answer is incorrect. As described in FASB ASC 405-30-25-1, to be recognized, the assessment must have been made or information available before the financial statements are issued or available to be issued that indicates it is probable that an assessment will be made.]

c. The inciting event occurred before the financial statement date. [This answer is correct. If an event that obligates the entity to pay the assessment has occurred on or before the date of the financial statements, FASB ASC 405-30-25-1 states that a liability for insurance-related assessments should be recognized.]

d. The assessment must be made by guaranty funds. [This answer is incorrect. Assessments by guaranty funds may be based on premiums written or received in one or more years before the insolvency of another insurance entity. However, this type of fund is not one of the conditions that must be met under FASB ASC 405-30-25-1 for a liability to be recognized.]

DISCLOSURE REQUIREMENTS

LONG-TERM OBLIGATIONS—GENERAL

When a classified statement of financial position is presented, current liabilities should include amounts of long-term obligations that will mature within 12 months and other short-term debts (FASB ASC 210-10-45-9)

The notes to the financial statements should include the following disclosures:

- The combined amount of maturities and sinking fund requirements for all long-term borrowings for each of the five years following the latest statement of financial position presented. (FASB ASC 470-10-50-1)

- Unused letters of credit, assets pledged as security for loans, and commitments (such as those for plant acquisition, an obligation to reduce debts, or an obligation to maintain working capital). (FASB ASC 440-10-50-1 and 860-30-50-1A)

- If a debtor is in violation of a provision of a debt agreement at the statement of financial position date but classifies the obligation as noncurrent because the creditor waived its right to demand payment or it is probable that the violation will be cured within the specified grace period, a description of the circumstances (FASB ASC 470-10)

OBLIGATIONS EXPECTED TO BE REFINANCED

If a short-term obligation is classified as a noncurrent liability because it will be refinanced on a long-term basis (see the discussion earlier in this lesson), the notes to the financial statements should contain a general description of the financing agreement and the terms of any new obligation incurred or expected to be incurred as a result of the refinancing. (FASB ASC 470-10-50-4)

CALLABLE OBLIGATIONS

For long-term debt with a subjective acceleration clause, if the likelihood of acceleration is other than remote and the debt has not been reclassified as current, the existence of the clause should be disclosed. (FASB ASC 470-10-45-2)

PARTICIPATING MORTGAGE LOANS

Participating mortgage loan borrowers should disclose the following: (FASB ASC 470-30-50-1)

a. The total amount of participating mortgage loan obligations, with separate disclosure of the total participation liabilities and related debt discounts

b. Terms of the lender's participation in either the appreciation of the mortgage property's fair value or the mortgage property's results of operations, or both

PRODUCT FINANCING ARRANGEMENTS

There are no disclosure requirements unique to product financing arrangements. Consequently, the disclosure requirements for product financing arrangements are the same as for other long-term obligations. Those disclosures were discussed above.

MODIFICATIONS AND EXTINGUISHMENTS

If debt was extinguished prior to December 31, 1996, through an in-substance defeasance under the provisions of previous guidance, a general description of the transaction and the amount of debt that is considered extinguished at the end of each period that the debt remains outstanding should be disclosed. (FASB ASC 470-50-50-1)

TROUBLED DEBT RESTRUCTURINGS

Debtors should disclose the following information about troubled debt restructurings that occur during the period: (FASB ASC 470-60-50-1)

a. Description of the principal changes in terms, major features of settlement, or both for each restructuring (Separate restructurings within a fiscal period for the same categories of payable may be grouped.)

b. Aggregate gain on restructuring of payables

c. Aggregate net gain or loss on transfers of assets

For periods after a troubled debt restructuring, debtors also should disclose the extent to which contingently payable amounts are included in the carrying amount of the restructured debt. In addition, if it is at least reasonably possible that contingent amounts will be required to be paid, the total contingently payable amounts and the conditions under which they would become payable or would be forgiven should be disclosed. (FASB ASC 470-60-50-2)

A creditor should disclose the amount of any commitment to lend additional funds to a debtor owing a receivable whose terms have been modified in a troubled debt restructuring. (FASB ASC 310-40-50-1) Additional disclosures about impaired loans also may be required. Those disclosures are discussed in Lesson 7.

For each period for which a statement of activities is presented, the following information should be disclosed about troubled debt restructurings of financing receivables: [This disclosure does not apply to receivables measured at fair value with changes in fair value reported in the change in net assets; receivables measured at lower of cost or fair value; trade accounts receivable (except for credit card receivables) with a contractual maturity of one year or less that arose from the sale of goods or services; participant loans in defined contribution pension plans; or loans acquired with deteriorated credit quality that are accounted for within a pool.] (FASB ASC 310-10-50-31 through 50-34)

a. For restructurings that occurred during the period—

   (1) By class of financing receivable, qualitative and quantitative information about how the financing receivables were modified and the financial effects of the modifications

   (2) By portfolio segment, qualitative information about how such modifications are factored into the determination of the allowance for credit losses

b. For financing receivables modified as troubled debt restructurings within the previous 12 months and for which there was a payment default during the period—

   (1) By class of financing receivable, qualitative and quantitative information about those defaulted financing receivables, including the types and amount of financing receivables that defaulted.

   (2) By portfolio segment, qualitative information about how such defaults are factored into the determination of the allowance for credit losses.

INSURANCE-RELATED ASSESSMENTS

For insurance-related assessments, the following should be disclosed: (FASB ASC 405-30-50-1)

a. If the amounts have been discounted:

   (1) Undiscounted amounts of the liability.

   (2) Any related assets for premium tax offsets or policy surcharges.

   (3) Discount rate used.

b. If the amounts have not been discounted:

   (1) Amounts of the liability.

   (2) Any related assets for premium offsets or policy surcharges.

   (3) Periods over which the assessments are expected to be paid.

   (4) Period over which the recorded premium tax offsets or policy surcharges are expected to be realized.

JOINT AND SEVERAL LIABILITY ARRANGEMENTS

The following should be disclosed about each obligation (or group of similar obligations) from a joint and several liability arrangement if the total amount of the obligation is fixed at the reporting date. These disclosures are in addition to the organization's disclosures about related parties. (FASB ASC 405-40-50-1 and 50-2)

a. The nature of the arrangement, including how the liability was created, the relationship with other co-obligors, and the arrangement's terms and conditions.

b. The total amount outstanding under the arrangement. (This amount should not be reduced by the effect of any amounts potentially recoverable from other entities.)

c. The carrying amounts of any liability and recognized receivable.

d. The nature of recourse provisions, if any, that would allow for recovery from other entities of amounts paid, as well as any limitations on the amounts that could be recovered.

e. In the period of initial recognition and measurement of the liability or in a period in which the measurement changes significantly:

   (1) the corresponding entry, and

   (2) the location where the entry was recorded in the financial statements.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

10. Which of the following statements best describes a general disclosure requirement for an organization's long-term obligations?

    a. Sinking fund requirements for all long-term borrowings for the next five years.

    b. A general description of any financing agreements and the terms of any new obligation.

    c. The aggregate gain on the restructuring of payables and aggregate net gain or loss on transfers of assets.

    d. The organization's relationship with other co-obligors, along with related terms and conditions.

11. Disclosure of which of the following is necessary when the amounts of an insurance-related assessment have been discounted?

    a. The amounts of the liability.

    b. The discount rate that was used.

    c. Periods during which assessments will be paid.

    d. Related assets for premium tax offsets or policy surcharges.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

10. Which of the following statements best describes a general disclosure requirement for an organization's long-term obligations? **(Page 136)**

    a. Sinking fund requirements for all long-term borrowings for the next five years. [This answer is correct. Per FASB ASC 470-10-50-1, the notes to an organization's financial statements should include the combined amount of maturities and sinking fund requirements for all long-term borrowings for each of the five years following the latest statement of financial position presented.]

    b. A general description of any financing agreements and the terms of any new obligation. [This answer is incorrect. Per FASB ASC 470-10-50-4, if a short-term obligation is classified as a noncurrent liability because it will be refinanced on a long-term basis, the notes to the financial statements should contain a general description of the financing agreement and the terms of any new obligation incurred or expected to be incurred as a result of the refinancing. However, this is specific to such refinancings, and not related to general long-term debt.]

    c. The aggregate gain on the restructuring of payables and aggregate net gain or loss on transfers of assets. [This answer is incorrect. As discussed in FASB 470-60-50-1, these two disclosures are required for troubled debt restructurings. They are not related to general long-term debt.]

    d. The organization's relationship with other co-obligors, along with related terms and conditions. [This answer is incorrect. Per FASB ASC 405-40-50-1 and 50-2, this disclosure is required specifically when an organization has joint and several liability arrangements. It is not related to general long-term debt.]

11. Disclosure of which of the following is necessary when the amounts of an insurance-related assessment have been discounted? **(Page 137)**

    a. The amounts of the liability. [This answer is incorrect. Per FASB ASC 405-30-50-1, this would be disclosed if amounts have *not* been discounted. Undiscounted amounts would need to be disclosed if the amounts were discounted.]

    b. The discount rate that was used. [This answer is correct. Following the guidance in FASB ASC 405-30-50-1, if the amounts are discounted, one of the required disclosures is the discount rate used. Other disclosures are also required under these circumstances.]

    c. Periods during which assessments will be paid. [This answer is incorrect. As discussed in FASB ASC 405-30-50-1, if the amounts have *not* been discounted, the periods over which the assessments are expected to be paid must be disclosed.]

    d. Related assets for premium tax offsets or policy surcharges. [This answer is incorrect. When the guidance in FASB ASC 405-30-50-1 is followed, such assets are disclosed whether or not the amounts are discounted.]

Lesson 4: Derivatives and Hedging

INTRODUCTION

SOURCE: FASB ASC 815

A nonprofit organization should measure all derivative financial instruments (including certain derivatives embedded in other contracts) at fair value and record them as either assets or liabilities in the statement of financial position. An organization should recognize the gain or loss on a hedging instrument or any nonhedging derivative instrument as a change in net assets in the period of change.

A nonprofit organization may designate a derivative as a fair value hedge or a foreign currency hedge. If the derivative instrument is designated as a hedge of a net investment in a foreign operation, the guidance in FASB ASC 830, *Foreign Currency Matters*, should be followed. Any change in the carrying amount of a hedged item in a fair value hedge should be reported as a change in net assets.

To use hedge accounting, the derivative must be designated as a hedge at the inception of the contract. In addition, the organization must document the risk being hedged and the reason for undertaking the hedge, including the hedging instrument, the hedged item, and how the hedging instrument's effectiveness in offsetting exposure to changes in fair value attributable to the hedged risk will be assessed. Nonderivative instruments may be designated as a hedge only against the change in fair value of a firm commitment attributed to foreign currency exchange rates or against an organization's net investment in foreign operations.

Learning Objectives:

Completion of this lesson will enable you to:
- Identify the GAAP accounting and disclosure requirements that nonprofit organizations must uphold in relation to derivatives and hedging.

ACCOUNTING REQUIREMENTS

All derivative financial instruments should be measured at fair value and reported in the statement of financial position as assets or liabilities. Nonprofit organizations should recognize the gain or loss on a derivative instrument as a change in net assets in the period of change. (FASB ASC 815-10-35-3; 815-25-35-19)

A nonprofit organization may designate a derivative as a hedge against a particular risk. Specifically, it may designate it as a—

- *Fair value hedge*, which hedges the organization's exposure to changes in fair value of a recognized asset or liability or an unrecognized firm commitment.

- *Foreign currency hedge*, which hedges the organization's exposure from a net investment in a foreign operation.

Fair value hedges and foreign currency hedges are discussed later in this lesson. (FASB ASC 815-10-35-3; 815-25-35-19)

WHAT ARE DERIVATIVES?

A derivative is a financial instrument or other contract with all three of the following characteristics (FASB ASC 815-10-15-83):

a. *It Has at Least One Underlying and at Least One Notional Amount or Payment Provision or Both.* An *underlying* is a specified interest rate, security price, commodity price, foreign exchange rate or rate index, or other variable (including the occurrence or nonoccurrence of a specified event, such as a scheduled

payment under a contract). A *notional amount* is a number of currency units, shares, bushels, pounds, or other units specified in the contract. A *payment provision* specifies a fixed or determinable settlement to be made if the underlying performs in a specified manner. An underlying, along with either a notional amount or a payment provision, determines the settlement of a derivative and, in some cases, whether or not a settlement is required. Therefore, a derivative instrument must have at least one underlying and at least one notional amount or payment provision (or both). (FASB ASC 815-10-20; 815-10-15-88; 815-10-15-92 and 15-93)

b. *It Requires No Initial Net Investment or an Initial Net Investment Less Than That Required for Other Types of Contracts Expected to Respond Similarly to Changes in Market Factors.* Derivative instruments either require no initial net investment or an initial net investment less than other types of contracts that respond similarly to changes in market factors. For example, entering into a commodity futures contract generally does not require an initial net investment. Swap or forward contracts also generally require no initial net investment unless the terms favor one party over the other. However, options generally require the party that has rights under the contract to make an initial net investment (a premium). (FASB ASC 815-10-15-94 and 15-95)

c. *Its Terms Require or Allow Net Settlement, It Can Readily Be Settled Net by a Method outside the Contract, or It Provides for Delivery of an Asset That Puts the Recipient in a Position Similar to Net Settlement.* A contract satisfies the net settlement requirement if its settlement provisions meet one of the following three criteria: (FASB ASC 815-10-15-99 and ; 815-10-15-100815-10-15-110; 815-10-15-119 and 15-120)

   (1) Neither party is required to deliver an asset associated with the underlying and that has a principal amount, stated amount, number of shares, face value, or other denomination equal to the notional amount (or equal to the notional amount plus or minus a premium or a discount). For example, the two parties in an interest rate swap do not exchange principal.

   (2) One of the parties must deliver an asset in a denomination equal to the notional amount, but a market mechanism facilitates net settlement. For example, a party to a forward contract to buy units of foreign currency has a mechanism to immediately sell the units bought under the forward, so that it only has a net receipt or payment.

   (3) One of the parties must deliver an asset in a denomination equal to the notional amount, but that asset is readily convertible to cash or is itself a derivative. For example, a swaption (which is an option to enter into a swap contract) is a derivative.

Contracts Not Subject to the Guidance in This Lesson

The following types of contracts are not subject to the requirements discussed in this lesson even though, depending on the facts and circumstances, they otherwise might be considered derivatives: (FASB ASC 815-10-15-13)

a. *"Regular-way" Security Trades.* Contracts providing for delivery of a security that is readily convertible to cash within customary time frames established by marketplace regulations are not subject to the guidance in this lesson provided there is no net settlement provision or market mechanism to facilitate net settlement (unless the contract is required to be accounted for on a trade-date basis). (FASB ASC 815-10-15-15 through 15-17)

b. *Normal Purchases and Sales.* Contracts for the purchase or sale of something (other than financial or derivative instruments) that will be delivered in quantities expected to be used or sold over a reasonable period in the normal course of business are not subject to the guidance in this lesson. For example, an agreement for a cooperative to sell grain is considered a normal sale if the contract's terms are consistent with the terms of the cooperative's normal sales.

   Forward contracts that contain net settlement provisions also are not subject to the guidance in this lesson if it is likely that they will result in the physical delivery of assets and will not settle net. For example, the guidance does not apply to a contract that results in gross delivery of a commodity under a commodity

contract. The guidance in this lesson does, however, apply to a contract that requires cash settlements of gains or losses or otherwise periodically settles gains or losses. The reason is those settlements are *net* settlements. The entity should document, either by individual contract or for groups of similarly designated contracts, the basis for determining that the contract will not settle net and will result in physical delivery. (FASB ASC 815-10-15-22; 815-10-15-35 through 15-38; 815-10-15-41)

c. *Certain Insurance Contracts.* Insurance policies that reimburse the holder only for losses incurred as a result of identifiable insured events (such as traditional life insurance and property and casualty insurance policies) are not subject to the guidance in this lesson. However, some insurance policies may include investment features that are embedded derivatives. (FASB ASC 815-10-15-52 through 15-54) (See the discussion of embedded derivatives below.)

d. *Certain Financial Guarantee Contracts.* Contracts that only reimburse the guaranteed party for a loss if the debtor fails to satisfy its required payment obligations are not subject to the guidance in this lesson. However, contracts that provide for payment in response to changes in an underlying (such as a decrease in a specific debtor's creditworthiness) are derivatives subject to the guidance in this lesson. For example, a contract that requires the guarantor to make a payment if the debtor's financial condition falls below a prescribed level is subject to the guidance in this lesson. (FASB ASC 815-10-15-58)

e. *Certain Contracts That Are Not Traded on an Exchange.* Contracts that are not traded on an exchange are not subject to the guidance in this lesson if the underlying on which settlement is based is any of the following: (FASB ASC 815-10-15-59)

   (1) a climatic, geological, or other physical variable (such as a forward contract for a distributor to buy fuel oil if the total of average daily low temperatures for a month is below a specified amount),

   (2) the price or value of a nonfinancial asset that is not readily convertible to cash (such as an option based on the fair value of a tract of undeveloped land) or the fair value of a nonfinancial liability that does not require delivery of an asset that is readily convertible to cash (such as an option that requires payment if the amount of outstanding service warranty claims exceeds a specified amount), or

   (3) specified volumes of sales or service revenues (such as an operating lease that requires rents contingent upon the lessee having prescribed levels of sales from the leased asset).

f. *Derivatives That Prevent Sales Accounting.* Derivative instruments that prevent one party from recognizing a related contract as a sale or the counterparty from recognizing a purchase are not subject to the guidance in this lesson. For example, a call option that enables the transferor of financial assets to repurchase those assets prevents sales accounting. (FASB ASC 815-10-15-63)

g. *Investments in Life Insurance.* A policyholder's investment in a life insurance contract accounted for under FASB ASC 325-30, *Investments—Other—Investments in Insurance Contracts*, is not subject to the guidance in this lesson. This exclusion does not apply to the issuer of the life insurance contract, however. (FASB ASC 815-10-15-67)

h. *Certain Investment Contracts.* Investment contracts of defined benefit pension plans accounted for under FASB ASC 960-325-35-1 or 960-325-35-3 are not subject to the guidance in this lesson. This exclusion applies only to the party accounting for the contract under those standards, however. (FASB ASC 815-10-15-68)

i. *Loan Commitments.* Potential borrowers that hold commitments to originate loans, and issuers of commitments to originate loans (other than mortgage loans held for sale), are not subject to the guidance in this lesson. (FASB ASC 815-10-15-69 and 15-71)

j. *Registration payment arrangements.* Contingent obligations to make future payments or otherwise transfer consideration under a registration payment arrangement, whether issued as a separate agreement or included as a provision of a financial instrument or other agreement, should be separately recognized and measured in accordance with FASB ASC 450-20, *Contingencies—Loss Contingencies*. (FASB ASC 815-10-15-82)

In addition to the contracts listed above, contracts to enter into an acquisition by a nonprofit organization or a merger of nonprofit organizations should not be considered derivative instruments. (FASB ASC 815-10-15-74 and 15-75)

Embedded Derivatives

Certain contracts (such as bonds, insurance policies, and leases) that do not meet the definition of a derivative provided previously may contain embedded derivative instruments. *Embedded derivatives* affect the cash flow or value of other exchanges required by the contract in a manner similar to a derivative instrument. (FASB ASC 815-15-20)

Generally, an embedded derivative is accounted for separately if *all* of the following criteria are met: (FASB ASC 815-15-25-1)

a. The economic characteristics and risks of the embedded derivative are not clearly and closely related to the host contract,

b. GAAP does not require the contract (the hybrid instrument) to be remeasured at fair value, with changes in fair value reported in the current change in net assets, and

c. It would be accounted for as a derivative if it were a standalone contract.

A transfer of credit risk that is only in the form of subordination of one financial instrument to another (such as the subordination of one beneficial interest to another tranche of a securitization), thereby redistributing credit risk, does not require bifurcation and separate accounting from the host contract. However, other embedded credit derivatives, such as credit default swaps on a referenced credit or embedded derivatives that expose the holder of an interest in a securitized financial instrument to the possibility of having to make future cash payments, should be analyzed to determine if they meet the criteria for bifurcation listed in the previous paragraph. (FASB ASC 815-15-15-9)

If the only underlying for an embedded derivative is an interest rate or interest rate index and the host contract is a debt instrument for which the underlying alters the net interest payments required under the contract, the embedded derivative meets the clearly and closely related criteria unless: (a) the holder is required or could be forced to settle the contract in a way that would result in the holder not recovering substantially all of its initial investment or (b) the embedded derivative could at least double the investor's initial rate of return on the host contract *and* would simultaneously result in the investor earning a rate of return at least twice what otherwise would be the market return for a similar contract. (FASB ASC 815-15-25-26)

Interest-only strips and principal-only strips are not considered derivative instruments provided they (a) represent the right to receive only a specified proportion of the contractual interest or principal cash flows of a specific debt instrument and (b) incorporate only terms present in the original debt instrument. Other interests in securitized financial assets should be evaluated to identify interests that are freestanding derivatives or hybrid financial instruments containing an embedded derivative. (FASB ASC 815-10-15-11; 815-10-15-72)

An embedded foreign currency derivative should not be separated from the host contract and considered a derivative instrument if, at inception, the host contract is not a financial instrument and it requires payments denominated in (a) the functional or local currency of any substantial party to the contract, (b) the currency in which the related goods or services acquired or delivered under the contract are commonly denominated in international commerce, or (c) the currency used by a substantial party as its functional currency in a highly inflationary economy. Also, other aspects of the embedded foreign currency derivative should be clearly and closely related to the host contract. (FASB ASC 815-15-15-10)

If an embedded derivative cannot be reliably identified and measured separate from the host contract, the entire contract should be measured at fair value with gains or losses recognized in the change in net assets. In addition, when a hybrid financial instrument that would be separated into a host contract and embedded derivative is initially recognized, an entity may irrevocably elect to measure the entire hybrid instrument at fair value with changes in fair value recognized in the change in net assets. The election can be made on an

instrument-by-instrument basis and is also available when a previously recognized financial instrument is subject to new basis accounting. An instrument measured at fair value in its entirety may not be designated as a hedge. (FASB ASC 815-15-25-4 and 25-5; 815-15-25-53; 815-15-30-1; 815-15-35-1)

Exhibit 4-1 provides additional guidance on applying the bifurcation criteria listed previously to several types of embedded derivatives.

Exhibit 4-1

Application of the Clearly and Closely Related Criteria to Selected Types of Embedded Derivatives

Embedded Derivative	Accounted for Separately?
Inflation-indexed interest payments	No. Interest rates and the rate of inflation in the economic environment are considered to be clearly and closely related.
Credit sensitive payments	No. Creditworthiness of the borrower and the interest rate on the debt are considered clearly and closely related.
Calls and puts on debt instruments	No, for call or put options that accelerate principal payments (provided the put or call option is clearly and closely related to the debt based on the criteria provided previously), unless the debt involves a substantial premium or discount and the put or call option is only contingently exercisable. Yes, for call or put options that do not accelerate principal payments but rather require a cash settlement equal to the option price at date of exercise, and for contingently exercisable calls and puts that are indexed to an underlying other than interest rates or credit risk.
Calls and puts on equity instruments	Yes, provided (a) GAAP does not require the instrument to be remeasured at fair value with changes in fair value reported currently in the change in net assets and (b) the put or call would be accounted for as a derivative if it were a standalone contract. However, if the issuer would classify the put or call in equity, it is not considered a derivative and should not be accounted for separately by the issuer. [The holder of the related equity instrument that includes the embedded call option should account for the derivative separately, however, if the criteria in (a) and (b) are met.]
Interest rate floors, caps, and collars	No, provided the criteria for clearly and closely related provided previously are met.
Term-extending options	Yes. A contractual provision that either (a) allows one party to significantly extend the remaining term to maturity or (b) automatically significantly extends the remaining term to maturity if triggered by specific conditions or events is not clearly and closely related to the host contract unless the interest rate on the debt is reset to the approximate current market rate for the extended term and there was not a significant discount with the initial debt instrument.
Equity-indexed interest payments	Yes. Changes in the fair value of an equity instrument or index are not clearly and closely related to the interest rate based economic characteristics of debt.
Commodity-indexed principal or interest	Yes. Changes in the fair value of a commodity or other asset are not clearly and closely related to the interest rate based economic characteristics of debt.
Inflation-indexed rentals	No. Changes in inflation and rentals for the use of leased assets are considered to be clearly and closely related. Thus, unless the contract includes a significant leverage factor, the inflation-related embedded derivative should not be accounted for separately from the lease agreement.

Embedded Derivative	Accounted for Separately?
Contingent rentals based on sales	No. The contingent rental-related derivative should not be accounted for separately from the host lease contract because it is a nonexchange-traded contract whose underlying is specified sales volumes of one of the parties to the contract.
Contingent rentals based on a variable interest rate	No. Changes in variable interest rates and changes in lease payments for the use of a leased asset are considered to be clearly and closely related.
Hybrid instruments that are beneficial interests in securitized financial assets	Yes. An embedded derivative that exposes the holder of a beneficial interest in securitized financial assets to any possibility of having to make potential future payments is not clearly and closely related to the economic characteristics and risks of the host contract.

* * *

FAIR VALUE HEDGES

The guidance in this section is amended by ASU 2017-12, *Derivatives and Hedging (Topic 815)—Targeted Improvements to Accounting for Hedging Activities*, which simplifies the application of hedge accounting. The new guidance changes what qualifies for hedge accounting, how it is documented, how to assess hedge effectiveness and measure hedge ineffectiveness, and how to present and disclose hedging results in the financial statements. Due to the delayed effective dates of ASU 2017-12, the new guidance and other amendments of the ASU may not be fully incorporated in other lessons. An overview of the ASU, including its effective dates, is provided later in this lesson. Future editions of this course will be more fully updated for the requirements of ASU 2017-12 as the effective dates near.

A derivative instrument may be designated to hedge the exposure to changes in the fair value of a recognized asset or liability (or an unrecognized firm commitment) due to a particular risk. A derivative instrument qualifies as a fair value hedge if all of the following criteria are met:

a. At the inception of the hedge, the organization must document the hedging relationship, the risk being hedged, and the reason for undertaking the hedge, including the hedging instrument, the hedged item, and how the hedging instrument's effectiveness (and ineffectiveness) in offsetting exposure to changes in fair value attributable to the hedged risk will be assessed. There must be a reasonable basis for how the organization plans to assess the hedging instrument's effectiveness. Certain components of a hedging derivative's change in fair value may be excluded from the assessment of hedge effectiveness (for example, the change in fair value of an option contract attributed to time value). For a fair value hedge of a firm commitment, the documentation must include a reasonable method for recognizing as a change in net assets the gain or loss on the hedged firm commitment.

b. Both at the inception of the hedge and on an ongoing basis, the organization must expect the hedging relationship to be highly effective in offsetting changes in fair value attributable to the hedged risk. Effectiveness of the hedge should be considered both prospectively and retrospectively to determine if the requirement for highly effective offset is met. The prospective assessment should consider all reasonably possible changes in fair value and not be limited to only likely or expected changes, although likely or expected changes can be given more weight in the assessment. Retrospectively, the effectiveness of the hedging relationship should be assessed when financial statements are prepared and at least every three months.

c. If a written option is designated as hedging a recognized asset or liability or an unrecognized firm commitment, the combination of the option and the hedged item must provide at least as much potential for gains from favorable changes in the fair value of the combined instruments as for losses from unfavorable changes.

A nonderivative instrument (such as a Treasury note) should not be designated as a hedging instrument except for certain foreign currency hedges. (FASB ASC 815-20-25-1 and 25-3; 815-20-25-11; 815-20-25-71; 815-20-25-75; 815-20-25-79; 815-20-25-82; 815-20-25-94)

An asset or liability can be designated as a hedged item in a fair value hedge if *all* of the following criteria are met: (FASB ASC 815-20-25-12 and 25-43)

a. The organization specifically identifies a recognized asset or liability or an unrecognized firm commitment (or a specific portion of an asset, liability, or firm commitment) as the hedged item. The hedged item can be a single asset or liability (or portion) or a portfolio of similar assets or similar liabilities.

   (1) If a portfolio of assets or liabilities is designated as the hedged item, the individual assets or individual liabilities must have the same risk exposure for which they are designated as being hedged.

   (2) If a specific portion of an asset or liability is designated as the hedged item, the hedged item may be (a) a percentage of the entire asset or liability, (b) one or more selected contractual cash flows, (c) a put or call option, including an interest rate or price cap or floor, embedded in an existing asset or liability that is not accounted for separately as an embedded derivative, or (d) the residual value in a lessor's net investment in a direct financing or sales-type lease.

b. Exposure to changes in the fair value of the hedged item due to the hedged risk could affect the reported change in net assets.

c. The hedged item is not (1) an asset or liability that is remeasured at its fair value, with changes in fair value reported in the current change in net assets, (2) an equity method investment, (3) a noncontrolling interest in a consolidated subsidiary, (4) an equity investment in a consolidated subsidiary, (5) a firm commitment to enter into a business combination or acquire or dispose of an equity method investee, noncontrolling interest, or subsidiary, (6) a component of an embedded derivative in a hybrid instrument, (7) an implicit fixed-to-variable swap perceived to be embedded in a host contract with fixed cash flows, where the entire asset or liability is an instrument with variable cash flows, or (8) an intracompany transaction between entities included in consolidated financial statements.

d. If the hedged item is a nonfinancial asset or liability, the hedged risk is the risk of changes in the fair value of the total asset or liability, not a separate component thereof. The hedged risk is not due to changes in the fair value of a component or a similar asset in a different location.

e. If the hedged item is a financial asset or liability, a recognized loan servicing right, or a nonfinancial firm commitment with financial components, the hedged risk is due to (1) changes in the overall fair value of the entire hedged item, (2) changes in the designated benchmark interest rate (referred to as interest rule risk), (3) changes in related foreign currency exchange rates (referred to as foreign exchange risk), or (4) changes in both the debtor's creditworthiness and changes in the spread over the benchmark interest rate with respect to the hedged item's credit sector at the hedge's inception (referred to as credit risk).

In a hedge of interest rate risk, the benchmark interest rate being hedged must specifically be identified and documented at the hedging relationship's inception. (FASB ASC 815-20-25-6)

Accounting for Fair Value Hedges

A derivative instrument that qualifies as a fair value hedge should be reported at its fair value. The change in the derivative's fair value should be added to the basis of the asset, liability, or firm commitment that it hedges. (In most cases, a firm commitment has no basis and therefore the change in basis creates an asset or liability.) The gain or loss on the hedging instrument and the change in fair value of the hedged item should be included in the change in net assets in the period of the change. If the hedge is completely effective, the change in net assets will not be affected because the gain or loss on the hedged item will offset the gain or loss on the hedging instrument. However, if the hedge is not entirely effective, the net gain or loss will affect the change in net assets. (FASB ASC 815-10-30-1; 815-25-35-1 and 35-2)

Adjustments to the carrying amounts of hedged assets or liabilities that are required by the previous paragraph should be subsequently accounted for as any other adjustment to the basis of the asset or liability. (FASB ASC 815-25-35-8)

The accounting for fair value hedges discussed above should be discontinued for an existing hedge in the event of any of the following:

a. The derivative instrument or the hedged item no longer meets any of the criteria at the beginning of this discussion.

b. The derivative expires or is sold, terminated, or exercised.

c. The designation as a fair value hedge is removed by the organization.

In the instances noted above, the organization may elect to designate prospectively a new hedging relationship with a different hedging instrument or a different hedged item or transaction. (FASB ASC 815-25-40-1 and 40-2)

Hedge Ineffectiveness. The portion of the change in fair value of the derivative that is attributed to hedge ineffectiveness is recognized in the statement of activities as a result of the requirement to recognize both the change in fair value of the derivative and the change in fair value of the hedged item that is related to the hedged risk. If the offsetting changes in fair value of the hedged instrument and the hedged item do not equal, the difference is recognized in the change in net assets. (FASB ASC 815-25-35-2 through 35-4) If the organization's periodic assessment of hedge effectiveness indicates that the hedge is not effective (that is, it does not meet the effectiveness criteria from the beginning of this discussion), the change in the fair value of the derivative should be recognized in the change in net assets with no offset from changes in the fair value of the hedged item after the last date on which the hedge was assessed as being effective. If the organization discontinues the fair value hedge of a firm commitment because the hedged item no longer meets the definition of a firm commitment, any asset or liability recognized related to the firm commitment should be written off and reflected in the change in net assets. (FASB ASC 815-25-40-3 and 40-5)

Foreign Currency Fair Value Hedges. An organization can designate a derivative instrument (or a nonderivative financial instrument) that results in a foreign currency transaction gain or loss as a hedging change in the fair value of an unrecognized firm commitment attributable to foreign currency exchange rates. A derivative instrument that hedges foreign currency exposure for an unrecognized firm commitment denominated in a foreign currency should be measured at fair value, and changes in fair value should be recognized in the current change in net assets, if all the criteria from the beginning of this discussion of fair value hedges are met. (FASB ASC 815-20-25-58) [In addition, for consolidated financial statements, either (a) the operating unit that has the foreign currency exposure is a party to the hedging instrument or (b) another member of the consolidated group that has the same functional currency as that operating unit, subject to certain restrictions, is a party to the hedging instrument. There may be no intervening subsidiary with a different functional currency. The hedged transaction must also be denominated in a currency other than the hedging unit's functional currency.] If a nonderivative financial instrument is designated as hedging the changes in fair value of a firm commitment attributable to foreign exchange rates, the foreign currency transaction gains or losses should be recognized in the current change in net assets along with the change in the carrying amount of the hedged firm commitment. Changes in fair value should be based on spot exchange rates, regardless of whether there is a fair value hedging relationship. (FASB ASC 815-25-35-16 and 35-18)

Recognized assets or liabilities denominated in a foreign currency may be the hedged item in a foreign currency fair value hedge since the recognition in the current change in net assets of the foreign currency transaction gain or loss on the foreign-currency denominated asset or liability based on changes in exchange rates is not considered to be a remeasurement of that asset or liability as previously discussed. (FASB ASC 815-20-25-29) Therefore, an entity may designate a derivative instrument as hedging the changes in the fair value of a recognized asset or liability (or a specific portion thereof) for which a foreign currency translation gain or loss is included in the change in net assets. However, a nonderivative financial instrument may not be designated as the hedging instrument in a fair value hedge of the foreign currency exposures of a recognized asset or liability. If a derivative instrument hedges foreign currency exposure for a recognized foreign-currency-denominated asset or liability for which a foreign currency transaction gain or loss is included in the change in net assets, the derivative should be measured at fair value and changes in the derivative's fair value should be included in the change in net assets if all of the

criteria for fair value hedges from the beginning of this discussion are met. (FASB ASC 815-20-25-37 and 25-71) [In addition, for consolidated financial statements, either (1) the operating unit that has the foreign currency exposure is a party to the hedging instrument or (2) another member of the consolidated group that has the same functional currency as that operating unit, subject to certain restrictions, is a party to the hedging instrument. There may be no intervening subsidiary with a different functional currency. The hedged transaction must also be denominated in a currency other than the hedging unit's functional currency.]

Illustration of Accounting for a Fair Value Hedge

Exhibit 4-2 illustrates the accounting for a fair value hedge. The listed exchange rates are for illustrative purposes only and are not representative of actual exchange rates currently in effect.

Exhibit 4-2

Illustration of Accounting for a Fair Value Hedge

FACTS

1. On January 1, 20X0, ABC Organization, Inc. entered into a firm commitment to purchase a piece of equipment from a German manufacturer for delivery on July 1, 20X0. The price of the equipment will be 1,000,000 Euros (EUR1,000,000). ABC Organization's functional currency is the U.S. dollar.

2. Also on January 1, 20X0, ABC Organization entered into a forward contract to purchase 1,000,000 Euros (EUR1,000,000) on July 1, 20X0, for $.80 per EUR1 ($800,000), which is the current forward exchange rate on January 1, 20X0. ABC Organization has designated the forward exchange contract as a hedge against the risk of changes in the fair value of the firm commitment resulting from changes in the U.S. dollar/Euro forward exchange rate.

3. Forward exchange rates in effect on certain key dates are as follows:

January 1, 20X0	$.80 = EUR1
March 31, 20X0	$.78 = EUR1
June 30, 20X0	$.77 = EUR1
July 1, 20X0	$.77 = EUR1

Documentation of Hedging Strategy:

Date of Designation—January 1, 20X0

Hedging Instrument—Forward exchange contract to purchase EUR1,000,000 on July 1, 20X0, for EUR1:$.80.

Hedged Item—Firm commitment to purchase equipment for EUR1,000,000 on July 1, 20X0.

Hedging Strategy and Nature of Risk Being Hedged—Changes in the fair value of the forward exchange contract should perfectly offset changes in the fair value of the firm commitment due to changes in the U.S.$/EUR forward exchange rates.

Assessment of Effectiveness—ABC Organization, Inc. will assess effectiveness by comparing the overall changes in the fair value of the forward exchange contract to the changes in the fair value in U.S. dollars of the firm commitment due to changes in the U.S. dollar/Euro forward exchange rates. There is no hedge ineffectiveness because the fair value of the firm commitment is being valued using the forward exchange rate. The hedge qualifies as a fair value hedge.

COMPUTATIONS

	1/1/X0	3/31/X0	6/30/X0
Forward contract:			
$/EUR forward exchange rate (July 1, 20X0 settlement)	$ .80	$ .78	$ .77
Units of currency (EUR)	× 1,000,000	× 1,000,000	× 1,000,000
Forward price of EUR (in dollars)	600,000	580,000	570,000
Contract price (in dollars)	(600,000)	(600,000)	(600,000)
Fair Value[a]	$ -0-	$ (20,000)	$ (30,000)
Change in fair value during the period	$ -0-	$ (20,000)	$ (10,000)
Firm Commitment:			
$/EUR forward exchange rate (July 1, 20X0 settlement)	$ .80	$ .78	$ .77
Units of currency (EUR)	× 1,000,000	× 1,000,000	× 1,000,000
Forward price of EUR (in dollars)	800,000	780,000	770,000
Initial forward price in dollars	800,000	(800,000)	(800,000)
Fair Value[a]	$ -0-	$ 20,000	$ 30,000
Change in fair value during the period	$ -0-	$ 20,000	$ 10,000

Note:

[a] Time value of money has been ignored for purposes of this illustration.

Accounting Entries:

March 31, 20X0

Change in net assets	20,000	
EUR forward exchange contract		20,000

To recognize change in fair value of forward exchange contract.

Firm commitment	20,000	
Change in net assets		20,000

To recognize change in fair value of firm commitment.

June 30, 20X0

Change in net assets	10,000	
EUR forward exchange contract		10,000

To recognize change in fair value of forward exchange contract.

Firm commitment	10,000	
Change in net assets		10,000

To recognize change in fair value of firm commitment.

July 1, 20X0

Equipment	800,000	
Firm commitment		30,000
Cash		770,000

To record purchase of equipment.

EUR forward exchange contract	30,000	
Cash		30,000

To record settlement of foreign exchange contract.

* * *

Impairment

Any asset or liability that has been designated as a hedged item continues to be subject to the applicable GAAP requirements for assessing and recognizing impairment. When being assessed for impairment, the carrying amount of the asset or liability should reflect any adjustments made to the carrying amount resulting from hedge accounting. However, because the hedging instrument is recognized as a separate asset or liability, its fair value should not be taken into account when assessing the hedged item for impairment. (FASB ASC 815-25-35-10)

FOREIGN CURRENCY HEDGES OF A NET INVESTMENT IN A FOREIGN OPERATION

The guidance in this section is amended by ASU 2017-12, *Derivatives and Hedging (Topic 815)—Targeted Improvements to Accounting for Hedging Activities*, which simplifies the application of hedge accounting. The new guidance changes what qualifies for hedge accounting, how it is documented, how to assess hedge effectiveness and measure hedge ineffectiveness, and how to present and disclose hedging results in the financial statements. Due to the delayed effective dates of ASU 2017-12, this course does not fully incorporate the new guidance and other amendments of the ASU.

An organization can designate a derivative instrument (or a nonderivative financial instrument) resulting in a foreign currency transaction gain or loss as hedging the foreign currency exposure of a net investment in a foreign operation. However, a nonderivative instrument reported at fair value cannot be designated as the hedging instrument. [For consolidated financial statements, either (a) the operating unit that has the foreign currency exposure is a party to the hedging instrument or (b) another member of the consolidated group that has the same functional currency as that operating unit, subject to certain restrictions, is a party to the hedging instrument. There may be no intervening subsidiary with a different functional currency. The hedged transaction must also be denominated in a currency other than the hedging unit's functional currency.] The gain or loss in fair value on the hedging instrument should be reported in other comprehensive income as part of the cumulative translation adjustment to the extent the instrument is effective as a hedge. The hedged net investment should be accounted for in accordance with FASB ASC 830, *Foreign Currency Matters*. The provisions of paragraphs –.217 for recognizing gains or losses in a fair value hedge are not applicable to the hedge of a net investment in a foreign operation. (FASB ASC 815-20-25-66; 815-35-35-1 and 35-2)

OVERVIEW OF THE GUIDANCE IN ASU 2017-12

In August 2017, the FASB issued ASU 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, to improve and simplify hedge accounting. The amendments change what qualifies for hedge accounting, how (and when for most nonprofit organizations) to assess and measure hedge effectiveness, and how to present and disclose hedging results in the financial statements.

For nonprofit organizations, ASU 2017-12 is effective for years beginning after December 15, 2019, and interim periods within years beginning after December 15, 2020. Early adoption is permitted. Due to the delayed effective

dates of ASU 2017-12, this course does not fully incorporate the new guidance and other amendments of the ASU. Instead, the following paragraphs provide a summary of the new guidance. This course will be more fully updated for the requirements of ASU 2017-12 as the effective dates near. Accountants requiring additional information can download the ASU from the FASB's website at **www.fasb.org** or from Checkpoint at **checkpoint.riag.com**.

Scope

The provisions of ASU 2017-12 apply to all nonprofit organizations that currently use hedge accounting, as it amends significant portions of FASB ASC 815, *Derivatives and Hedging*, as well as certain industry specific guidance related to hedging activity.

Significant Changes to Existing GAAP

The amendments in ASU 2017-12—

- Expand the risk components that are eligible for hedge accounting by adding the Securities Industry and Financial Markets Association (SIFMA) municipal swap rate to the allowable benchmarks for fair value hedges of interest rate risk.
- For fair value hedges of interest rate risk, remove certain limitations for designating and measuring changes in fair value.
- Require the presentation of the earnings effect of the hedging instrument in the same line item in the statement of activities as the earnings effect of the hedged item.
- Ease the requirements for testing hedge effectiveness by:
    - Expanding the items that can be excluded from the assessment to include the change in fair value of a current swap due to a cross-currency basis spread.
    - Allowing, in certain situations, qualitative subsequent effectiveness assessments to be performed after the initial quantitative assessment.
    - Allowing entities using the critical terms match method to assume that the hedging derivative matures at the same time as the forecasted transaction if both occur within the same 31-day (or fiscal month) period.
    - Allowing the initial prospective quantitative assessment of hedge effectiveness to be performed anytime before the first quarterly effectiveness testing date.
    - Allowing most nonprofit organizations to select the method of hedge effectiveness testing and perform the initial quantitative and subsequent quarterly assessments before the date the next interim or annual financial statements are available for issuance.
    - Allowing entities, in certain situations, to use the long-haul method for assessing effectiveness when it determines the short cut method was not or is no longer appropriate.
- Change disclosure requirements by requiring the effect of fair value hedges on the statement of activities to be disclosed in a table, and eliminating the requirement to disclose the ineffective portion of the change in fair value of hedging instruments.

Early Adoption and Transition

Early application of ASU 2017-12 is permitted for any interim period after issuance of the ASU (August 2017). The transition requirements, discussed below, should be applied to all existing hedging relationships on the date of adoption. However, the initial adoption date should be the beginning of the fiscal year, and the effects of adoption should be reflected as of that date. The guidance should not be applied to hedging instruments that have expired,

been sold, terminated, or exercised, or if the hedging relationship designation has been removed as of the adoption date. (FASB ASC 815-20-65-3c)

In general, when applying ASU 2017-12, a nonprofit organization should apply a cumulative-effect adjustment to the opening balance of net assets, as of the initial adoption date. (FASB ASC 815-20-65-3d) The amended presentation and disclosure guidance is required only prospectively. In the period of adoption, the following disclosures are required for annual and interim financial statements: (FASB ASC 815-20-65-3j and 65-3k)

- The nature of and reason for the change in accounting principle.
- Cumulative effect of the change to net assets or other components of equity at the beginning of the period of adoption.

There are a number of elections permitted upon adoption of ASU 2017-12, in the following areas: FASB ASC 815-10-65-3e)

- Fair value hedges of interest rate risk.
- Fair value hedges of foreign exchange risk with currency swaps.
- Components of hedging instruments excluded from the effectiveness assessment.
- Documentation of hedging relationships.
- Debt securities eligible to be hedged under the last-of-layer method.

For most nonprofit organizations, the elections should be made before the next interim or annual financial statements are available to be issued following adoption. [FASB ASC 815-20-65-3(f)]

DISCLOSURE REQUIREMENTS

GENERAL DISCLOSURES

The guidance in this section is amended by ASU 2017-12, *Derivatives and Hedging (Topic 815)—Targeted Improvements to Accounting for Hedging Activities*.

Organizations with derivative instruments (or nonderivative instruments that are designated and qualify as hedging instruments) should disclose information that enables users to understand (a) how and why derivative instruments are used, (b) the accounting for derivative instruments and related hedged items, and (c) how derivative instruments and related hedged items affect financial position, changes in net assets, and cash flows. (FASB ASC 815-10-50-1)

An organization that holds or issues derivative instruments (or nonderivative instruments that are designated and qualify as hedging instruments) should disclose the following for each annual and interim reporting period for which a statement of financial position and statement of activities are presented: (FASB ASC 815-10-50-1A and 50-1B; 815-10-50-2 and 50-5)

a. The organization's objectives for holding or issuing the instruments, the context needed to understand the objectives, and the organization's strategies for achieving those objectives. (Disclosure should be made in the context of each instrument's primary underlying risk exposure. Instruments should be distinguished between those used for risk management purposes and those used for other purposes.)

b. For instruments designated as hedging instruments, the description in item a. above should distinguish between derivative (and nonderivative) instruments designated as (1) fair value hedging instruments and (2) hedging instruments of the foreign currency exposure in a net investment in a foreign operation.

c. For derivative instruments not designated as hedging instruments, the description in item a. should indicate the purpose of the derivative activity, distinguishing between derivatives used for risk management purposes and derivatives used for other purposes.

d. Information about the volume of the organization's derivative activity.

e. If additional qualitative disclosures about the organization's overall exposures to interest rate risk, foreign currency exchange rate risk, commodity price risk, credit risk, and equity price risk are made, a discussion of those exposures, even though the organization does not manage some of those exposures by using derivative instruments.

For organizations that hold or issue derivative instruments (and nonderivative instruments that are designated and qualify as hedging instruments), the following should be disclosed for each annual and interim reporting period for which a statement of financial position and statement of activities are presented: [The quantitative disclosures required by items a. and b. below should be presented in tabular format except for the information required for hedged items in item b.(1), which can be presented in a tabular or nontabular format.] (FASB ASC 815-10-50-4A through 50-4F)

a. The financial statement line item(s) and fair value amounts of derivative instruments reported in the statement of financial position showing:

   (1) The fair value of derivative instruments presented on a gross basis, even when the derivative instruments are subject to master netting arrangements and qualify for net presentation in the statement of financial position. (Associated cash collateral payables and receivables should not be netted against fair value amounts.)

   (2) Fair value amounts presented as separate asset and liability values segregated between (a) derivatives that are designated and qualifying as hedging instruments and (b) those that are not, with further separate presentation by type of derivative contract within those two categories.

b. The financial statement line item(s) and amount of gains and losses reported in the statement of activities with separate presentation of gains and losses by the class or classes of net assets affected for: (The information should be presented separately by type of derivative contract, for example, interest rate contracts, foreign exchange contracts, equity contracts, commodity contracts, credit contracts, other contracts, etc.)

   (1) Derivative instruments designated and qualifying as hedging instruments in fair value hedges and related hedged items designated and qualifying in fair value hedges.

   (2) The effective portion of gains and losses on derivative instruments designated and qualifying as net investment hedges that was recognized in the change in net assets during the current period.

   (3) The portion of gains and losses on derivative instruments designated and qualifying as net investment hedges representing (a) the amount of the hedges' ineffectiveness and (b) the amount, if any, excluded from the assessment of hedge effectiveness.

   (4) Derivative instruments not designated or qualifying as hedging instruments.

c. For derivative instruments that are not designated or qualifying as hedging instruments, if the organization elects to not separately disclose gains and losses as indicated in item b.(4), disclosure should be made of the following:

   (1) The gains and losses on both derivative and nonderivative instruments recognized in the statement of activities, separately by major types of items (such as fixed income/interest rates, foreign exchange, equity, commodity, and credit) and by the class or classes of net assets affected.

   (2) The line items in the statement of activities in which gains and losses on derivative instruments are included.

   (3) A description of the nature of its investing activities and related risks, and how the entity manages those risks.

If this disclosure election is made, a footnote should be added to the required tabular information referencing this disclosure.

If the organization holds or issues derivative instruments (or nonderivative instruments that are designated and qualify as hedging instruments), the following should be disclosed for each annual and interim reporting period for which a statement of financial position is presented: (FASB ASC 815-10-50-4H)

a. The existence and nature of credit-risk-related contingent features and the circumstances in which the features could be triggered in derivative instruments that are in a net liability position at the end of the reporting period.

b. The aggregate fair value amounts of derivative instruments that contain credit-risk-related contingent features that are in a net liability position at the end of the reporting period.

c. The aggregate fair value of assets that are already posted as collateral at the end of the reporting period and (1) the aggregate fair value of additional assets that would be required to be posted as collateral and/or (2) the aggregate fair value of assets needed to settle the instrument immediately, if the credit-risk-related contingent features were triggered at the end of the reporting period.

If information on derivative instruments (or nonderivative instruments that are designated and qualify as hedging instruments) is disclosed in more than a single note to financial statements, a cross-reference should be made from the derivative note to other notes in which derivative-related information is disclosed. (FASB ASC 815-10-50-4I)

The following should be disclosed for every annual and interim reporting period for which a statement of financial position and statement of activities are presented: (FASB ASC 815-25-50-1; 815-30-50-1)

a. For derivative instruments (as well as nonderivative instruments that may give rise to foreign currency transaction gains or losses) designated and qualifying as fair value hedging instruments and for the related hedged items:

   (1) The net gain or loss recognized in the change in net assets during the reporting period representing (a) the amount of the hedges' ineffectiveness and (b) the component of the derivative instruments' gain or loss, if any, excluded from the assessment of hedge effectiveness.

   (2) The amount of net gain or loss recognized in the change in net assets when a hedged firm commitment no longer qualifies as a fair value hedge.

Organizations with hybrid financial instruments that are measured at fair value under the fair value election and practicability exception discussed earlier in this lesson should make the disclosures for the fair value option discussed below. The fair values of those instruments should be reported separately on the face of the statement of financial position from non-fair-value carrying amounts, either through separate line items or parenthetical disclosure of fair value amounts included in aggregated totals. Information should be provided about the effect of changes in the fair value of hybrid financial instruments on the change in net assets. (FASB ASC 815-15-45-1; 815-15-50-1)

A seller of credit derivatives should disclose information about its credit derivatives (and hybrid instruments with embedded credit derivatives) that allows users of the financial statements to assess their potential effect on its financial position, financial performance, and cash flows. Some such disclosures would include the nature and approximate term of the credit derivative and reason(s) for entering into it; the events or circumstances that would require the seller to perform under the credit derivative; an estimate of the maximum potential amount of future payments (undiscounted) the seller could be required to make under the credit derivative or the reasons why an estimate cannot be made; the fair value of the credit derivative as of the date of the statement of financial position; and the nature of any recourse provisions that would enable the seller to recover from third parties amounts paid under the credit derivative and any assets held either as collateral or by third parties that, upon the occurrence of a specified triggering event or condition, the seller could obtain and liquidate to recover all or a portion of the amounts paid under the credit derivative. For hybrid instruments with embedded credit derivatives, the seller should disclose the required information for the entire hybrid instrument not just the embedded credit derivatives. (FASB ASC 815-10-50-4K and 50-4L)

In addition to the disclosures summarized in the preceding paragraphs, specific disclosures are needed for all recognized derivative instruments, including bifurcated embedded derivatives that are offset in accordance with either FASB ASC 210-20-45 or FASB ASC 815-10-45, or are subject to an enforceable master netting arrangement or similar agreement. (FASB ASC 815-10-50-7A)

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

12. What is an *underlying*?

    a. A number of currency units, etc., as specified in a contract.

    b. A fixed or determinable settlement.

    c. A specified interest rate, commodity price, security price, etc.

    d. A financial instrument with three specific characteristics.

13. Which of the following contracts is exempt from derivative accounting under GAAP?

    a. "Regular way" security trades.

    b. Contracts that are traded on an exchange.

    c. Derivatives that use sales accounting.

    d. Insurance contracts with investment features.

14. Assuming all other criteria are met, when could an asset or liability be designated as a hedged item in a fair value hedge?

    a. Net assets will not change if the hedged item is exposed to changes in fair value due to the hedged risk.

    b. The organization has specifically identified a recognized asset or liability or unrecognized commitment as a hedged item.

    c. The hedged item is an asset or liability that is remeasured at its fair value with change reported in the current change in net assets.

    d. If a nonfinancial item, the hedged risk is a separate component of the asset or liability's total fair value.

15. An organization holding or issuing derivative instruments should disclose the following when statements of financial position and activities are presented?

    a. Information about the frequency of the organization's derivative activity.

    b. A list of derivatives that are designated as fair value hedging instruments.

    c. A breakdown of all derivatives distinguishing between those used for risk management and those used for other purposes.

    d. The organization's objectives for holding or issuing the instruments and related context and strategies.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

12. What is an *underlying*? **(Page 141)**

    a. A number of currency units, etc., as specified in a contract. [This answer is incorrect. According to FASB ASC 815-10-15-83, a *notional amount* is a number of currency units, shares, bushels, pounds, or other units specified in the contract.]

    b. A fixed or determinable settlement. [This answer is incorrect. As described in FASB ASC 815-10-15-83, a *payment provision,* specifies a fixed or determinable settlement to be made if the underlying performs in a specified manner.]

    c. A specified interest rate, commodity price, security price, etc. [This answer is correct. Per FASB ASC 815-10-15-83, an *underlying* is a specified interest rate, security price, commodity price, foreign exchange rate or rate index, or other variable (including the occurrence or nonoccurrence of a specified event, such as a scheduled payment under a contract).]

    d. A financial instrument with three specific characteristics. [This answer is incorrect. As defined in FASB ASC 815-10-15-83, a *derivative* is a financial instrument with three specific characteristics. The underlying, along with either a notional amount or a payment provision, determines the settlement of a derivative.]

13. Which of the following contracts is exempt from derivative accounting under GAAP? **(Page 142)**

    a. "Regular way" security trades. [This answer is correct. Certain types of contracts, as described in FASB ASC 815-10-15-13, are not subject to the requirements discussed in this lesson even though, depending on the facts and circumstances, they might otherwise be considered derivatives. One such contract is a "regular way" security contract. These types of contracts provide for delivery of a security that is readily convertible to cash within customary time frames established by marketplace regulations, and, provided there is no net settlement provision or market mechanism to facilitate net settlement, they are not subject to the guidance in this lesson.]

    b. Contracts that are traded on an exchange. [This answer is incorrect. As described in FASB ASC 815-10-15-59, contracts that are *not* traded on an exchange are not subject to the guidance in this lesson if they are based on specific underlyings, such as a climatic, geological or other physical variable. However, those that are traded on an exchange would not fall into this category for exemption.]

    c. Derivatives that use sales accounting. [This answer is incorrect. Per FASB ASC 815-10-15-63, derivative instruments that prevent one party from recognizing a related contract as a sale or the counterparty from recognizing the purchase are not subject to the guidance in this lesson. Derivatives that use sales accounting would not fall into that category for exemption.]

    d. Insurance contracts with investment features. [This answer is incorrect. Per FASB ASC 815-10-15-52 through 15-54, insurance policies that reimburse the holder only for losses incurred as a result of identifiable insured events are not subject to the guidance in this lesson. However, some insurance policies may include investment features that are embedded derivatives, and then they would not be exempt.]

14. Assuming all other criteria are met, when could an asset or liability be designated as a hedged item in a fair value hedge? **(Page 147)**

    a. Net assets will not change if the hedged item is exposed to changes in fair value due to the hedged risk. [This answer is incorrect. Per FASB ASC 815-20-25, an asset or liability can be designated as a hedged item in a fair value hedge if exposure to changes in the fair value of the hedged item due to the hedged risk could affect the reported change in net assets.]

    b. The organization has specifically identified a recognized asset or liability or unrecognized commitment as a hedged item. [This answer is correct. According to the guidance provided in FASB ASC 815-20-25-12 and 25-43, one of the criteria that must be met for an asset or liability to be designated as a hedged item in a fair value hedge is that the organization must specifically identify the recognized asset or liability or an unrecognized firm commitment as the hedged item. The hedged item can be a single asset or liability (or portion) or a portfolio of similar assets or similar liabilities.]

    c. The hedged item is an asset or liability that is remeasured at its fair value with change reported in the current change in net assets. [This answer is incorrect. As described as FASB ASC 815-20-25, the hedged item *cannot* be a variety of specific things, including (1) an asset or liability that is remeasured at its fair value with changes in fair value reported in the current change in net assets, (2) an equity method investment, (3) a noncontrolling interest in a consolidated subsidiary, and (4) an equity investment in a consolidated subsidiary.]

    d. If a nonfinancial item, the hedged risk is a separate component of the asset or liability's total fair value. [This answer is incorrect. If the hedged item is a nonfinancial asset or liability, the hedged risk (per FASB ASC 815-20-25) is the risk of changes in the fair value of the total asset or liability, *not* a separate component thereof. The hedged risk is not due to changes in the fair value of a component or a similar asset in a different location.]

15. An organization holding or issuing derivative instruments should disclose the following when statements of financial position and activities are presented? **(Page 153)**

    a. Information about the frequency of the organization's derivative activity. [This answer is incorrect. Per FASB ASC 815-10-50, one of the required disclosures is information about the *volume* of the organization's derivative activity. While frequency may increase volume, volume is the measurement specifically called out in the guidance.]

    b. A list of derivatives that are designated as fair value hedging instruments. [This answer is incorrect. According to FASB ASC 815-10-50, for instruments designated as hedging instruments, the description provided should distinguish between derivative (and nonderivative) instruments designated as (1) fair value hedging instruments and (2) hedging instruments of foreign currency exposure in a net investment in a foreign operation. Therefore, while distinguishing fair value hedging instruments is part of the required disclosure, it is not enough by itself. Therefore, there is a better, more accurate answer to this question.]

    c. A breakdown of all derivatives distinguishing between those used for risk management and those used for other purposes. [This answer is incorrect. As described in FASB ASC 815-10-50, for derivative instruments *not designated as hedging instruments,* the description provided should indicate the purpose of the derivative activity, distinguishing between derivatives used for risk management purposes and derivatives used for other purposes. However, this is only needed for derivative instruments not designated as hedging instruments, so using this breakdown on all derivative instruments would be more than required by GAAP.]

    d. The organization's objectives for holding or issuing the instruments and related context and strategies. [This answer is correct. As explained in FASB ASC 815-10-50-1A and 50-1B, as well as 50-2 and 50-5, disclosures should include the organization's objectives for holding or issuing the instruments, the context needed to understand the objectives, and the organization's strategies for achieving those objectives.]

Lesson 5: Exit or Disposal Cost Obligations and Guarantees

INTRODUCTION

SOURCE: FASB ASC 420-10 and FASB ASC 460-10

This lesson discusses accounting and disclosure requirements that nonprofit organizations must address related to exit or disposal cost obligations and guarantees.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize the accounting and disclosure requirements that nonprofit organizations must adhere to when dealing with exit or disposal cost obligations and guarantees.

EXIT OR DISPOSAL COST OBLIGATIONS

A liability for costs associated with exit or disposal activities should be recognized when incurred and measured at its fair value. Examples of such costs include conract termination costs and certain employee severance costs associated with a restructuring, discontinued operation, consolidation of facilities, or other exit or disposal activities.

Costs associated with an exit or disposal activity that involves discontinued operations should be included in the results of discontinued operations. Costs associated with an exit or disposal activity that does not involve discontinued operations should not be included in the results of discontinued operations in the statement of activities.

ACCOUNTING REQUIREMENTS

Costs associated with exit or disposal activities include: (FASB ASC 420-10-05-2)

a. Termination benefits provided to current employees involuntarily terminated under the terms of a one-time benefit arrangement that is not an ongoing benefit arrangement or an individual deferred compensation contract.

b. Costs to terminate a contract other than a capital lease.

c. Costs to consolidate facilities or relocation costs.

RECOGNITION AND MEASUREMENT

A liability for costs associated with exit or disposal activities should be recognized when incurred and measured at its fair value. In the unusual case in which fair value cannot be estimated, the liability should be recognized when fair value can be estimated. An entity's commitment to an exit or disposal plan, by itself, does not create an obligation that meets the definition of a liability. (FASB ASC 420-10-25-1 and 25-2; 420-10-30-1)

Using quoted market prices is the best method to determine the fair value of a liability for an exit or disposal activity. However, quoted market prices generally are not available and therefore a present value technique is often the best available valuation method. When the liability contains uncertainties in both timing and amount, an expected present value method is generally appropriate. (FASB ASC 420-10-30-2)

Using a valuation technique other than a present value technique is acceptable when the resulting measurement is not materially different from a fair value measurement obtained using a present value technique, as long as the valuation technique is consistent with the objective of fair value measurement. (FASB ASC 420-10-30-3)

After initial measurement, entities should recognize changes in the liability using the credit-adjusted, risk-free rate initially used to measure the liability. The cumulative effect of changes resulting from revisions in either the timing or amount of estimated cash flows should be recognized as an adjustment to the liability in the period of the change, and reported in the statement of activities line item initially used to recognize the related costs. Changes due to the passage of time should be recognized by increasing the carrying amount of the liability and as an expense, such as accretion expense. (FASB ASC 420-10-35-1; 35-2; and 35-4; 420-10-45-1)

One-time Termination Benefits

One-time employee termination benefits (also called severance pay) are provided to employees who have been involuntarily terminated under a one-time benefit arrangement. (FASB ASC 420-10-20) A one-time benefit arrangement applies for a specified termination event or for a specified future period. Such an arrangement exists at the date, called the "communication date," when the plan has been communicated to employees and meets all of the following criteria: (FASB ASC 420-10-25-4)

a. Management, having the authority to approve the action, commits to a termination plan.

b. The plan identifies the number of terminated employees, their job functions or classifications and locations, and the expected date of completion.

c. The plan establishes the benefit arrangement terms, including the benefits received upon termination (including, but not limited to, cash payments) in sufficient detail to allow employees to determine the type and amount of benefits they would receive if involuntarily terminated.

d. Actions required to complete the plan indicate that it is unlikely that significant changes will be made to the plan or that the plan will be withdrawn.

The recognition and measurement of a liability for these costs depends on whether the employee is required to render service until the date of termination and, if so, whether employees are required to render service beyond a minimum retention period. (The minimum retention period should not exceed the *legal notification period*, which is the period an entity is required by existing law, statute, or contract to provide to employees in advance of a specified termination event. If there is no legal notification requirement, the minimum retention period is 60 days.) (FASB ASC 420-10-20; 420-10-25-6 and 25-7; 420-10-30-4)

Not Required to Render Service. If employees are entitled to receive termination benefits, regardless of when they leave or if employees will not be retained required to render service beyond the minimum retention period, a liability for termination benefits should be recognized and measured at fair value at the communication date. (FASB ASC 420-10-25-8; 420-10-30-5)

Required to Render Service. If employees are required to render service until terminated and retained to render service beyond the minimum retention period, a liability for the termination benefits should be measured initially at the communication date based on the liability's fair value at the termination date and recognized ratably over the future service period. Any changes to the liability resulting from a revision, due to the timing or amount of estimated cash flows, should be measured using the credit-adjusted, risk-free rate initially used to measure the liability. The cumulative effect of the change should be recognized as an adjustment to the liability in the period of the change. In periods subsequent to the termination date, the guidance provided previously should be followed. (FASB ASC 420-10-25-9; 420-10-30-6; 420-10-35-1, 35-2, and 35-4)

Changes to the Plan. If the termination plan changes and employees are then required to render service beyond the minimum retention period, the previously-recognized liability should be adjusted to the amount that would have been recognized had it initially been measured at the communication date and the guidance from FASB ASC 420-10-35-1; 35-2; and 35-4; 420-10-45-1 (discussed above) should be followed in all periods after the communication date. The cumulative effect of the change adjusts the liability in the period of the change. (FASB ASC 420-10-35-3)

Voluntary and Involuntary Benefits. If a termination plan includes both voluntary and involuntary benefits, the liability for involuntary termination is recognized under the guidance in this lesson, but the liability for the incremen-

tal voluntary benefits should be recognized differently. (FASB ASC 420-10-15-8; 420-10-25-10) An in-depth discussion of incremental voluntary benefits is beyond the scope of this course, but more information is available in *PPC's Guide to Nonprofit GAAP*.

Contract Termination Costs

Contract termination costs are costs to terminate an operating lease or other contract before the end of its term, or costs that will continue to be incurred under the contract for its remaining term without economic benefit to the entity. A liability for costs to terminate a contract before the end of its term should be recognized and measured at fair value when the entity terminates the contract under the contract terms, which generally is when the entity gives written notice to the counterparty or negotiates termination. A liability for costs that will continue to be incurred under a contract for its remaining term without economic benefits should be recognized and measured at its fair value when the entity stops using the rights conveyed by the contract (the *cease-use date*). If the contract is an operating lease, the fair value of the liability at the cease-use date is determined based on the remaining lease rentals, adjusted for any prepaid or deferred items under the lease, and reduced by estimated sublease rentals that reasonably could be obtained, even if the organization does not intend to enter into a sublease. Remaining lease rentals should not be reduced to less than zero. (FASB ASC 420-10-20; 420-10-25-11 through 25-13; 420-10-30-7 and 30-8)

Other Associated Costs

Other exit or disposal activity costs may include costs to consolidate or close facilities and relocate employees. A liability for such costs should be recognized and measured at fair value only in the period in which the liability is incurred, which generally is when goods or services associated with the activity are received. The liability should not be recognized before it is incurred even if the cost is a direct result of the exit plan. (FASB ASC 420-10-25-14 and 25-15; 420-10-30-10)

REPORTING

Exit or disposal activity costs *not* involving a discontinued operation should be included in the change in net assets before discontinued operations in a statement of activities and included in an intermediate measure of operations if such a subtotal is used. Exit plan or disposal activity costs involving a discontinued operation should be included in the results of discontinued operations. (FASB ASC 420-10-45-2 and 45-3)

If circumstances that remove the entity's responsibility to settle a previously-recognized liability occur, the liability should be reversed through the same line item in the statement of activities used to originally recognize the costs. (FASB ASC 420-10-40-1)

DISCLOSURE REQUIREMENTS

The following disclosures are required if an exit or disposal activity was initiated or in process during the period (until the activity is completed): (FASB ASC 420-10-50-1)

a. A description of the exit or disposal activity, including the facts and circumstances leading to the activity and the expected completion date

b. For each major type of cost associated with the activity (one-time termination benefits, contract termination costs, and other associated costs):

    (1) The total amount expected to be incurred with the activity, the amount incurred during the period, and the cumulative amount incurred to date.

    (2) A reconciliation of the beginning and ending liability balances showing separately the changes during the period attributable to costs incurred and charged to expense, costs paid or otherwise settled, and any adjustments to the liability. (The reasons for any adjustments should be explained.)

c. The line items in the statement of activities in which the costs associated with the exit or disposal activities are included

d. If a liability for a cost associated with the activity is not recognized because fair value cannot reasonably be estimated, that fact and the related reasons

GUARANTEES

An obligation to stand ready to perform under a guarantee is noncontingent. A guarantor should recognize a liability for a guarantee based on its fair value at inception. Guarantees also should be disclosed, even if the likelihood of loss is remote.

ACCOUNTING REQUIREMENTS

The issuance of a guarantee obligates the guarantor in two ways: (a) the guarantor is contingently obligated to make future payments if specified triggering events or conditions occur (the contingent element) and (b) the guarantor is obligated to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur (the noncontingent element). (FASB ASC 460-10-25-2) Examples of guarantees include the direct or indirect guarantee of indebtedness of others and guarantees to repurchase receivables that have been sold or assigned. (FASB ASC 460-10-50-2)

At the inception of a guarantee, guarantors should recognize a liability based on the fair value of the guarantee. The amount recognized at inception should be the greater of (a) the fair value of the guarantor's obligation (the noncontingent element) or (b) the loss contingency that should be recognized under FASB ASC 450-20-30, *Contingencies—Loss Contingencies—Initial Measurement* (that is, the amount of future payments under the guarantee that are probable and can be reasonably estimated). (FASB ASC 460-10-30-3)

In a standalone arm's-length transaction with an unrelated party, as a practical expedient, the fair value of the guarantor's obligation at inception equals the premium received or receivable by the guarantor. In an arm's-length transaction with an unrelated party that involves multiple elements, the fair value of the obligation is the premium that would be required by the guarantor to issue the same guarantee in a standalone transaction. When the guarantee is issued as a contribution (that is, when no premium is received), the fair value of the liability would be measured in accordance with FASB ASC 460-10-30-2. (FASB ASC 460-10-30-2)

When recording a liability at the inception of a guarantee, the offsetting entry may be consideration received (such as cash or accounts receivable). If no consideration is received and the guarantee is not issued in conjunction with another transaction or ownership relationship, the offset would be to expense. If the guarantee is issued in conjunction with another transaction or ownership relationship, the offset depends on the nature of the transaction. For example, the offset may affect the gain or loss on a sale transaction, or the carrying amount of an investment. (FASB ASC 460-10-55-23)

Subsequent to inception, the fair value liability for a guarantee is included in the change in net assets as the guarantor is released from risk. The appropriate method of reducing the liability depends on the nature of the guarantee. For example, the liability may be reduced only on expiration or settlement of the guarantee, over the term of the guarantee using a systematic and rational method, or as its fair value changes. The liability is not adjusted for fair value each reporting period unless that accounting is supported by other GAAP, for example, FASB ASC 815, *Derivatives and Hedging*, for guarantees accounted for as derivative instruments. (FASB ASC 460-10-35-4)

A guarantee may be initially measured based on the loss contingency for probable future payments that should be recognized under FASB ASC 450-20, as described in item (b) above, or it subsequently may become necessary to recognize such a loss contingency. The accounting for the loss contingency is separate from and has no effect on the accounting for any fair value liability recorded at inception. (FASB ASC 460-10-35-4) More information about loss contingencies is available in *PPC's Guide to Nonprofit GAAP*.

CONTRIBUTIONS

A guarantee issued as a contribution to a third party is measured at fair value. (FASB ASC 460-10-30-2; 460-10-55-15)

Paragraph 5.61 of the Audit Guide explains that a nonprofit organization that guarantees the debt of another unaffiliated entity without receiving commensurate consideration in return has provided a promise to give that is—

a. *partly conditional*—represented by the promise to make payments in future periods upon the entity's default, and

b. *partly unconditional*— represented by the gift of the guarantor's credit support, which enables the entity to obtain a lower interest rate on its borrowing.

A nonprofit organization that receives a guarantee without providing commensurate consideration has received a contribution.

RESIDUAL VALUE GUARANTEES

A lessee-guarantor should recognize a liability for the fair value of its obligation to stand ready to perform under a residual value guarantee provision of an operating lease. The offsetting entry should be accounted for as prepaid rent. (FASB ASC 460-10-55-23)

Upon the adoption of ASU 2016-02, *Leases (Topic 842)*, a lessee's guarantee of the residual value of the underlying leased property at the end of the lease term and contracts accounted for as variable lease payments according to FASB ASC 842 will not be subject to the guidance discussed in this lesson. (FASB ASC 460-10-15-7)

DISCLOSURE REQUIREMENTS

For each guarantee or group of similar guarantees, the following disclosures are required, even if the likelihood of loss is remote:

a. The nature of the guarantee, including its approximate term, how it arose, and the events or circumstances that would require performance under the guarantee. (FASB ASC 460-10-50-4)

b. The current status, as of the statement of financial position date, of the payment/performance risk of the guarantee. For an entity that uses internal groupings to manage risk, the disclosure should indicate how those groupings are determined and used for managing risk. (FASB ASC 460-10-50-4)

c. The maximum potential amount of future payments the guarantor could be required to make (undiscounted and not reduced by possible recoveries under recourse or collateralization provisions) or the reasons why an estimate of that amount cannot be made. If there is no limitation on the maximum amount, that fact should be disclosed. (FASB ASC 460-10-50-4)

d. Carrying amount of the liability, if any, for obligations under the guarantee, including amounts recognized under FASB ASC 450-20-30 for loss contingencies. (FASB ASC 460-10-50-4)

e. Recourse provisions that would enable the guarantor to recover amounts paid under the guarantee or collateral that could be sold. (If estimable, the extent to which proceeds from the sale of collateral would be expected to cover the maximum potential amount of future payments under the guarantee should be disclosed.) (FASB ASC 460-10-50-4)

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

16. Costs related to an organization's exit or disposal activities include all of the following **except**:

    a. Termination benefits for involuntarily terminated employees.

    b. Termination costs related to relocation.

    c. Termination costs related to capital leases.

    d. Termination costs for consolidating facilities.

17. Which of the following statements best describes the accounting and disclosure requirements for guarantees?

    a. At inception, guarantors should recognize a liability that is the lessor of the fair value of the obligation or the loss contingency under FASB ASC 450-20-30.

    b. After inception, the guarantor should include the fair value liability for a guarantee in the change in net assets as the guarantor is released from risk.

    c. A lessee-guarantor should account for an offsetting entry for a residual value guarantee as a contingency.

    d. When making disclosures about guarantees, guarantors must break out each guarantee individually with its specific disclosures.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

16. Costs related to an organization's exit or disposal activities include all of the following **except**: **(Page 161)**

    a. Termination benefits for involuntarily terminated employees. [This answer is incorrect. As discussed in FASB ASC 420-10-05-2, such costs include termination benefits provided to current employees involuntarily terminated under the terms of a one-time benefit arrangement that is not an ongoing benefit arrangement or an individual deferred compensation contract.]

    b. Termination costs related to relocation. [This answer is incorrect. Costs for exit or disposal activities are discussed in FASB ASC 420-10-05-2. Per this guidance, they include relocation costs.]

    c. Termination costs related to capital leases. [This answer is correct. Per FASB ASC 420-10-05-2, costs associated with exit or disposal activities include, among others, costs to terminate a contract *other than a capital lease.* Therefore, costs for terminating a capital lease would not be included in this category.]

    d. Termination costs for consolidating facilities. [This answer is incorrect. Costs an organization incurs when consolidating facilities are considered costs for exit or disposal activities under FASB ASC 420-10-05-2.]

17. Which of the following statements best describes the accounting and disclosure requirements for guarantees? **(Page 164)**

    a. At inception, guarantors should recognize a liability that is the lessor of the fair value of the obligation or the loss contingency under FASB ASC 450-20-30. [This answer is incorrect. At the inception of a guarantee, guarantors should recognize a liability based on the fair value of the guarantee. The amount recognized at inception should be the *greater* of (1) the fair value of the guarantor's obligation (the noncontingent element) or (2) the loss contingency that should be recognized under FASB ASC 450-20-30, *Contingencies—Loss Contingencies—Initial Measurement* (that is, the amount of future payments under the guarantee that are probable and can be reasonably estimated.]

    b. After inception, the guarantor should include the fair value liability for a guarantee in the change in net assets as the guarantor is released from risk. [This answer is correct. As discussed in FASB ASC 460-10-35-4, subsequent to inception, the fair value liability for a guarantee is included in the change in net assets as the guarantor is released from risk. The appropriate method of reducing the liability depends on the nature of the guarantee.]

    c. A lessee-guarantor should account for an offsetting entry for a residual value guarantee as a contingency. [This answer is incorrect. According to FASB ASC 460-10-55-23, a lessee-guarantor should recognize a liability for the fair value of its obligation to stand ready to perform under a residual value guarantee provision of an operating lease. The offsetting entry should be accounted for as prepaid rent, not a contingency.]

    d. When making disclosures about guarantees, guarantors must break out each guarantee individually with its specific disclosures. [This answer is incorrect. According to GAAP, guarantors can make disclosures for each guarantee or for groups of similar guarantees.]

Lesson 6: Inventory

INTRODUCTION

SOURCE: FASB ASC 330

Inventories of nonprofit organizations usually consist of purchased or donated supplies, materials, publications, and other items used in the organization's activities or programs or held for resale to the public. Generally, inventory should be recorded at cost, which includes all direct and indirect costs incurred to prepare it for sale or use. However, in some cases, inventory should be stated at other than cost. For example, donated materials are measured at fair value at the date of donation. In addition, for inventories measured using the last-in, first-out (LIFO) or retail method when cost exceeds market value, the inventories should be written down to market value and an unrealized loss should be recognized in the current period change in net assets. Inventories measured using other methods, such as first-in, first-out (FIFO) or average cost, should be subsequently measured at the lower of cost and net realizable value. Also, inventory items may be stated above cost if certain conditions are met.

In July 2015, the FASB issued ASU 2015-11, *Inventory (Topic 330): Simplifying the Measurement of Inventory*, which revised the subsequent measurement of inventory. Before the effective date of ASU 2015-11, all inventories are required to be measured at the lower of cost or market value. ASU 2015-11 is effective for fiscal years beginning after December 15, 2016 and interim periods within fiscal years beginning after December 15, 2017. Early application is permitted as of the beginning of an interim or annual reporting period.

The primary objective when determining the sequence in which inventory costs are charged to cost of sales or other expense is to select the method that most accurately reflects the current change in net assets. GAAP essentially permits an organization to use the following methods to account for inventory:

- Specific identification
- First-in, first-out
- Average cost
- Last-in, first-out

GAAP recognizes certain variations of the above methods and allows them to be used when appropriate. (For example, the retail method is a variation of the average cost method.) In addition, different methods may be used to account for different components of inventory so long as the methods are applied consistently.

Learning Objectives:

Completion of this lesson will enable you to:
- Identify the accounting and disclosure requirements that apply when a nonprofit organization maintains inventory.

ACCOUNTING REQUIREMENTS

DEFINITION

Inventory is defined as personal tangible property that is:

a. held for sale or use in the ordinary course of business;

b. in the process of production for sale or use; or

c. consumed in the production of goods or services to be available for sale or use.

Long-term assets that are subject to depreciation (or will be subject to depreciation when they are put into use) are specifically excluded from the definition of inventory. In addition, depreciable assets that are retired from use and held for sale are not considered inventory. (FASB ASC 330-10-20)

INVENTORY VALUATION

Inventories should initially be recorded at cost. Although that rule may seem relatively straightforward, applying it in practice may be difficult. It involves (a) identifying product costs (that is, the costs that should be charged to inventory rather than current period expenses) and (b) determining how costs will be charged to cost of sales or other expense as inventory is sold or used in the organization's programs. (FASB ASC 330-10-30-1 and 30-2)

IDENTIFYING PRODUCT COSTS

An inventory item's product cost includes all direct and indirect costs incurred to prepare the item for sale. Thus, for a college bookstore, an item's product cost may include the purchase price, excise and sales taxes, freight, storage, insurance, etc. For items manufactured by a nonprofit organization, inventory typically includes the cost of the following:

a. Direct materials, including invoice cost, freight-in, and tooling charges from vendors

b. Direct labor, including payroll costs of personnel whose efforts directly result in the manufacture of the product

c. Indirect costs, including factory facility costs, utilities, and indirect manufacturing labor and related costs (Interest costs incurred to finance inventory and selling costs are not indirect product costs. Those costs should be expensed when incurred rather than included in inventory.)

Allocating indirect costs between inventory and period expense is a key factor in determining inventory cost. That process can be challenging given the number of considerations involved. For example, while variable production overhead is generally allocated to production units based on the actual use of the production facilities, fixed production overhead should be allocated based on the normal capacity of the production facilities. Unallocated overhead, as well as abnormal freight, handling costs, and spoilage should be charged to current period expense. Conversely, general and administrative costs, which usually are considered period expenses, should be allocated to inventory if they relate to purchasing or producing products for sale. In no case, however, should all overhead be excluded from inventory. (FASB ASC 330-10-30-3 through 30-8)

Methods Used to Charge Inventory to Cost of Sales or Other Expense

The primary objective in determining how inventory will be charged to cost of sales or other expense is to select a method that most accurately reflects the organization's change in net assets for the period. In some cases, it may be appropriate to apply one method to one portion of inventory and other methods to other portions of inventory. Generally accepted accounting principles essentially permit the following methods of determining the sequence of costs to be charged to cost of sales or other expense: (FASB ASC 330-10-30-9)

a. *Specific identification.* Under the specific identification method, the cost of each inventory item is tracked from the time of purchase through the time of sale or use in one of the organization's programs. When an item is sold or used, its specific cost is charged to cost of sales or other expense. Generally, organizations use the specific identification method when there are small numbers of easily identifiable inventory items, such as jewelry, art reproduction items, or large pieces of specialized equipment.

b. *First-in, first-out.* The first-in, first-out (FIFO) method assumes that items flow through inventory in the order they were purchased. That is, the first items purchased are the first items used or sold. The FIFO method produces an inventory account that more closely approximates replacement costs since inventory consists of the items that were purchased most recently. The FIFO cost flow method may be preferred in instances where spoilage or obsolescence is a concern because it more closely corresponds to the physical flow of goods.

c. *Average cost.* The average cost method values inventory based on the average cost of all similar items available during the period. Generally, average cost is determined using either the weighted-average method or the moving-average method.

(1) Under the weighted-average method, average cost is computed at the end of a period by dividing the cost of all items available for sale or use during the period by the number of units available for sale or use during the period. That result is multiplied by the number of items remaining in inventory to obtain the ending inventory's cost, and remaining product costs are charged to cost of sales or other expense.

(2) Under the moving-average method, a new average cost is computed after each purchase rather than at the end of the period. Thus, when an inventory item is sold or used, the average cost existing at that time is charged to cost of sales or other expense.

The weighted-average method generally is applied when a periodic inventory system is used, and the moving-average method is applied when a perpetual inventory system is used.

d. *Last-in, first-out.* The last-in, first-out (LIFO) method assumes that the most recently purchased inventory items are the first items to be sold or used. Because it results in the most recent purchases being charged to cost of sales or other expense, the LIFO method more closely matches current costs with current revenues. However, it also results in an inventory account that consists of old costs, which may or may not reflect the current value of the assets.

Exhibit 6-1 illustrates how inventory and cost of sales or other expense is calculated under the FIFO, average cost, and LIFO methods.

Exhibit 6-1

Illustrative Calculations under the FIFO, Average Cost, and LIFO Inventory Methods

Assume that XYZ Organization, which uses a periodic inventory system, made the following inventory purchases during the year:

	Units	Unit Cost	Total Cost
January 28	300	$ 1.00	$ 300
April 5	400	1.10	440
June 8	200	1.20	240
October 14	600	1.25	750
November 3	300	1.30	390
December 10	600	1.35	810
	2,400		$ 2,930

Assume further that XYZ Organization's beginning inventory contained 1,000 units at $.90 per unit and its ending inventory contains 1,200 units.

First-in, First-out

Under the FIFO method, ending inventory contains the most recently purchased items. Thus, ending inventory and cost of sales would be computed as follows:

	Units	Unit Cost	Total Cost
Ending inventory:			
December 10 purchase	600	$ 1.35	$ 810
November 3 purchase	300	1.30	390
October 14 purchase	300	1.25	375
	1,200		$ 1,575
Cost of sales:			
Beginning inventory (1,000 × $.90)			$ 900
Purchases			2,930
			3,830
Ending inventory			(1,575)
			$ 2,255

Weighted Average Cost

Under the weighted average cost method, inventory and cost of sales is based on the average cost per unit as follows:

	Units	Unit Cost	Total Cost
Beginning inventory	1,000	$ .90	$ 900
Purchases	2,400		2,930
	3,400		$ 3,830
Average cost per unit ($3,830 ÷ 3,400)			$ 1.13
Ending inventory (1,200 × $1.13)			$ 1,356
Cost of sales:			
Beginning inventory (1,000 × $.90)			$ 900
Purchases			2,930
			3,830
Ending inventory			(1,356)
			$ 2,474

Last-in, First-out

Under the LIFO method, the most recently purchased items are charged to cost of sales and inventory contains the oldest items. Thus, inventory and cost of sales would be computed as follows:

	Units	Unit Cost	Total Cost
Ending inventory:			
Beginning inventory	1,000	$ .90	$ 900
January 28 purchase	200	1.00	200
	1,200		$ 1,100
Cost of sales:			
Beginning inventory (1,000 × $.90)			$ 900
Purchases			2,930
			3,830
Ending inventory			(1,100)
			$ 2,730

* * *

GAAP recognizes that in some cases, it may be preferable to use variations of the methods described in the preceding paragraph. (FASB ASC 330-10-30-13) For example, a museum gift shop whose inventories consist of large numbers of low-dollar value items may find it preferable to use a reversed mark-up procedure of inventory pricing, such as the retail inventory method. The retail method is an average cost method designed to approximate the lower of FIFO cost or market. It requires determining inventory at the end of the period at retail and converting it to cost using an average cost ratio as follows:

	Cost	Retail
Beginning inventory	$ 50,000	$ 62,500
Purchases	75,000	90,000
	$ 125,000	152,500
Sales		(100,000)
Ending inventory at retail		$ 52,500
Ratio of cost to retail ($125,000 ÷ $152,000)		82%
Ending inventory at cost ($52,500 × 82%)		$ 43,050

Although rarely used by nonprofit organizations, another method of accounting for inventories is the standard cost method. The standard cost method values inventory items based on predetermined unit costs for material, labor, and manufacturing overhead. The standard costs used approximate the ideal or expected costs based on past performance or other criteria. Differences between standard costs and actual costs are recorded in variance accounts and charged to current period expense rather than inventory. GAAP permits organizations to use the standard cost method, but only if standard costs are adjusted periodically to reflect the approximate cost under one of the recognized inventory cost methods above. (FASB ASC 330-10-30-12)

Subsequent Measurement of Inventory after the Effective Date of ASU 2015-11

The guidance below applies *after* the effective date of ASU 2015-11, *Inventory (Topic 330): Simplifying the Measurement of Inventory*. ASU 2015-11 is effective for fiscal years beginning after December 15, 2016 and interim periods within fiscal years beginning after December 15, 2017. Early application is permitted as of the beginning of an

interim or annual period. The guidance is required to be applied prospectively. (FASB ASC 330-10-65-1) Guidance that applies *before* the effective date of ASU 2015-11 is discussed later in this lesson.

The subsequent measurement of inventory is different for inventory measured using (a) LIFO or the retail inventory method, and (b) any other method. (FASB ASC 330-10-35-1A) The guidance for inventory measured at LIFO or the retail inventory method is discussed below. The guidance for inventory measured using other than the LIFO or retail inventory methods and subsequent measurement guidance that applies to all inventory are discussed later in this lesson.

Inventory Measured Using LIFO or the Retail Inventory Method. When evidence exists that the utility of the goods (through their disposal in the ordinary course of business) will be less than their cost, whether due to obsolescence, deterioration, damage, price changes, or other factors, the inventory should generally be written down to *market* and a loss should be recognized in the current period. This is referred to as the rule of the lower of cost or market. Market is considered to be current replacement cost, with the following limitations: (FASB ASC 330-10-20; 330-10-35-1C through 35-5)

a. Market should not exceed the inventory's net realizable value, which is its estimated selling price less reasonably predictable costs of completion, disposal, and transportation. (In other words, net realizable value should be used to value inventory if it is lower than current replacement cost.)

b. Market should not be less than net realizable value reduced by an allowance for an approximately normal profit margin. (Thus, cost should be used to value inventory if net realizable value will provide for an approximately normal profit, even if current replacement cost is lower than historical cost.)

To illustrate, assume that an inventory item measured using LIFO has a cost of $100, sells for $120 (which provides for a normal profit margin of $20) and its current replacement cost drops to $80.

- If the selling price is unaffected by the drop in current replacement cost (perhaps because of firm sales commitments), the item would continue to be carried at $100 since the selling price will recover cost plus the normal profit margin.

- If the selling price drops to $100, the item would be carried at $80. The current period statement of activities would report a loss of $20 for the loss in value.

- If the item's net realizable value drops to $40, the item would be stated at $40.

Inventory Measured Using Methods Other Than LIFO or the Retail Inventory Method. Inventories measured using methods other than LIFO or the retail inventory method, such as FIFO or average cost, should be subsequently measured at the lower of cost and *net realizable value*. Net realizable value is the estimated selling price less reasonably predictable costs of completion, disposal, and transportation. Consequently, a loss should be recognized in the period when evidence exists that the net realizable value of inventory is lower than its cost. A loss may be necessary due to obsolescence, deterioration, damage, price changes, or other factors. (FASB ASC 330-10-35-1B)

Subsequent Measurement Considerations Applicable to All Inventory. The inventory measurement methods described above are commonly applied to each item in inventory. However, a method may be applied to each inventory item, total inventory, or the total of the components of each major category of inventory depending on the method that most clearly presents current period income. For example, if the cost of a minor component of a finished product exceeds its current replacement cost (for LIFO and retail method inventories) but the cost of the finished product does not exceed market value, the cost of the component need not be reduced to market. (FASB ASC 330-10-35-8 through 35-11)

If the inventory is the hedged item in a fair value hedge, the carrying amount of the inventory (including adjustments resulting from hedge accounting) should be the "cost" used to determine whether a write down to lower of cost or market (or net realizable value) is necessary. (FASB ASC 330-10-35-7A) Fair value hedges were discussed in Lesson 4.

Subsequent Measurement of Inventory before the Effective Date of ASU 2015-11

Obsolescence, deterioration, damage, changing prices, or other factors may cause an inventory's recorded cost to exceed its market value. In such cases, GAAP requires inventory to be written down to market value and an unrealized loss to be recognized in the current period change in net assets. Market value is considered to be current replacement cost, with the following limitations: (FASB ASC 330-10-35-1 through 35-5)

a. Market value should not exceed the inventory's net realizable value, which is its estimated selling price less reasonably predictable costs of completion, disposal, and transportation. (In other words, net realizable value should be used to value inventory if it is lower than current replacement cost.)

b. Market value should not be less than net realizable value reduced by an allowance for an approximately normal profit margin. (Thus, cost should be used to value inventory if net realizable value will provide for an approximately normal profit, even if current replacement cost is lower than historical cost.)

To illustrate, assume that an item costs $100, sells for $120 (which provides for a normal profit margin of $20) and its current replacement cost drops to $80.

- If the selling price is unaffected by the drop in current replacement cost (perhaps because of firm sales commitments), the item would continue to be carried at $100 since the selling price will recover cost plus the normal profit margin.

- If the selling price drops to $100, the item would be carried at $80. The current period statement of activities would report a loss of $20 for the loss in value.

- If the item's net realizable value drops to $40, the item would be stated at $40.

Generally, the lower of cost or market rule should be applied to each item in inventory. However, it may be applied to each inventory item, total inventory, or the total of the components of each major category of inventory depending on the method that most fairly presents the current period change in net assets. (FASB ASC 330-10-35-8 through 35-11) For example, if the cost of a minor component of a finished product exceeds its current replacement cost but the cost of the finished product does not exceed market value, the cost of the component need not be reduced to market.

Stating Inventories above Cost

Precious metals that have a fixed monetary value with no substantial cost of marketing may be stated at that monetary value, even if it exceeds cost. Other inventory items may be stated above cost only if all of the following conditions are met:

- Appropriate approximate costs for the item cannot be determined.

- The item is immediately marketable at a quoted market price.

- The item is interchangeable.

In such cases, the items generally are stated at market price less disposal costs. Agricultural or mineral products are examples of inventories that may meet the preceding conditions. (FASB ASC 330-10-35-15 and 35-16)

Donated Inventories

Donated materials are recorded as contributions and inventory at fair value in the period received. GAAP also requires unconditional promises to give materials to be recorded as contributions, even though the nonprofit organization may not receive the assets until a future period. (Donations of inventory that simply pass through the organization to their intended beneficiaries with the organization acting only as an agent are not recorded, however.) If donated assets have questionable or uncertain value and no alternative use that adds to their value, they should not be recognized in the financial statements. Finally, materials donated for a specific use would be reported as restricted contributions. (FASB ASC 958-605-25-4; 958-605-30-2; 958-605-45-3)

LOSSES ON FIRM PURCHASE COMMITMENTS

Expected losses on firm, noncancelable purchase commitments for inventory goods should be measured in the same manner as inventory losses and accrued through a charge to the current period change in net assets. However, there is no loss on such commitments when the sale of such items is protected by firm sales commitments or other circumstances that reasonably assure sales without price decline. (FASB ASC 330-10-35-17 and 35-18)

CONSIGNED INVENTORIES

Generally accepted accounting principles do not specifically address consigned inventories. However, a basic accounting concept is that an organization should not record an asset until it receives title to the asset, and it should not record a sale until title transfers to the customer. In traditional consignment arrangements, the consignor ships goods to the consignee but continues to own them until they are sold by the consignee. When the goods are sold, title passes directly from consignor to the purchaser—title never passes to the consignee. Under such arrangements, no entries are needed at the time of consignment. That is, consigned goods continue to be included in inventory in the consignor's financial statements and not in the consignee's financial statements. When the consigned goods are sold, however, an entry is needed on the consignor's books to record the sale and on the consignee's books to record commission income. (In some consignment arrangements, the consignee acquires title to the goods from the consignor at the time of the sale. In such cases, when the consigned inventory is sold, the consignee records the transaction as a sale to the purchaser rather than as commission income.)

DISCLOSURE REQUIREMENTS

An organization should include the following disclosures about inventories in its financial statements: (FASB ASC 235-10-50-4; 330-10-50-1 through 50-5)

a. Basis for stating inventories (for example, the cost basis).

b. Method of determining costs (for example, average cost; first-in, first-out; last-in, first-out). It is common practice to disclose the inventory basis and method of determining cost within the statement of financial position caption (for example, "Inventories, at the lower of first-in, first-out cost or market"). However, the disclosures may be made in the notes rather than on the face of the statement of financial position.

c. If applicable, the fact that inventories are stated above cost.

d. Accrued net losses on firm purchase commitments for inventory separately disclosed in the statement of activities.

e. After the effective date of ASU 2015-11, substantial and unusual losses resulting from the subsequent measurement of inventory.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

18. Inventory is defined as which of the following?

    a. Long-term assets.

    b. Depreciable assets held for sale.

    c. Property used in relation to an organization's nonprofit purpose.

    d. Property used in the process of production for sale or use.

19. Under what inventory method is the cost of each item tracked from purchase until its sale or use?

    a. Average cost.

    b. First-in, first-out (FIFO).

    c. Last-in, first-out (LIFO).

    d. Specific identification.

20. Assuming all other conditions are met, when can inventory items be stated above cost?

    a. The inventory items are building materials.

    b. The value of the item can be estimated.

    c. The item is immediately marketable at a quoted price.

    d. The item is unique.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

18. Inventory is defined as which of the following? **(Page 169)**

    a. Long-term assets. [This answer is incorrect. Long-term assets that are subject to depreciation (or will be subject to depreciation when they are put into use) are specifically *excluded* from the definition of inventory under GAAP.]

    b. Depreciable assets held for sale. [This answer is incorrect. Per GAAP, depreciable assets that are retired from use and held for sale are *not* considered inventory.]

    c. Property used in relation to an organization's nonprofit purpose. [This answer is incorrect. As defined in FASB ASC 330-10-20, inventory is personal tangible property that is held for sale or use in the ordinary course of business. That definition is not specific to a nonprofit organization's tax-exempt purpose.]

    d. Property used in the process of production for sale or use. [This answer is correct. Per FASB ASC 330-10-20, inventory is defined as personal tangible property that is (1) held for sale or use in the ordinary course of business, (2) in the process of production for sale or use, or (3) consumed in the production of goods or services to be available for sale or use.]

19. Under what inventory method is the cost of each item tracked from purchase until its sale or use? **(Page 170)**

    a. Average cost. [This answer is incorrect. The average cost method values inventory based on the average cost of all similar items available during the period. Generally, average cost is determined using either the weighted-average method or the moving-average method.]

    b. First-in, first-out (FIFO). [This answer is incorrect. The FIFO method assumes that the items flow through inventory in the order in which they were purchased. That is, the first items purchased are the first items used or sold.]

    c. Last-in, first-out (LIFO). [This answer is incorrect. The LIFO method assumes that the most recently purchased inventory items are the first items to be sold or used.]

    d. Specific identification. [This answer is correct. As described in FASB ASC 330-10-30-9, under the specific identification method, the cost of each inventory item is tracked from the time of purchase through the time of sale or use in one of the organization's programs.]

20. Assuming all other conditions are met, when can inventory items be stated above cost? **(Page 175)**

    a. The inventory items are building materials. [This answer is incorrect. Precious metals that have a fixed monetary value with no substantial cost of marketing may be stated at that monetary value, even if it exceeds costs. However, that is the only category of inventory with this type of universal rule. Building materials would have to meet the conditions from FASB ASC 330-10-35-15 and 35-16 to be stated above cost.]

    b. The value of the item can be estimated. [This answer is incorrect. As discussed in FASB ASC 330-10-35-15 and 35-16, to be stated above cost, appropriate approximate costs for the inventory items cannot be determinable.]

    c. The item is immediately marketable at a quoted price. [This answer is correct. Inventory items may be stated above cost only if they meet all of the conditions listed in from FASB ASC 330-10-35-15 and 35-16. One of those conditions is that the item be immediately marketable at a quoted market price.]

    d. The item is unique. [This answer is incorrect. Per from FASB ASC 330-10-35-15 and 35-16, one of the conditions that must be met for an inventory item to be stated above cost is that it be interchangeable.]

Lesson 7: Receivables—Other

INTRODUCTION

SOURCE: FASB ASC 310-10 and 326

Receivables due within one year are generally recorded at their face amount. Notes receivable should be valued at the present value of the consideration exchanged at the date of the transaction. When interest is not stated, the stated amount is unreasonable, or the stated amount of a note is significantly different from its fair value, the note should be recorded at the fair value of the property, goods, or services exchanged or an amount that approximates the note's fair value, whichever is more clearly evident. An allowance for uncollectible receivables should be recorded if it is probable that receivables recorded at the financial statement date will not be collected and the uncollectible amount can be reasonably estimated. The allowance should be recorded even if specific uncollectible receivables cannot be identified.

A loan is considered impaired if it is probable that at least some of the scheduled principal or interest payments will not be collected. An impaired loan should be measured based on the present value of expected future cash flows. (Expected future cash flows should be discounted using the loan's effective interest rate.) As a practical expedient, however, an impaired loan may be measured at its market value or the fair value of its collateral if it is collateral dependent.

If the measured value of the loan is less than the recorded investment in the loan, a loss should be recognized by recording a valuation allowance (or adjusting an existing valuation allowance for the impaired loan) and a corresponding charge to bad debt expense or loss.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine the GAAP accounting and disclosure requirements for specific receivables that nonprofit organizations may have, such as loan impairment.

ACCOUNTING REQUIREMENTS

GENERAL

Receivables are contractual rights to receive money, either on demand or on fixed or determinable dates, that may or may not include a stated provision for interest. Receivables may be in the form of loans, notes, or other types of financial instruments and may arise from loans or other transactions. (FASB ASC 310-10-05-4; 310-10-25-10)

Nonprofit organizations frequently have receivables that do not arise from donor promises or pledges. Accounts receivables may result from programs of the organizations, such as from program service fees or sales of publications and program materials. Organizations may also have receivables from members, including membership dues, initiation fees, service fees, tuition charges, or assessments. In addition, organizations might have notes receivable that result from student loans, selling a piece of property, mortgages held by church development funds, or as a normal part of their programs and activities. For example, a symphony orchestra association might receive donor restricted donations that are to be used as a loan fund for members of the orchestra to purchase instruments.

Another type of receivable frequently reported by nonprofit organizations arises from grants. In some cases a grant may be considered a contribution, in others it may be considered an exchange transaction, and in still others a grant may have elements of both types of transactions. Accordingly, an organization must determine whether a grant receivable is an unconditional promise to give, a conditional promise to give, or a receivable from an exchange transaction. That determination will often require significant judgment.

Receivables due within one year are generally recorded at their face amount. Notes receivable are valued at the present value of the consideration exchanged at the date of the transaction. When a note is received solely for cash,

its present value is presumed equal to the cash proceeds exchanged. When a note is received for property, goods, or services, its present value may be based on the established exchange price (i.e., cash price) for the property, goods, or services, if determinable, or the quoted price of notes traded in an active market. When interest is not stated, the stated amount is unreasonable, or the stated amount of a note is significantly different from its fair value, the note should be recorded at the fair value of the property, goods, or services exchanged or an amount that approximates the note's fair value, whichever is more clearly evident. In the absence of evidence about the fair value of the property, goods, or services or the fair value of the note, the present value should be determined by discounting future payments under the note at an imputed interest rate. (FASB ASC 310-10-30-2 through 30-6)

Uncollectible Receivables

There usually exists some degree of uncertainty about whether other receivables will be collected. An allowance for uncollectible receivables should be recorded if both of the following conditions are met:

a. it is probable that receivables recorded at the financial statement date will not be collected and

b. the uncollectible amount can be reasonably estimated.

The allowance should be recorded even if specific uncollectible receivables cannot be identified. (FASB ASC 310-10-35-7 through 35-9)

An organization may base its estimate of uncollectible receivables on its own experience, the experience of similar organizations, the debtor's ability to pay, or an appraisal of current economic conditions. An organizations inability to reasonably estimate uncollectible receivables precludes it from recording an allowance and may suggest that it should use another method; for example, cost recovery or cash basis. (FASB ASC 310-10-35-10 and 35-11)

LOAN IMPAIRMENT

A *loan* is defined as the contractual right to receive money on demand or on fixed or determinable dates and is recorded as an asset in the creditor's statement of financial position. Examples of loans include notes and accounts receivable with terms longer than one year. Notes and accounts receivable maturing within one year are *not* considered loans, however. (FASB ASC 310-10-20)

When Is a Loan Impaired?

A loan is considered impaired if it is probable that the creditor will be unable to collect all amounts due under the contractual terms of the loan agreement. In other words, a loan is impaired if it is probable that at least some of the scheduled principal or interest payments will not be collected. (For a loan that has been restructured in a troubled debt restructuring, the "contractual terms of the loan agreement" refers to the terms of the original agreement, not the restructured agreement.) GAAP does not provide specific guidance on making that determination although it states that the judgment should be based on normal loan review procedures. GAAP does list the following events that do *not* cause a loan to be considered impaired, however: (FASB ASC 310-10-35-16 and 35-17)

- There are insignificant delays or shortfalls in payment amounts.
- There is a delay in payment, but the creditor expects to collect all amounts due plus accrued interest at the contractual rate for the period of the delay

Measuring Impairment

If a loan is considered to be impaired, its value generally should be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate. As a practical expedient, however, the loan's value may be based on (a) the loan's observable market price or (b) the fair value of the loan's collateral, less discounted estimated costs to sell, if the collateral is expected to be the sole source of repayment. (The fair value of the loan's collateral must be used to value the loan if foreclosure is probable.) The selection of the method used to value a loan may be made either on a loan-by-loan or aggregate basis. (However, certain methods used to measure impairment may only be appropriate on a loan-by-loan basis because of risk characteristics that are

unique to an individual borrower.) Once a method is selected for a loan, it should be applied consistently unless circumstances change. (FASB ASC 310-10-35-21 through 35-24; 310-10-35-29; 310-10-35-32)

If the value of the loan (as determined in the preceding paragraph) is less than the recorded investment in the loan, a loss should be recognized by recording a valuation allowance (or adjusting an existing valuation allowance for the impaired note) and a corresponding charge to bad debt expense or loss. (FASB ASC 310-10-35-24) As changes in the amount or timing of the expected future cash flows occur (thus affecting the net present value of the impaired loan), the valuation allowance should be adjusted accordingly. (FASB ASC 310-10-35-37)

Using the Expected Cash Flows Method to Measure the Loan. Measuring the impaired loan based on expected future cash flows requires making subjective judgments about several uncertainties. For example, if the loan is past due (which probably is the case for most impaired loans), a judgment must be made about when the delinquent payments will be made. The creditor should consider all available evidence, including estimated costs to sell if those costs are expected to reduce the cash flows available to satisfy the loan. The weight given to the evidence should be commensurate with the creditor's ability to objectively verify the evidence. (FASB ASC 310-10-35-26)

Under the expected cash flows method, the loan's *effective interest rate* should be used to discount the expected future cash flows. The effective rate of the loan is the contractual rate, adjusted for any premiums, discounts, or deferred loan fees or costs existing at the loan origination date. (FASB ASC 310-10-20) In addition—

a. if the loan has a floating interest rate, the effective rate should be initially computed using the rate in effect at the date the loan is first considered impaired. When measuring the impaired loan thereafter, cash flows may be discounted using the effective interest rate at the recalculation date or the rate in effect at the date the allowance initially was provided. (FASB ASC 310-10-35-28)

b. if the loan was restructured in a troubled debt restructuring, the effective interest rate should be based on the original contractual rate, not the rate specified in the restructuring agreement. (FASB ASC 310-40-35-12)

Recognizing Income on Impaired Loans

GAAP does not prescribe how interest income from an impaired loan should be measured, recognized, or displayed. Some methods used to recognize income may result in a recorded investment in the impaired loan that is less than the measured value of the loan (for example, if interest is recognized using the cost-recovery method, cash-basis method, or a combination of those methods). In that case, even though the loan may meet the definition of an impaired loan, no additional impairment should be recognized. (FASB ASC 310-10-35-39)

OVERVIEW OF THE GUIDANCE IN ASU 2016-13

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, which introduces the current expected credit loss (CECL) impairment model. Current GAAP for credit losses is based on an incurred loss methodology that delays recognition of a credit loss until it is probable that a loss has been incurred. The CECL model replaces the incurred loss impairment methodology (that is, the *probable* threshold) in current GAAP with a forward-looking methodology that reflects expected credit losses and requires consideration of a broader range of information for estimating those losses. ASU 2016-13 also expands existing disclosure requirements.

ASU 2016-13 adds new FASB ASC 326, *Financial Instruments–Credit Losses*. Various conforming amendments affecting numerous other FASB ASC Topics also have been made.

For nonprofit organizations, ASU 2016-13 is effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. Early application is permitted for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Due to the delayed effective dates, this course does not fully incorporate the new guidance in FASB ASC 326 or other amendments throughout the FASB ASC that were made by the ASU. Instead, the following paragraphs provide a summary of the new guidance. This course will be more fully updated for the requirements of ASU 2016-13 as the effective dates near. Accountants requiring additional information can download the ASU from the FASB's website at **www.fasb.org** or from Checkpoint at **checkpoint.riag.com**.

Current Expected Credit Loss (CECL) Model for Assets Carried at Amortized Cost

Scope. The CECL model applies to all entities with the following items: (FASB ASC 326-20-15-2)

- Financial assets measured at amortized cost, including financing receivables (loans), held-to-maturity debt securities, trade receivables, reinsurance recoverables, and receivables related to repurchase and securities lending agreements.

- Net investments in leases recorded by lessors.

- Off balance sheet credit exposures not accounted for as insurance, including loan commitments, standby letters of credit, and financial guarantees.

The guidance does not apply to the following items: (FASB ASC 326-20-15-3)

- Nonprofit organization promises to give (pledges receivable).

- Financial assets that are measured at fair value through the change in net assets.

- Defined contribution employee benefit plan loans to participants.

- Loans and receivables between entities under common control.

Measuring Expected Credit Losses. The allowance for credit losses is a valuation account that should be deducted from the amortized cost basis of an asset to present the net amount expected to be collected. (FASB ASC 326-20-30-1) Expected credit losses should be measured based on relevant information about past events, including historical experience, current conditions, and reasonable and supportable forecasts. The remaining contractual life of the asset, including prepayments, should be considered. However, extensions, renewals, or modifications should not be considered unless there is a reasonable expectation that the organization will enter into a troubled debt restructuring with the borrower. (FASB ASC 326-20-30-6 and 30-7)

Methods that may be used to measure expected credit losses include: discounted cash flow, loss-rate, roll-rate, probability-of-default, or an aging schedule. The guidance does not require use of a discounted cash flow method to estimate expected credit losses. (FASB ASC 326-20-30-3) The method chosen should use relevant information about past events, current conditions, and reasonable and supportable forecasts that affect the reported amount's collectibility. If forward-looking information is beyond time periods for reasonable and supportable forecasts, an organization may revert to historical information that reflects the contractual term of the asset, considering prepayments, either immediately or using a straight-line or other rational and systematic basis. (FASB ASC 326-20-30-7 and 30-9)

Credit losses should be assessed at each reporting date, applying a consistent measurement method. Estimates should be recognized through an allowance for credit losses account, which reduces the net carrying amount of the asset. Subsequent changes in the allowance for credit losses should be adjusted through the change in net assets by increasing or decreasing the credit loss expense account. (FASB ASC 326-20-35-1)

Purchased Credit Deteriorated (PCD) Assets. *Purchased financial assets with credit deterioration* are defined as financial assets that at acquisition have experienced more than an insignificant amount of credit deterioration (according to the acquirer). (FASB ASC 326-10-20) Credit losses for PCD assets should be determined in a manner similar to other assets measured at amortized cost; however, the initial amortized cost of the assets is recorded as the purchase price plus the allowance for credit losses. Subsequent changes in the allowance for credit losses use the CECL model and are included in earnings through credit loss expense. Interest income is recognized on the effective interest rate method, which excludes any credit-related discount at the date of acquisition. (FASB ASC 326-20-30-13; 326-20-35-1; 310-10-35-53B)

Collateral-Dependent Financial Assets. A practical expedient is provided for collateral-dependent financial assets; that is, assets expected to be repaid substantially through the operation or sale of the collateral when the borrower is having financial difficulties. Under the practical expedient, a creditor may record the asset at the fair

value of the collateral, adjusted for discounted estimated costs to sell the collateral (unless the operation of the asset alone is expected to satisfy repayment). (FASB ASC 326-20-35-4 and 35-5)

Disclosures

Existing disclosure requirements for credit losses are enhanced to enable financial statement users to understand (a) the inherent credit risk in the portfolio, (b) how management assesses the credit quality of the portfolio, and (c) the estimate of credit losses and any changes in the estimate during the period. (FASB ASC 326-20-50-2; 326-30-50-2) Many of the current disclosures required for financial assets and credit losses are retained and amended to reflect the change to the expected credit loss methodology. In addition, item a. of the rollforward of the allowance for credit losses discussed later in this lesson is required for each major security type and should indicate any initial allowance for credit losses related to PCD assets. (FASB ASC 326-20-50-13)

Transition

The credit loss guidance generally should be implemented with a cumulative-effect adjustment to beginning net assets in the period of adoption. (FASB ASC 326-10-65-1) In the period of adoption, the following disclosures are required: (FASB ASC 326-10-65-1f)

- The nature of the change in accounting principle, and an explanation of the principle
- Method of applying the change
- Material effects on specific line items in the statement of financial position (excluding subtotals) at the beginning of the period of adoption
- Cumulative effect of the change to net assets at the beginning of the period of adoption

DISCLOSURE REQUIREMENTS

The "Current Expected Credit Loss (CECL) Model for Assets Carried at Amortized Cost" discussion earlier in this lesson provided an overview of disclosures required by ASU 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. As previously discussed, this course does not fully incorporate the requirements of ASU 2016-13 due to its delayed effective dates.

GENERAL

All significant categories of loans and trade receivables should be presented separately in the statement of financial position or disclosed (for example, trade receivables, grants from exchange transactions, advance payments on purchases, etc.). Amounts due from affiliated organizations, employees or directors, and loans or trade receivables held for sale or that collateralize borrowing, should be presented separately in the statement of financial position. (FASB ASC 310-10-45-2; 310-10-45-13; 310-10-50-3; 860-30-25-5) Amounts due from officers, employees, affiliates or subsidiaries should be classified as current, if applicable, only if they are collectible in the ordinary course of business within a year. (FASB ASC 310-10-45-9; 210-10-45-1) In addition, the following should be disclosed:

a. The allowance for doubtful accounts (or allowance for credit losses) (FASB ASC 310-10-50-1A; 310-10-50-4)

b. Accounting policies for loans and trade receivables (including those held for sale), interest income, credit losses and doubtful accounts, and nonaccrual and past due loans and trade receivables (FASB ASC 310-10-50-1A; 310-10-50-2; 310-10-50-4A; 310-10-50-6; 310-10-50-9; 310-20-50-1)

c. The aggregate amount of gains or losses on sales of loans or trade receivables (including recorded unrealized gains and losses), either presented separately in the financial statements or disclosed in the notes to the financial statements (FASB ASC 860-20-50-5)

d. Foreclosed and repossessed assets not subsequently to be used in operations, either presented separately in the financial statements or disclosed in the notes to the financial statements. The carrying

amount of foreclosed residential real estate properties held at the reporting date as a result of obtaining physical possession also should be disclosed. (FASB ASC 310-10-45-3; 310-10-50-11)

e. For receivables that are collateral:

   (1) The carrying amount and classification of loans and trade receivables that serve as collateral for borrowings and that are not reported separately in the statement of financial position (FASB ASC 310-10-50-5; 860-30-50-1A)

   (2) The carrying amounts and classification of the related liabilities, including qualitative information about the relationship between the assets that serve as collateral and the related liabilities. (FASB ASC 310-10-50-5; 860-30-50-1A)

   (3) The recorded investment in consumer mortgage loans secured by residential real estate properties for which formal foreclosure proceedings are in process according to applicable local jurisdictional requirements. (FASB ASC 310-10-50-35)

f. Unearned income, unamortized discounts and premiums, net unamortized deferred fees and costs, and imputed interest for loans and trade receivables (FASB ASC 310-10-50-1A; 310-10-50-4; 310-20-50-1)

Nonaccrual and Past Due Receivables

The following information should be disclosed about nonaccrual and past due loans and trade receivables as of the date of each statement of financial position presented: [This disclosure should be provided for financing receivables by *class of financing receivable*, except for (a) receivables measured at fair value with changes in fair value reported in the change in net assets, (b) receivables measured at the lower of cost or fair value, and (c) trade receivables (other than credit card receivables) with a contractual maturity of one year or less that arose from the sale of goods or services. This disclosure does not apply to loans acquired with deteriorated credit quality.] (FASB ASC 310-10-50-5A; 50-5B and 50-7)

a. Recorded investment in such receivables on nonaccrual status.

b. Recorded investment in such receivables past due ninety days or more and still accruing.

In addition, disclosures should include an analysis of the age of the recorded investment in financing receivables that are past due at the end of the period, by class of financing receivable. [This disclosure is not required for (a) receivables measured at fair value with changes in fair value reported in the change in net assets, (b) receivables measured at lower of cost or fair value, (c) trade receivables (other than credit card receivables) with a contractual maturity of one year or less that arose from the sale of goods or services, or (d) loans acquired with deteriorated credit quality.] (FASB ASC 310-10-50-5A; 50-5B; 50-7A and 50-7B)

Allowance for Credit Losses Related to Loans

The following should be disclosed for each period for which a statement of activities is presented: [These disclosures should be provided by *portfolio segment*. In addition, the disclosures do not apply to (a) receivables measured at fair value with changes in fair value reported in the change in net assets, (b) receivables measured at lower of cost or fair value, (c) trade receivables (other than credit card receivables) with a contractual maturity of one year or less that arose from the sale of goods or services, or (d) lessor's net investment in leveraged leases. (FASB ASC 310-10-50-11A and 50-11B)]

a. The activity in the allowance for credit losses, including the beginning and ending balances, current year provision, direct write-downs charged against the allowance, and recoveries of amounts previously charged off.

b. The quantitative effect of changes in the policy for estimating the allowance for credit losses on the current year provision for credit losses

c. Amount of any significant purchases of financing receivables, sales of financing receivables, or reclassifications of financing receivables to be held for sale during each reporting period

d. Balance in the allowance for credit losses, and recorded investment in financing receivables related to each balance in the allowance for credit losses, at the end of each period disaggregated based on the organization's impairment method

To disaggregate the information in item d. above, amounts collectively evaluated for impairment, amounts individually evaluated for impairment, and amounts related to loans acquired with deteriorated credit quality should be separately disclosed. (FASB ASC 310-10-50-11C)

Credit Quality Information

Organizations should provide credit quality information that allows users to (a) understand how and to what extent management performs ongoing monitoring of the credit quality of financing receivables and (b) assess the quantitative and qualitative risks arising from the credit quality of financing receivables. To meet that objective, quantitative and qualitative information about the credit quality of financing receivables should be provided, by class of financing receivable, including: (FASB ASC 310-10-50-27 through 50-29)

a. Description of the credit quality indicator

b. Recorded investment in financing receivables by credit quality indicator

c. For each credit quality indicator, the date (or range of dates) when information for that credit quality indicator was updated

The credit quality disclosures in this paragraph do not apply to (a) receivables measured at fair value with changes in fair value reported in the change in net assets, (b) receivables measured at lower of cost or fair value, or (c) trade receivables (other than credit card receivables) with a contractual maturity of one year or less that arose from the sale of goods or services.

LOAN IMPAIRMENT

A creditor should disclose the following information about impaired loans: (This disclosure should be provided by class of financing receivable.) (FASB ASC 310-10-50-15)

a. As of the date of each statement of financial position presented:

    (1) The total recorded investment in impaired loans (as defined earlier in this lesson)

    (2) The amount of the recorded investment for which there is a related valuation allowance determined as discussed earlier in this lesson and the amount of the allowance

    (3) The amount of the recorded investment for which there is no valuation allowance determined as discussed earlier in this lesson

    (4) The total unpaid principal balance of impaired loans

b. The creditor's policy for recognizing interest income on impaired loans, including how cash receipts are recorded

c. For each period for which a statement of activities is presented:

    (1) The average recorded investment in impaired loans during the period

    (2) The related amount of interest income recognized during the time within that period that the loans were impaired

(3) If practicable, the amount of interest income recognized using a cash-basis method of accounting during the time within the period that the loans were impaired

d. The policy for determining which loans are assessed for impairment and the factors considered in determining that a loan is impaired

The information in items a. and c. above need not be disclosed about an impaired loan that was restructured in a troubled debt restructuring involving a modification of debt terms in years after the restructuring if (a) the interest rate in the restructuring agreement is at least equal to the rate the creditor was willing to accept at the time of the restructuring for a new loan with comparable risk and (b) the loan is not impaired based on the terms of the restructuring agreement. (FASB ASC 310-10-50-15; 310-40-50-2)

When an organization recognizes the change in present value of impaired loans attributable to the passage of time as interest income (versus including the entire change in bad debt expense), the amount of interest income recognized should be disclosed. (FASB ASC 310-10-50-19)

For loans that are impaired (as discussed earlier in this lesson) and individually evaluated for impairment, the amount and accounting for such loans should be disclosed for each class of financing receivable. (FASB ASC 310-10-50-14A)

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

21. Which of the following statements is accurate?

    a. Receivables due within the next twelve months are usually recorded at face value.

    b. Notes receivable are typically valued at their face amount at inception.

    c. If there is any doubt about collecting a receivable, an allowance for uncollectible receivables is required.

    d. Significant categories of loans and trade receivables should be aggregated for financial statement disclosures.

22. The current expected credit loss (CECL) model for assets carried at amortized cost applies to which of the following entities?

    a. Entity 1 is a nonprofit organization that received promises to give.

    b. Entity 2 has financial assets that are measured at fair value through changes in net assets.

    c. Entity 3 has net investments in leases that were recorded by lessors.

    d. Entity 4 has a loan from Entity 5, and both entities are under common control.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

21. Which of the following statements is accurate? **(Page 179)**

    a. Receivables due within the next twelve months are usually recorded at face value. [This answer is correct. Per FASB ASC 310-10-30-2 through 30-6, receivables due within one year are generally recorded at their face amount.]

    b. Notes receivable are typically valued at their face amount at inception. [This answer is incorrect. As described in FASB ASC 310-10-30-2 through 30-6, notes receivable are valued at the present value of the consideration exchanged at the date of the transaction.]

    c. If there is any doubt about collecting a receivable, an allowance for uncollectible receivables is required. [This answer is incorrect. Based on the guidance in FASB ASC 310-10-36-7 through 35-9, there usually exists some degree of uncertainty about whether other receivables will be collected. An allowance for uncollectible receivables should only be recorded if two conditions are met. One of those conditions is that not being able to collect is probable.]

    d. Significant categories of loans and trade receivables should be aggregated for financial statement disclosures. [This answer is incorrect. Under GAAP, all significant categories of loans and trade receivables should be presented separately in the statement of financial position or disclosed.]

22. The current expected credit loss (CECL) model for assets carried at amortized cost applies to which of the following entities? **(Page 182)**

    a. Entity 1 is a nonprofit organization that received promises to give. [This answer is incorrect. According to FASB ASC 326-20-15-3, the CECL model and related guidance do not apply to nonprofit organization promises to give.]

    b. Entity 2 has financial assets that are measured at fair value through changes in net assets. [This answer is incorrect. The CECL model and related guidance do not apply to financial assets that are measured at fair value through the change in net assets, per FASB ASC 326-20-15-3.]

    c. Entity 3 has net investments in leases that were recorded by lessors. [This answer is correct. Per FASB ASC 326-20-15-2, the CECL model applies to all entities with the following items: (1) financial assets measured at amortized cost; net investments in leases recorded by lessors; and (3) off balance sheet credit exposures not accounted for as insurance.]

    d. Entity 4 has a loan from Entity 5, and both entities are under common control. [This answer is incorrect. As discussed in FASB ASC 326-20-15-3, loans and receivables between entities under common control are not covered by the CECL model and related guidance.]

Lesson 8: Transfers of Financial Assets

INTRODUCTION

SOURCE: FASB ASC 860

A transfer of an entire financial asset (or group of entire financial assets or participating interest in an entire financial asset) in which the transferor has surrendered control over those assets is accounted for as a sale. When control of financial assets has been surrendered, the organization removes the financial assets from its statement of financial position.

A transferor has surrendered control over transferred assets if (a) the transferred assets have been isolated from the transferor, (b) each transferee (or third-party holder of beneficial interests if the transferee solely engages in securitization or asset-backed financing activates and is constrained from pledging or exchanging the assets) has the right to pledge or exchange the assets, and no condition constrains that right and provides more than a trivial benefit to the transferor, and (c) the transferor does not maintain effective control over the transferred assets.

After a transfer of financial assets, an organization initially recognizes servicing assets, servicing liabilities, and any other assets obtained and liabilities incurred at fair value. For participating interests transferred, the transferor allocates the previous carrying amount of the financial asset to interests sold and interests retained on the basis of relative fair values at the date of the transfer.

If the transfer does not meet the criteria for a sale or if a portion of an entire financial asset does not qualify as a participating interest, the transferor and transferee should account for the transfer as a secured borrowing and pledge of collateral.

Lease payments for sales-type and direct-financing leases and residual values that are guaranteed at the inception of a lease meet the definition of financial assets. Accordingly, a transfer of those assets in which the transferor surrenders control should be accounted for as a sale; if control is not surrendered, the transfer should be accounted for as a secured borrowing.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize the GAAP requirements that apply when nonprofit organizations account for and make disclosures about transfers of financial assets.

ACCOUNTING REQUIREMENTS

DEFINITION OF A FINANCIAL ASSET

A *financial asset* is cash, evidence of ownership in an entity, or a contract that conveys to another entity the right to: (FASB ASC 860-10-20)

a. receive cash or another financial instrument from the first entity or

b. exchange other financial instruments on potentially favorable terms with the first entity.

TRANSFERS OF FINANCIAL ASSETS

Conditions for a Sale of Financial Assets

When considering the accounting for a transfer of financial assets, the objective is to determine whether the transferor has surrendered control over the transferred assets. This includes considering: (FASB ASC 860-10-40-4)

a. Whether the transferee would be consolidated by the transferor.

b. The transferor's continuing involvement in the transferred assets.

c. All arrangements or agreements made at the same time as, or in contemplation of, the transfer.

To qualify for sale accounting, an entire financial asset cannot be divided into components before a transfer unless all components meet the definition of a participating interest. A transfer of an entire financial asset or a participating interest should not be accounted for partly as a sale and partly as a secured borrowing. (FASB ASC 860-10-40-4D)

A transfer of an entire financial asset (including a group of entire financial assets or a participating interest in an entire financial asset) in which the transferor surrenders control over the financial assets should be accounted for as a sale if all of following conditions are met: (FASB ASC 860-10-40-5)

a. The transferred financial assets have been isolated from the transferor (that is, put beyond the reach of the transferor and its creditors, even if the transferor is in bankruptcy or receivership).

b. Each transferee (or third party holder of beneficial interests if the transferee solely engages in securitization or asset-backed financing activities and is constrained from pledging or exchanging the assets it receives) has the right to pledge or exchange the transferred assets (or beneficial interests) it received, and no condition both (1) constrains the transferee (or third-party holder) from taking advantage of that right and (2) provides more than a trivial benefit to the transferor.

c. Effective control over the transferred assets (or third party beneficial interests) is not maintained by the transferor (including its consolidated affiliates or agents). Examples of effective control over the transferred assets include agreements that (1) both entitle and obligate the transferor to repurchase or redeem the transferred financial assets before their maturity, (2) provide the transferor with both the unilateral ability to cause the holder to return specific financial assets and a more-than-trivial benefit related to that ability (other than through a clean-up call), or (3) allow the transferee to require the repurchase of transferred financial assets by the transferor at a price so favorable that it is probable the repurchase will occur.

Accounting for Transfers of Financial Assets

If a transfer of an entire financial asset (or a group of entire financial assets) meets the conditions for sale accounting, the transferor (seller) should: (FASB ASC 860-20-25-1; 860-20-30-1 and 30-2; 860-20-40-1B)

a. Derecognize the transferred assets

b. Recognize and measure at fair value the servicing assets, servicing liabilities, and any other assets received (including a transferor's beneficial interest in the transferred assets) and liabilities incurred in the sale

c. Recognize any gain or loss on the sale in the change in net assets

The transferee should record any assets obtained and liabilities incurred at fair value.

If the transfer of an entire financial asset (or group of entire financial assets) does not meet the conditions for a sale, the transferor and transferee should account for the transfer as a secured borrowing with pledge of collateral as discussed later in this lesson. (FASB ASC 860-60-25-2)

Accounting for Transfers of Participating Interests

In addition to transfers of entire financial assets or groups, the guidance for accounting for a transaction as a sale discussed previously also applies to transfers of participating interests. A participating interest must possess the following characteristics from the date of transfer: (FASB ASC 860-10-40-6A)

a. The interest represents a proportionate (*pro rata*) ownership interest in the entire financial asset. This requirement applies regardless of the number of interests transferred. That is, the transferor's remaining interest must represent a proportionate interest in the entire financial asset before and after any subsequent interest transfers.

b. All cash flows from the entire financial asset are divided proportionately among the participating interest holders. The applicable cash flows for this requirement exclude cash flows allocated as compensation for services performed and any proceeds received by the transferor for the transferred portion. The compensation exclusion only applies if the cash flows allocated to compensation are not (1) subordinate to the proportionate cash flows and (2) significantly higher than an amount necessary to fairly compensate a substitute service provider. The proceeds exclusion applies as long as the transferor does not receive disproportionate cash flows from the entire financial asset due to the transfer.

c. Each interest holder of the entire financial asset has rights of equal priority and no interest is subordinated to another interest. This requirement is applicable even if the transferor enters bankruptcy or other receivership proceedings. In addition, interest holders have no recourse to the transferor or to other interest holders except for (1) standard representations and warranties, (2) ongoing servicing or administrative obligations, or (3) contractual obligations to share set-off benefits.

d. The entire financial asset may not be pledged or exchanged without approval of all interest holders.

If a transferred interest in an entire financial asset possesses the characteristics of a participating interest, and the transfer meets the conditions for a sale discussed earlier in this lesson, the transferor should: (FASB ASC 860-20-25-1; 860-20-30-1; 860-20-40-1A)

a. Allocate the previous carrying amount of the entire financial asset between the participating interests sold and the participating interest retained on the basis of their relative fair values at the date of the transfer

b. Derecognize the participating interests sold

c. Recognize and measure at fair value servicing assets, servicing liabilities, and any other assets obtained and liabilities incurred in the sale

d. Recognize any gain or loss on the sale in the change in net assets

e. Report any participating interest retained as the difference between the previous carrying amount of the entire financial asset and the amount derecognized.

The transferee should record the participating interests and any other assets obtained and liabilities incurred at fair value.

A transfer of a portion of an entire financial asset should be accounted for as a secured borrowing with pledge of collateral by the transferor and transferee, as discussed later in this lesson, if either of the following applies: (FASB ASC 860-10-40-4E; 860-30-25-2)

a. The transfer does not meet the definition of a participating interest provided above.

b. The transfer meets the definition of a participating interest, but does not meet the requirements for a sale discussed previously.

However, if a transferor transfers an entire financial asset in portions that individually do not qualify as transfers of participating interests, the requirements for a sale should be applied to the entire financial asset at the completion of the transfers.

Agreements That Maintain Effective Control over Transferred Assets

When financial assets are transferred, the transferor may enter into an agreement with the transferee that in substance results in the transferor maintaining effective control over the assets. An agreement maintains the transferor's effective control over transferred assets if it both entitles and requires the transferor to repurchase or redeem transferred financial assets from the transferee and meets all of the following conditions: (FASB ASC 860-10-40-24; 860-30-25-7)

a. The agreement is for the repurchase or redemption of the financial assets prior to maturity at a fixed or determinable price.

b. The agreement is entered into concurrently with (or in contemplation of) the transfer.

c. The assets to be repurchased or redeemed are the same (or substantially the same) as the transferred assets.

The transferor also maintains effective control over transferred financial assets when it has the unilateral ability to have the holder return specific financial assets and that ability provides more than a trivial benefit. (However, clean-up calls are permitted.) More than a trivial benefit exists if the price to be paid under the call or right is fixed, determinable, or otherwise potentially advantageous, unless it is probable when the option is written that it will not be exercised. The transferor's right to reclaim specific transferred assets at their fair value generally does not maintain effective control if it does not convey a more than trivial benefit to the transferor. (FASB ASC 860-10-40-28; 40-34 and 40-35)

An agreement that allows the transferee to require the transferor to repurchase the transferred financial assets at a price so favorable it is probable that the transferee will require the repurchase results in effective control by the transferor. As an example, a put option that is deep in the money when written would result in the transferor's effective control because it is probable that the transferee will exercise the option. (FASB ASC 860-10-55-34 and 55-42D)

Financial Assets Subject to Prepayment

Except for derivative instruments subject to the guidance in Lesson 4, financial assets (such as interest-only strips, other beneficial interests, other receivables, or loans) that contractually can be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its carrying value should be subsequently measured like investments in debt securities or equity securities with readily determinable fair values. (FASB ASC 860-20-35-2)

Transfers of Receivables with Recourse

When an organization transfers receivables (including groups or portions of entire receivables) to another entity (the transferee), it often does so with recourse. When there is recourse, the transferee has the right to receive payment from the transferor or the transferor must repurchase the receivables if the debtor defaults. A transfer of receivables with recourse must meet the conditions listed earlier in this discussion to be accounted for as a sale. The effect of recourse provisions on the application of those conditions may vary by jurisdiction. In some jurisdictions, the transfer of receivables with full recourse may not place the transferred assets beyond the reach of the transferor, its consolidated affiliates, and its creditors (however, transfers with limited recourse may). If a transfer of receivables in their entirety with recourse meets the conditions for a sale, the transfer should be accounted for as a sale with the proceeds reduced by the fair value of the recourse obligation. If the transfer of receivables with recourse does not meet the conditions for a sale, the transfer should be accounted for as a secured borrowing as discussed below. (A transfer of a portion of a receivable with recourse does not meet the definition of a participating interest discussed previously and should always be accounted for as a secured borrowing.) (FASB ASC 860-10-05-15; 860-10-55-46)

Transfers of Leased Property or Rental Payments under Sales-type or Direct Financing Leases Before the Adoption of ASU 2016-02

The following guidance applies before the adoption of ASU 2016-02, *Leases (Topic 842)*. Guidance on transfers of lease receivables under sales-type or direct financing leases after the adoption of ASU 2016-02 is discussed later in this lesson.

After a lease is entered into, the lessor may transfer the lease or the property subject to the lease to a third party. In such a case, the original accounting for the lease should not be reversed. (FASB ASC 840-30-40-8) Receivables related to sales-type and direct financing leases are made up of two components: minimum lease payments and residual values. When selling or securitizing lease financing receivables, the lessor should allocate its gross investment in receivables between minimum lease payments, residual values guaranteed at inception, and residual

values not guaranteed at inception using the individual carrying amounts of those components at the transfer date. (FASB ASC 860-20-55-26) Transfers of those receivables should be accounted for as follows:

a. *Transfers of unguaranteed residual values.* A transfer of *unguaranteed* residual values is not subject to the accounting guidance for transfers. Accordingly, the difference between the sales price and the carrying amount of the unguaranteed residual values should be recognized at the time of the transaction as a gain or loss. (FASB ASC 840-30-40-8)

b. *Transfers of minimum lease payments and guaranteed residual values.* Minimum lease payments receivable and residual values that are guaranteed at the inception of the lease meet the definition of financial assets. Accordingly, a transfer of minimum lease payments receivable and guaranteed residual values in which the transferor surrenders control should be accounted for as a sale if the transfer meets the requirements for a sale (discussed earlier in this lesson). (FASB ASC 860-10-40-5; 860-10-55-6)

   If the transfer meets those conditions, the transferor should remove the assets sold from its statement of financial position, record all proceeds received from the sale at fair value, and recognize any gain or loss. A transfer that does not meet the requirements for a sale should be accounted for as a secured borrowing. (FASB ASC 860-20-40-18; 860-30-25-2)

Transfers of Lease Receivables under Sales-type and Direct Financing Leases After the Adoption of ASU 2016-02

After a lease is entered into, the lessor may transfer the lease receivable under a sales-type or direct financing lease. Lease receivables related to sales-type and direct financing leases consist of two components: the right to receive lease payments and guaranteed residual values. When selling or securitizing lease receivables, the lessor should allocate its gross investment in receivables between lease payments, residual values guaranteed at commencement, and residual values not guaranteed at commencement using the individual carrying amounts of those components at the transfer date. (FASB ASC 860-10-55-6 and 55-26) Transfers of those receivables should be accounted for as follows:

- *Transfers of unguaranteed residual assets*. A transfer of unguaranteed residual assets is not subject to the accounting guidance for transfers since they do not meet the definition of a financial asset. (FASB ASC 860-10-55-6)

- *Transfers of lease receivables and guaranteed residual values*. Lease payments for sales-type and direct-financing leases and residual values guaranteed at the commencement of the lease meet the definition of financial assets. Accordingly, a transfer of such assets in which the transferor surrenders control should be accounted for as a sale if the transfer meets the requirements for a sale listed earlier in this lesson. (FASB ASC 860-10-40-5; 860-10-55-6)

  If the transfer meets those conditions, the transferor should remove the assets sold from its statement of financial position, record all proceeds received from the sale at fair value, and recognize any gain or loss. A transfer that does not meet the requirements for a sale should be accounted for as a secured borrowing. (FASB ASC 860-20-40-1B; 860-30-25-2)

ACCOUNTING FOR SECURED BORROWINGS

When a transfer does not meet the requirements for sale accounting, the transferor and transferee should account for the transfer as a secured borrowing with a pledge of collateral. The transferor should continue to report the transferred assets in the statement of financial position with no change in measurement. (FASB ASC 860-30-25-2)

A debtor may grant a security interest in assets to a lender to serve as collateral for its debt, and the lender may be allowed to sell or repledge the collateral. The same debtor/lender relationship effectively occurs in a transfer accounted for as a secured borrowing. The accounting for noncash collateral depends on whether the lender

(transferee) has the right to sell or repledge the collateral as follows: (FASB ASC 860-30-05-2 and 05-3; 860-30-25-5; 860-30-30-1; 860-30-40-1; 860-30-45-1)

a. If the lender (transferee) has the right (by contract or custom) to sell or repledge the collateral, the debtor (transferor) should reclassify the asset and report the asset separately from unencumbered assets in its statement of financial position.

b. If the lender (transferee) sells collateral pledged to it, the lender (transferee) should record the proceeds from the sale and a liability for the obligation to return the collateral.

c. A debtor (transferor) that defaults under the terms of the secured borrowing and is no longer entitled to redeem the pledged asset should remove the pledged asset from its statement of financial position. The lender (transferee) should record the collateral as an asset initially measured at fair value. If the lender has already sold the collateral, it should remove the obligation to return the collateral from its statement of financial position.

d. Except as allowed in item c., the debtor (transferor) should continue to carry the collateral as its asset, and the lender (transferee) should not recognize the pledged asset.

DISCLOSURE REQUIREMENTS

The principal objective for disclosures about transfers of financial assets is to provide an understanding of (a) a transferor's continuing involvement, if any, with transferred financial assets, (b) the nature of any restrictions on assets related to a transferred financial asset and the carrying amounts of those assets, (c) how servicing assets and servicing liabilities are reported, and (d) for transfers accounted for as sales when the transferor has continuing involvement and for transfers of financial assets accounted for as secured borrowings, how the transfer affects financial position, financial performance, and cash flows. For this purpose, involvement by the transferor includes involvement by its consolidated affiliates and agents. Disclosures should be presented in a manner that clearly explains the transferor's risk exposure related to transferred assets and any restrictions on its assets. (Disclosures about transfers of financial assets may be reported in the aggregate for similar transfers if separate reporting would not provide more useful information.) (FASB ASC 860-10-50-3; 50-4A; 50-6; and 50-7)

If applicable, transferors should disclose how similar transfers are aggregated. In addition, transfers that are accounted for as sales should be distinguished from those that are accounted for as secured borrowings. (FASB ASC 860-10-50-4A)

If specific disclosures for a particular form of a transferor's continuing involvement with transferred financial assets are required by other GAAP, the disclosures required by paragraphs (a), (b), and (a) should be made along with a cross-reference to the separate notes to the financial statements to allow users of the financial statements to understand the retained risks. The organization is not required to provide each specific disclosure required by paragraphs (c) and if the disclosure is not required by other GAAP and the overall objectives of paragraphs and are met. (The organization should assess whether the other disclosures required by paragraphs and are necessary in order to meet the overall objectives of those paragraphs.) (FASB ASC 860-20-50-2A)

For securitizations, asset-backed financing arrangements, and similar transfers accounted for as sales when the transferor has continuing involvement with the transferred financial assets, the following should be disclosed for each statement of activities presented: (FASB ASC 860-20-50-3)

a. Characteristics of the transfer (including a description of the transferor's continuing involvement with the transferred financial assets, the nature and initial fair value of the assets obtained as proceeds and liabilities incurred in the transfer, and the gain or loss from the sale of transferred financial assets).

b. For initial fair value measurements of assets obtained and liabilities incurred in the transfer:

   (1) The level within the fair value hierarchy in which the fair value measurements fall, segregating fair value measurements using Level 1 inputs, Level 2 inputs, and Level 3 inputs.

(2) Key inputs and assumptions used in measuring the fair value of assets obtained and liabilities incurred as a result of the sale that relate to the transferor's continuing involvement. (The disclosure should include, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, including any expected static pool losses.)

(3) Valuation technique(s) used to measure fair value.

c. Cash flows between a transferor and transferee. (The disclosure should include proceeds from new transfers, proceeds from collections reinvested in revolving period transfers, purchases of previously transferred financial assets, servicing fees, and cash flows received from beneficial interests.)

For securitizations, asset-backed financing arrangements, and similar transfers accounted for as sales when the transferor has continuing involvement with the transferred financial assets, the following should be disclosed for each statement of financial position presented, regardless of when the transfer occurred: (FASB ASC 860-20-50-4)

a. Qualitative and quantitative information about the transferor's continuing involvement with transferred financial assets that provides sufficient information about the reasons for the continuing involvement, the continuing risks related to the transferred financial assets, and the extent to which the transferor's risk profile has changed as a result of the transfer (including credit risk, interest rate risk, and other risks), including:

(1) Total principal amount outstanding, the amount that has been derecognized, and the amount that continues to be recognized in the statement of financial position.

(2) Terms of arrangements that could require the transferor to provide financial support to the transferee or its beneficial interest holders, including events or circumstances that could expose the transferor to loss and the amount of the maximum exposure to loss.

(3) Whether the transferor has provided financial or other support to the transferee or its beneficial interest holders during the periods presented that was not previously contractually required, or assisted the transferee or its beneficial interest holders in obtaining support, including the type, amount, and reasons for providing the support.

(4) Information about any liquidity arrangements, guarantees, or other commitments provided by third parties related to the transferred financial assets that may affect the transferor's exposure to loss or risk of the transferor's interest. (NOTE: This disclosure is encouraged but not required.)

b. Accounting policies for subsequently measuring assets or liabilities that relate to the continuing involvement with the transferred financial assets.

c. Key inputs and assumptions used in measuring the fair value of assets or liabilities related to the transferor's continuing involvement. (The disclosure should include, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, including any expected static pool losses.)

d. For interests in the transferred financial assets, a sensitivity analysis or stress test showing the hypothetical effect on the fair value of those interests (including servicing assets or servicing liabilities) of two or more unfavorable variations from the expected levels for each key assumption reported in item c independent from changes in other key assumptions, and a description of the objectives, methodology, and limitations of the sensitivity analysis or stress test.

e. Information about the asset quality of transferred financial assets and any other assets managed together with them, separated between assets that have been derecognized and assets that continue to be recognized in the statement of financial position (for example, information on receivables would include delinquencies at the end of the period and credit losses, net of recoveries, during the period).

For transactions accounted for as sales that comprise both (a) a transfer of financial assets to a transferee and (b) an agreement entered into in connection with the initial transfer that results in the transferor keeping substantially all of the exposure to the economic return on the transferred financial assets throughout the transaction term, the following should be disclosed by type of transaction (for example, repurchase agreement, securities lending transaction, and sale and total return swap) for outstanding transactions at the reporting date: (FASB ASC 860-20-50-4A and 50-4D)

a. Carrying amount of assets derecognized as of the derecognition date.

b. If amounts derecognized have significantly changed from amounts derecognized in prior periods or are not representative of the activity during the period, a discussion of the reasons for the change.

c. Amount of gross cash proceeds that the transferor received for assets derecognized as of the derecognition date.

d. Information about the transferor's ongoing exposure to the economic return on the transferred financial assets, including:

    (1) Fair value of assets derecognized by the transferor as of the reporting date.

    (2) Amounts reported in the statement of financial position that arose from the transaction (such as the carrying value or fair value of forward repurchase agreements or swap contracts). (If such amounts are captured in the derivative disclosures described previously, a cross-reference to the appropriate line item in that disclosure should be provided.)

e. A description of the arrangements that resulted in the transferor retaining substantially all of the exposure to the economic return on the transferred financial assets along with associated risks.

The following disclosures should be made for collateral: (FASB ASC 860-30-50-1A)

a. The organization's policy for requiring collateral or other security interests for repurchase agreements or securities lending transactions,

b. If assets have been pledged as collateral but not separately reported in the statement of financial position (for example, as securities pledged to creditors), the carrying amounts and classifications of both the assets and the related liabilities (including qualitative information about the relationship between those assets and liabilities), and

c. If the organization has accepted any collateral that it is permitted to sell or repledge, the fair value on the date of each statement of financial position presented of that collateral and any portion of it that has been sold or repledged. Information about the sources and uses of the collateral should also be provided.

For repurchase agreements, securities lending transactions, and repurchase-to-maturity transactions accounted for as secured borrowings at the reporting date, the following should be disclosed: (FASB ASC 860-30-50-7)

a. A disaggregation of the gross obligation by class of collateral pledged. (The appropriate level of disaggregation and classes should be determined based on the nature, characteristics, and risks of the collateral pledged.)

b. A reconciliation of the total gross obligation in item a. of this paragraph to the amount of the gross liability for repurchase agreements and securities lending transactions disclosed in accordance with item a. of the previous paragraph, before any adjustments for offsetting.

c. Remaining contractual maturity of repurchase agreements, securities lending transactions, and repurchase-to-maturity transactions.

d. Discussion of the potential risks associated with the agreements and associated pledged collateral, including obligations arising from a decline in the fair value of the pledged collateral and how risks are managed.

The disclosures for offsetting in the statement of financial position listed previously should be made for (a) recognized repurchase agreements and reverse repurchase agreements accounted for as collateralized borrowings and (b) recognized securities borrowing and lending transactions that are offset or subject to an enforceable master netting arrangement or similar agreement. (FASB ASC 860-30-50-8)

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

23. What should a transferor do if the transfer of an entire asset meets the conditions for sale accounting?

    a. Recognize the transferred assets.

    b. Measure assets received and liabilities incurred at fair value.

    c. Disclose any gain or loss on the sale.

    d. Account for the entire asset as a secured borrowing with pledge of collateral.

24. Which of the following is a characteristic of a participating interest?

    a. The interest represents the whole ownership of an asset.

    b. One interest holder can determine whether the entire asset is pledged or exchanged.

    c. The rights of interest holders are given priority based on the amount owned.

    d. All of the cash flows are proportionally divided among interest holders.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

23. What should a transferor do if the transfer of an entire asset meets the conditions for sale accounting? **(Page 190)**

    a. Recognize the transferred assets. [This answer is incorrect. Per FASB ASC 860-20-25-1, 860-20-30-1 and 30-2, and 860-20-40-1B, the transferor should *derecognize* the transferred assets.]

    b. Measure assets received and liabilities incurred at fair value. [This answer is correct. As described in FASB ASC 860-20-25-1, 860-20-30-1 and 30-2, and 860-20-40-1B, the transferor should recognize and measure at fair value the servicing assets, servicing liabilities, and any other assets received and liabilities incurred in the sale.]

    c. Disclose any gain or loss on the sale. [This answer is incorrect. The transferor should recognize any gain or loss on the sale in the change in net assets, per FASB ASC 860-20-25-1, 860-20-30-1 and 30-2, and 860-20-40-1B.]

    d. Account for the entire asset as a secured borrowing with pledge of collateral. [This answer is incorrect. According to FASB ASC 860-60-25-2, if the transfer of an entire financial asset does *not* meet the conditions for a sale, the transferor and transferee should account for the transfer as a secured borrowing with pledge of collateral.]

24. Which of the following is a characteristic of a participating interest? **(Page 190)**

    a. The interest represents the whole ownership of an asset. [This answer is incorrect. As described in FASB ASC 860-10-40-6A, the interest represents a proportionate ownership interest in the entire financial asset. This requirement applies regardless of the number of interests transferred.]

    b. One interest holder can determine whether the entire asset is pledged or exchanged. [This answer is incorrect. The entire financial asset may *not* be pledged or exchanged without approval of *all* interest holders, per FASB ASC 860-10-40-6A.]

    c. The rights of interest holders are given priority based on the amount owned. [This answer is incorrect. Per FASB ASC 860-10-40-6A, each interest holder of the entire financial asset has rights of equal priority and no interest is subordinated to another interest.]

    d. All of the cash flows are proportionally divided among interest holders. [This answer is correct. According to FASB ASC 860-10-40-6A, all cash flows from the entire financial asset are divided proportionately among the participating interest holders. The applicable cash flows for this requirement exclude cash flows allocated as compensation for services performed and any proceeds received by the transferor for the transferred portion.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Nonprofit GAAP—Course 2—Selected Topics Specific to Nonprofit Organizations (NPGTG172)

Testing Instructions

1. Following these instructions is an **EXAMINATION FOR CPE CREDIT** consisting of multiple choice questions. You may print and use the **EXAMINATION FOR CPE CREDIT ANSWER SHEET** to complete the examination. This course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of the course, the participant then answers the examination questions and records answers to the examination questions on either the printed **Examination for CPE Credit Answer Sheet** or by logging onto the Online Grading System. The **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation Form** for each course are located at the end of all course materials.

   ONLINE GRADING. Log onto our Online Grading Center at **cl.thomsonreuters.com/ogs** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam of $89 is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   PRINT GRADING. If you prefer, you may email, mail, or fax your completed answer sheet, as described below ($89 for email or fax; $99 for regular mail). The answer sheets are found at the end of the course PDFs. Answer sheets may be printed from the PDFs; they can also be scanned for email grading, if desired. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number. You may submit your answer sheet for grading three times. After the third unsuccessful attempt, another payment is required to continue.

   You may submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

   - Email to: *CPLGrading@thomsonreuters.com*
   - Fax to: **(888) 286-9070**
   - Mail to:

     Thomson Reuters
     Tax & Accounting—Checkpoint Learning
     NPGTG172 Self-study CPE
     36786 Treasury Center
     Chicago, IL 60694-6700

   Note: The answer sheet has four bubbles for each question. However, if there is an exam question with only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Each answer sheet sent for print grading must be accompanied by the appropriate payment ($89 for answer sheets sent by email or fax; $99 for answer sheets sent by regular mail). Discounts apply for three or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price

for grading all three is $254 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $320 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $378 (a 15% discount on all five courses). The 15% discount also applies if more than five courses are submitted at the same time by the same participant. The $10 charge for sending answer sheets in the regular mail is waived when a discount for multiple courses applies.

4. To receive CPE credit, completed answer sheets must be postmarked or entered into the Online Grading Center by **December 31, 2018**. CPE credit will be given for examination scores of 70% or higher.

5. When using our print grading services, only the **Examination for CPE Credit Answer Sheet** should be submitted. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Nonprofit GAAP—Course 2—Selected Topics Specific to Nonprofit Organizations (NPGTG172)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet. The answer sheet can be printed out from the back of this PDF or accessed by logging onto the Online Grading System.

1. If the fair value of an asset is known or can be estimated at the time of its retirement, when should a nonprofit record the fair value liability?

   a. The period the retirement obligation is incurred.

   b. When the fair value of the asset can be estimated.

   c. The period subsequent to the final use of the asset.

   d. Prorated over five years, starting when the retirement obligation is incurred.

2. Why might an organization use surety bonds, insurance policies, or letters of credit?

   a. To extinguish or satisfy its asset retirement liabilities.

   b. To provide assurance that it can satisfy asset retirement obligations.

   c. To change the previously recognized initial liability for asset retirement.

   d. To provide immunity from future environmental remediation liabilities.

3. McMillan Development, a nonprofit organization, has an environmental remediation liability. When estimating that liability, the organization comes up with a range of $5,000 to $10,000. No single amount in that range is more likely than the other amounts. What amount should McMillan use as its estimate?

   a. $5,000.

   b. $7,500.

   c. $8,000.

   d. $10,000.

4. Which of the following specific disclosures is required for a reasonably possible loss contingency related to an environmental remediation liability?

   a. A general description of any long-lived assets that are associated with the liability.

   b. A reconciliation of the beginning and ending carrying amounts.

   c. The nature and amount of the accrual, if it is necessary to prevent statements from being misleading.

   d. A description of the contingency along with the estimate of possible loss.

5. All of the following are commitments required by GAAP to be disclosed **except**:

   a. Unused letters of credit.

   b. Pledged assets that secure loans.

   c. Unconditional purchase obligations.

   d. Pension plans.

6. Cleaner World, a nonprofit organization, enters into an agreement with EcoTrash in which Cleaner World promises to pay a specific amount over the next two years and EcoTrash will supply Cleaner World with biodegradable trash bags and other clean-up supplies. This is an example of what?

    a. A gain contingency.

    b. A loss contingency.

    c. A subsequent event.

    d. An unconditional purchase obligation.

7. What is the correct term for an existing situation, condition, or set of circumstances that involve an uncertainty, which, when resolved, could result in gain or loss to the organization?

    a. A commitment.

    b. A contingency.

    c. A guarantee.

    d. A troubled debt restructuring.

8. The Portman Foundation, a nonprofit organization, faces a probable loss contingency. The amount of loss can be estimated. The contingency is not a guarantee. How should the organization account for this contingency?

    a. It does not need to accrue or disclose the loss.

    b. It does not need to accrue the loss, but disclosure is necessary.

    c. It needs to accrue the loss, but disclosure is unnecessary.

    d. It needs to accrue the loss and disclose it in its financial statements.

9. Assuming all other conditions are met, when would an organization need to accrue a loss due to threatened litigation or actual or possible claims and assessments?

    a. The underlying cause occurs within a year of the financial statement date.

    b. The likelihood of an unfavorable outcome is reasonably possible.

    c. The amount of related loss can be reasonably estimated.

    d. The claim or assessment is unasserted.

10. When debt is modified and it is not classified as a troubled debt restructuring, how is the new borrowing capacity accounted for if it is greater than or equal to the previous capacity?

    a. Unamortized deferred costs are deferred and amortized over the arrangement's new term.

    b. Unamortized deferred costs are reduced in proportion to the new capacity and the remainder is amortized over the arrangement's new term.

    c. The obligation is recognized and measured as the sum of the amount the organization agreed to pay and any additional amount it expects to pay.

    d. If extinguishment occurs, the resulting gain or loss is amortized into future periods.

11. If a troubled debt restructuring involves a combination of the primary types, what does the debtor organization account for first?

    a. The modification of terms.

    b. The transfer of assets.

    c. The liability for insurance-related assessments.

    d. The sponsoring organization's financing and holding costs.

12. Obligations are included in an organization's current liabilities if they are scheduled to mature within what length of time?

    a. Three months.

    b. Six months.

    c. One year.

    d. Two years.

13. When a subjective acceleration clause is used, who has the power to accelerate the maturity of the long-term debt?

    a. The creditor.

    b. The debtor.

    c. A third party.

    d. A regulatory official.

14. All of the following combine to make up the borrower's interest expense on a participating mortgage loan **except**:

    a. The interest stated in the mortgage agreement.

    b. Debt extinguishment gain or loss.

    c. Amounts related to the lender's participation in the results of operations.

    d. Amortization of the debt discount related to the lender's participation in appreciation.

15. Whammy Inc. purchases inventory for Nonprofit Grannies. Nonprofit Grannies agrees to purchase that inventory (or identical inventory) at a specific monthly price over the next year. This is an example of what?

    a. A callable obligation.

    b. A participating mortgage loan.

    c. A product financing arrangement.

    d. A troubled debt restructuring.

16. Which of the following occurs when assets in a troubled debt restructuring are transferred in full settlement of debt?

    a. The debtor will recognize two gains or a gain and a loss.

    b. The creditor will record receipt of an equity interest in a debtor for-profit entity.

    c. The debtor will not change the debt carrying amount unless it exceeds future cash payments under the new terms.

    d. The debtor will account for the restructuring as if it were an impaired loan.

17. Which of the following is accounted for under GAAP as a joint and several liability arrangement?

    a. Contingencies.

    b. Guarantees.

    c. Judicial rulings.

    d. Retirement benefits.

18. When would a nonprofit organization be exempt from disclosing the existence of a subjective acceleration clause?

    a. The likelihood of acceleration is remote.

    b. The likelihood of acceleration is probable.

    c. The debt has been reclassified as current.

    d. The debt is considered a short-term obligation.

19. Which of the following pieces of information should an organization disclose in the period after a troubled debt restructuring?

    a. A description of changes to principle terms and major features of the settlement.

    b. Any aggregate gain on the restructuring of payables.

    c. Any aggregate net gain or loss on the transfer of assets.

    d. The extent to which contingently payable amounts are included in the carrying amount.

20. All of a nonprofit organization's derivative financial instruments should be—

    a. reported on the balance sheet.

    b. measured at fair value.

    c. designated as a fair value hedge.

    d. designated as a foreign currency hedge.

21. How many payment provisions are required for a financial instrument to be considered a derivative?

    a. At least one.

    b. More than one.

    c. A payment provision is not necessary if there is an underlying.

    d. A payment provision is not necessary if there is a notional amount.

22. Mergers of nonprofit organizations and contracts to enter into the acquisition of a nonprofit organization are which of the following?

    a. Accounted for using GAAP for derivative instruments.

    b. Not considered derivative instruments.

    c. Accounted for as loan commitments.

    d. Considered an embedded derivative.

23. Assuming all other criteria are met, when would an embedded derivative be accounted for separately?

    a. The contract must be remeasured at fair value under GAAP.

    b. Its economic characteristics are clearly and closely related to the host contract.

    c. If it were a standalone contract, it would be accounted for as a derivative.

    d. It does not affect cash flow or the value of other exchanges similarly to a derivative.

24. Assuming all other criteria are met, when would a derivative instrument be accounted for as a fair value hedge?

    a. The hedging relationship is expected to be highly effective for offsetting changes in fair value attributed to the hedged risk.

    b. The hedging relationship, the reason for undertaking it, and other information is documented on an ongoing basis.

    c. There is more potential for loss in the combined instruments than there is for favorable gains.

    d. It is a nonderivative investment, such as a Treasury note.

25. Which of the following disclosures is required for an organization that holds or issues derivative instruments that are designated and qualify as hedging instruments?

    a. A cross-reference for information on derivatives presented in a single note.

    b. A list of separate amounts of assets that are posted as collateral.

    c. Disclosures related to the fair value option for hybrid financial instruments.

    d. The existence and nature of any credit-risk-related contingent features.

26. Assuming all other conditions are met, when does a one-time benefit arrangement exist?

    a. Management proposes a draft of the plan.

    b. The plan estimates the number of employees and job functions that may be affected.

    c. The plan establishes terms in enough detail for employees to understand their severance.

    d. Actions have been taken to complete the plan, but there is a reasonably possibility that it might be withdrawn.

27. When does an organization need to make disclosures about exit or disposal activities?

    a. In the period that the activities are initiated.

    b. In the initial period, as well as during any period the activity is in process.

    c. In the period that the activities are completed.

    d. In the initial period, all periods the activity is in process, and the period after the activity is completed.

28. Which of the following occurs when an organization is a guarantor?

    a. The guarantee is considered noncontingent.

    b. Disclosure is needed only if the likelihood of payment is reasonably possible.

    c. The guarantor only recognizes a liability if it has to fulfill the guarantee.

    d. The organization will account for the guarantee as a contribution.

29. Initially, how should inventory be recorded?

    a. At cost.

    b. At average cost.

    c. At fair value.

    d. At the price at which it will eventually be sold.

30. What method used to charge inventory most closely matches current costs with current revenues?

    a. Average cost.

    b. First-in, first-out (FIFO).

    c. Last-in, first-out (LIFO).

    d. Specific identification.

31. The Halfway Shop is a nonprofit thrift store that sells goods on consignment. When will consigned goods affect the store's books?

    a. Upon receipt from the consignor.

    b. While consigned goods are held for sale.

    c. When the consignor provides title to the purchaser.

    d. When the store receives income from the sale.

32. Which of the following should an organization disclose about its inventory?
    a. The basis used to state the inventory.
    b. The reason why the method of charging inventory (FIFO, etc.) was chosen.
    c. Any reason why inventories are stated below cost.
    d. Possible future losses on firm purchase commitments.
33. Contractual rights to receive money on demand or on fixed or determinable dates are called what?
    a. Commitments.
    b. Inventories.
    c. Receivables.
    d. Financial assets.
34. To be considered loans, notes and accounts receivable must mature for what minimum length of time?
    a. A month.
    b. Six months.
    c. A year.
    d. Five years.
35. At what point is a loan considered impaired?
    a. The entity that took out the loan has declared bankruptcy or cannot otherwise continue as a going concern.
    b. It is probable that the creditor will not be able to collect all amounts due.
    c. It is reasonably possible that the creditor will not be able to collect all amounts due.
    d. There is a remote chance that the entity will not be able to make payments as obligated.
36. How should disclosures about the allowance for credit losses related to loans be organized?
    a. They should be aggregated.
    b. They should be presented by portfolio segment.
    c. They should be presented by the class of financing receivable.
    d. They should be separately disclosed.
37. Which of the following conditions indicates that a transferor has surrendered control over transferred assets?
    a. The transferor has only limited access to the transferred assets.
    b. The transferee has constraints on the ability to pledge or exchange the assets.
    c. The transferor receives a significant benefit from the assets.
    d. The transferor does not maintain effective control over the assets.

38. Which of the following should a transferor do if a transferred interest in a financial asset is classified as a participating interest?

    a. Measure servicing assets at fair value.

    b. Report the amount of participating interest retained as a whole.

    c. Derecognize any gain or loss on the sale.

    d. Recognize the participating interests sold.

39. If a transfer cannot be accounted for as a sale, it is accounted for as which of the following?

    a. Collateral.

    b. A lease.

    c. A loan.

    d. A secured borrowing.

40. When making disclosures about transfers of financial assets, the principal objective is to provide an understanding of which of the following (among others)?

    a. The transferee's involvement with the transferred assets.

    b. The nature of any restrictions related to the asset.

    c. How sales and secured borrowings are related.

    d. The organization's policies for collateral.

GLOSSARY

Available to be issued: Financial statements are considered *available to be issued* when they are complete, in a form and format that complies with GAAP, and approved for issuance.

Average cost: A method for valuing *inventory* in which cost is computed at the end of a period based on the average cost of all similar items available during the period.

Benchmark interest rate: A widely recognized and quoted rate in an active financial market that is broadly indicative of the overall level of interest rates attributable to high-credit-quality obligators in that market. In the U.S., it should be the rate on U.S. Treasury obligations, the LIBOR, or the Fed Funds Effective Swap Rate.

Class of financing receivable: A group of financing receivables determined based on all of the following: (1) initial measurement attribute, such as amortized cost or purchased credit impaired; (2) risk characteristics; and (3) the organization's method of monitoring and assessing credit risk.

Conditional asset retirement obligation: A *legal obligation* to perform an asset retirement activity where the timing and (or) method of settlement are conditional on a future event.

Contingency: An existing condition, situation, or set of circumstances involving an uncertainty that, when resolved, may result in a gain or loss.

Contract termination costs: The costs to terminate an operating lease or other contract before the end of its term, or costs that will continue to be incurred under the contract for its remaining term without economic benefit to the entity.

Credit derivative: A derivative instrument (1) in which one or more of its *underlyings* are related to the credit risk of an entity (or group of entities) or an index based on the credit risk of a group of entities and (2) that exposes the seller to potential loss from credit-risk-related events specified in the contract.

Derivative: A financial instrument or other contract with all three of the following characteristics: (1) it has at least one *underlying* and at least one *notional amount* or *payment provision* or both; (2) it requires no net investment or an initial net investment less than that required for other types of contracts expected to respond similarly to changes in market factors; and (3) its terms require or allow net settlement, it can readily be settled net by a method outside the contract, or it provides for delivery of an asset that puts the recipient in a position similar to net settlement.

Debt extinguishment: When the debtor has paid the creditor and is relieved of its obligation for the liability or the debtor is legally released from primary obligation under the liability.

Embedded derivative: Implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by a contract in a manner similar to a derivative instrument. An *embedded credit derivative* is both an embedded derivative and a *credit derivative.*

Environmental remediation obligation: These generally arise from improper or other than normal operations and are accrued on a site-by-site basis when it is probable that a loss has been incurred and the amount of the loss can be reasonably estimated.

Financing receivables: These include loans, notes receivable, credit cards, and receivables organized in connection with capital leases. They do not include promises to give (contributions receivable) and debt securities.

First-in, first out (FIFO): A method for valuing *inventory* which assume that items flow through in the order they were purchased. The first items purchased are the first items used or sold.

Financial asset: Cash, evidence of ownership in an entity, or a contract that conveys to another entity the right to (1) receive cash or another financial instrument from the first entity or (2) exchange other financial instruments on potentially favorable terms with the first entity.

Hybrid instrument: A contract that embodies both an *embedded derivative* and a host contract.

Inventory: Personal tangible property that is (1) held for sale or use in the ordinary course of business, (2) in the process of production for sale or use, or (3) consumed in the production of goods or services to be available for sale or use. For a nonprofit organization, inventory usually consists of purchased or donated supplies, materials, publications, and other items used in the organization's activities or programs or held for resale to the public.

Issued: Financial statements are considered *issued* when they are widely distributed to users in a form that complies with GAAP.

Last-in, first-out (LIFO): A method for valuing *inventory* that assumes that the most recently purchased inventory items are the first items sold or used.

Legal obligation: An obligation that a party must settle as a result of existing or enacted laws, statutes, ordinances, written or oral contracts, or by legal construction of a contract under the promissory estoppel doctrine.

Legal notification period: The period an entity is required by existing law, statute, or contract to provide to employees in advance of a specified termination event.

Loan: The contractual right to receive money on demand or on fixed or determinable dates. It is recorded as an asset in the creditor's statement of financial position.

Loss contingency: A *contingency* that may result in the loss or impairment of an asset or the incurrence of a liability.

Net realizable value: The estimated selling price less reasonably predictable costs of completion, disposal, and transportation.

Notional amount: A number of currency units, shares, bushels, pounds or other units specified in the contract.

One time employee termination benefits: Benefits provided to employees who have been involuntarily terminated under a one-time benefit arrangement (also called *severance pay*).

Payment provision: This will specify a fixed or determinable settlement to be made if the *underlying* performs in a specified manner.

Portfolio segment: The level at which the organization develops and documents a systematic methodology to determine its allowance for credit losses.

Probable: Likely to occur.

Purchased financial assets with credit deterioration: *Financial assets* that, at acquisition, have experienced more than an insignificant amount of credit deterioration (according to the acquirer). Also called *purchased credit deteriorated (PCD) assets.*

Reasonably possible: More than a slight chance of occurring, but less than likely.

Receivables: Contractual rights to receive money, either on demand or on fixed or determinable dates, that may or may not include a stated provision for interest.

Remote: Slight chance of occurring.

Repurchase-to-maturity transaction: This occurs when the settlement date of the agreement to repurchase a transferred financial asset is at the maturity date of that asset and the agreement does not require the transferor to reacquire the financial asset.

Specific identification: A method for valuing *inventory* in which the cost of each item is tracked from the time of purchase through the time of sale or use in one of the organization's programs. When an item is sold or used, its specific cost is charged to cost of sales or other expense.

Subsequent events: Events or transactions that occur after the date of the statement of financial position, but before the financial statements are available to be issued.

Take-or-pay contract: In this type of contract, the purchaser is required to pay specified minimum amounts even if it does not take delivery of the specified goods or services. These contracts are usually limited to the oil and gas or chemical industries.

Throughput contract: In this type of contract, one party (the shipper) agrees to pay another paty specified amounts to transport or process a product. The contract requires the shipper to pay specified minimum amounts even if it does not provide the product for transporting or processing.

Troubled debt restructuring: When a creditor, for economic or legal reasons related to the debtor's financial difficulties, makes concessions to a debtor that it would not otherwise consider.

Underlying: A specified interest rate, security price, commodity price, foreign exchange rate or rate index, or other variable.

INDEX

A

ACCOUNTING POLICIES
- Loan impairments . . . 185

ASSET RETIREMENT OBLIGATIONS AND ENVIRONMENTAL OBLIGATIONS
- Accretion expense . . . 98
- Capitalized asset retirement cost . . . 98
- Conditional . . . 97
- Disclosure requirements . . . 100
- Funding and assurance provisions . . . 98
- Subsequent measurement . . . 98

C

COMMITMENTS
- Disclosure requirements
  - General . . . 105
  - Recorded unconditional purchase obligations . . . 107
  - Unconditional purchase obligations . . . 106
  - Unrecorded unconditional purchase obligations . . . 106

CONTINGENCIES
- Concentrations . . . 100
- Definitions
  - Contingency . . . 107
  - Gain contingencies . . . 107
  - Loss contingencies . . . 107
  - Probable . . . 107
  - Reasonably possible . . . 107
  - Remote . . . 107
- Disclosure requirements
  - Environmental obligations . . . 100
  - Gain contingencies . . . 113
  - Guarantees . . . 165
  - Loss contingencies . . . 112
  - Noncompliance with donor or grantor restrictions . . . 113
  - Other risks and uncertainties . . . 100
  - Subsequent events . . . 113
  - Unaccrued environmental contingencies . . . 101
  - Unasserted environmental claims . . . 101
- Environmental obligations . . . 98
- Estimates . . . 100
- Gain contingencies . . . 98, 107, 113
- Guarantees . . . 107, 164
- Loss contingencies
  - Arising after the financial statement date . . . 108
  - Business combinations, preacquisition contingencies . . . 111
  - Claims and assessments . . . 111
  - Damage of organization property . . . 108
  - Disclosure requirements . . . 112
  - Environmental remediation liabilities . . . 98
  - Examples . . . 108
  - Expropriation of assets . . . 111
  - Guarantees to repurchase receivables sold . . . 164
  - Hazards such as fire or explosions . . . 108
  - Indirect guarantees of indebtedness of others . . . 164
  - Interruption of activities . . . 108
  - Litigation, claims, and assessments . . . 111
  - Noncompliance with donor or grantor restrictions . . . 108
  - Preacquisition contingencies . . . 111
  - Range of loss . . . 107, 111
  - Receivables, collectibility . . . 180
  - Risk of loss . . . 108
  - Subsequent events . . . 108, 112
  - Unasserted claims . . . 111
  - Uncollectible receivables . . . 180
  - Uninsured risks . . . 108
- Loss contingency classifications
  - Probable . . . 107
  - Reasonably possible . . . 107
  - Remote . . . 107
- Preacquisition contingencies . . . 111
- Subsequent events
  - Arising after the financial statement date . . . 112
  - Disclosure requirements . . . 113

CONTRIBUTIONS
- Gifts-in-kind
  - Inventory . . . 175

D

DEBT
- Callable obligations
  - Accounting requirements . . . 121
  - Disclosure requirements . . . 136
  - Subjective accelerations clauses . . . 122
- Insurance-related assessments . . . 129
  - Disclosures . . . 137
  - Estimating liabilities . . . 130
  - Guaranty fund assessments . . . 130
  - Loss-based assessments . . . 130
  - Premium tax offsets . . . 131
  - Recognition . . . 130
- Joint and several liability arrangements
  - Disclosures . . . 138
  - Measurement . . . 131
  - Scope . . . 131
- Long-term borrowings
  - Disclosure requirements . . . 136
- Modifications and extinguishments
  - Debt extinguishments . . . 124
  - Disclosure requirements . . . 136
  - Modifications to lines-of-credit . . . 124
- Obligations expected to be refinanced
  - Accounting requirements . . . 121
  - Disclosure requirements . . . 136
- Participating mortgage loans
  - Accounting requirements . . . 122
  - Disclosure requirements . . . 136
  - Extinguishment of participating mortgage loans . . . 122
  - Interest expense . . . 122
  - Participation in the mortgaged asset's appreciation . . . 122
- Product financing arrangements
  - Accounting requirements . . . 124
  - Characteristics . . . 123
  - Disclosure requirements . . . 136
- Troubled debt restructurings
  - Combination of types . . . 128
  - Described . . . 125
  - Disclosure requirements . . . 137
  - Modification of terms . . . 127
  - Receipt of equity in full settlement . . . 127
  - Related issues
    - Contingently payable amounts . . . 129
    - Restructuring costs . . . 129
  - Transfers of assets in full settlement . . . 126

DERIVATIVES AND HEDGING
- Accounting requirements . . . 141
- Disclosure requirements
  - Derivatives that are offset or subject to a master netting arrangement or similar agreement . . . 156
  - Disclosures . . . 153
  - Hybrid financial instruments . . . 155

- Fair value hedges
  - Accounting requirements . . . 147
  - Definition . . . 146
  - Foreign currency fair value hedges . . . 148
  - Hedge ineffectiveness . . . 148
  - Impairment . . . 151
- Foreign currency hedges of a net investment in a foreign operation . . . 151
- Overview of ASU 2017-12 . . . 152
- What are derivatives?
  - Contracts not subject to guidance . . . 142
  - Definition . . . 141
  - Embedded derivatives . . . 144

E

ENVIRONMENTAL OBLIGATIONS
- Accounting requirements . . . 98
- Allocating shared costs . . . 99
- Claims for recovery . . . 99
- Disclosure requirements . . . 100
- Discounting environmental liabilities . . . 99
- Estimating environmental remediation costs . . . 99
- When to accrue a liability . . . 98

EXIT OR DISPOSAL COST OBLIGATIONS
- Accounting requirements . . . 161
- Contract terminations costs . . . 163
- Disclosure requirements . . . 163
- One-time terminations benefits . . . 162
- Other associated costs . . . 163
- Recognition and measurement . . . 161
- Reporting . . . 163

F

FOREIGN OPERATIONS AND CURRENCY TRANSLATION
- Forward exchange contracts . . . 151

G

GUARANTEES
- Accounting requirements . . . 164
- Contributions . . . 164
- Disclosure requirements . . . 165
- Residual value guarantees . . . 165

I

INVENTORY
- Agricultural products . . . 175
- Consigned . . . 176
- Cost basis . . . 170
- Cost components
  - Direct labor . . . 170
  - Direct materials . . . 170
  - Indirect costs . . . 170
  - Normal capacity . . . 170
- Definitions
  - Inventory . . . 169
  - Market value . . . 175
  - Net realizable value . . . 175
  - Product costs . . . 170
- Disclosure requirements . . . 176
- Donated materials . . . 175
- Indirect costs . . . 170
- Last-in, first-out (LIFO) . . . 170
- Lower of cost or market . . . 176
  - Unusual losses . . . 176
- Methods used to charge inventory to cost of sales
  - Average . . . 170
  - Disclosure requirements . . . 176
  - First-in, first-out (FIFO) . . . 170
  - Last-in, first-out (LIFO) . . . 170
  - Objective . . . 170
  - Retail inventory . . . 173
  - Specific identification . . . 170
  - Standard costs . . . 173
- Mineral products . . . 175
- Precious metals . . . 175
- Purchase commitments
  - Disclosure requirements . . . 176
  - Losses . . . 176
- Standard costs . . . 173
- Subsequent measurement after the effective date of ASU 2015-11
  - Lower of cost or market . . . 174
  - Obsolescence, deterioration, or damage . . . 174
  - Substantial and unusual losses . . . 174
- Subsequent measurement before the effective date of ASU 2015-11
  - Lower of cost or market . . . 175
  - Net realizable value . . . 175
  - Obsolescence, deterioration, or damage . . . 175

L

LEASES
- Operating leases
  - Residual value guarantee . . . 165
- Residual value guarantee
  - Accounting by lessee . . . 165

LONG-TERM OBLIGATION DISCLOSURES
- Losses on firm purchase commitments . . . 176

R

RECEIVABLES—OTHER
- Disclosure of credit quality information . . . 185
- Disclosures for nonaccrual and past due receivables . . . 184
- Loan impairment . . . 180
  - Disclosure requirements . . . 184, 185
  - Measuring impairment . . . 181
  - Recognizing income on impaired loans . . . 181
  - When is a loan impaired? . . . 181
- Overview of the guidance in ASU 2016-13 . . . 182
- Receivables in general . . . 179
  - Disclosure requirements . . . 183
  - Uncollectible receivables . . . 180

T

TERMINATION BENEFITS
- Accounting for employee termination benefits . . . 162
- Disclosure requirements . . . 163

TRANSFERS OF FINANCIAL ASSETS
- Accounting for collateral . . . 193
- Accounting for secured borrowings . . . 193
- Accounting for transfers of financial assets . . . 190
- Accounting for transfers of participating interests . . . 190
- Agreements that maintain effective control over transferred assets . . . 191
- Conditions for a sale of financial assets . . . 189
- Disclosures . . . 194
- Financial assets subject to prepayment . . . 192
- Overview . . . 189
- Transfers of leased property . . . 192
- Transfers of receivables with recourse . . . 192

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Nonprofit GAAP—Course 1—Selected Topics Specific to Nonprofit Organizations (NPGTG171)

Name: ______________________________

Firm Name: ______________________________

Firm Address: ______________________________

City: ______________________________ State /ZIP: ______________

Firm Phone: ______________________________ Firm Fax No.: ______________

Firm Email: ______________________________

Signature: ______________________________

Credit Card Number: ______________________________ Expiration Date: ______________

Birth Month: ______________________________ Licensing State: ______________

ANSWERS:

This answer sheet and the following evaluation can be printed. If filling out a printed version, please indicate your answer for each question by filling in the appropriate circle as shown: Fill in like this ● not like this ⃠ ⊗ ✓ .

You must complete the entire course to be eligible for credit.

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

You may complete the exam online for $89 by logging onto our Online Grading Center at **cl.thomsonreuters.com/ogs**. Alternatively, you may fax the completed Examination for CPE Credit Answer Sheet and Self-study Course Evaluation to Thomson Reuters (Tax & Accounting) Inc. at (888) 286-9070 or email it to *CPLGrading@thomsonreuters.com*. Mailing instructions are included in the Exam Instructions. Payment information must be included for all print grading. The price for emailed or faxed answer sheets is $89; the price for answer sheets sent by regular mail is $99.

Expiration Date: December 31, 2018

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Nonprofit GAAP—Course 1 —Selected Topics Specific to Nonprofit Organizations

Course Acronym: NPGTG171

Your Name (optional): ______________________ Date: ______________

Email: ______________________

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⃠ ⊗ ✓.

Satisfaction Level:	Low (1) . . . to . . . High (10)									
	1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○

Please enter the number of hours it took to complete this course. ______________

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? ________
5. How many employees are in your company? ________
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

For more information on our CPE & Training solutions, visit cl.thomsonreuters.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here _________.

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Nonprofit GAAP—Course 2—Selected Topics Specific to Nonprofit Organizations (NPGTG172)

Name: ______________________________

Firm Name: ______________________________

Firm Address: ______________________________

City: ______________________________ State /ZIP: ______________

Firm Phone: ______________________________ Firm Fax No.: ______________

Firm Email: ______________________________

Signature: ______________________________

Credit Card Number: ______________________________ Expiration Date: ______________

Birth Month: ______________________________ Licensing State: ______________

ANSWERS:

This answer sheet and the following evaluation can be printed. If filling out a printed version, please indicate your answer for each question by filling in the appropriate circle as shown: Fill in like this ● not like this ⦸ ⊗ ✓ .

You must complete the entire course to be eligible for credit.

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

You may complete the exam online for $89 by logging onto our Online Grading Center at **cl.thomsonreuters.com/ogs**. Alternatively, you may fax the completed Examination for CPE Credit Answer Sheet and Self-study Course Evaluation to Thomson Reuters (Tax & Accounting) Inc. at (888) 286-9070 or email it to *CPLGrading@thomsonreuters.com*. Mailing instructions are included in the Exam Instructions. Payment information must be included for all print grading. The price for emailed or faxed answer sheets is $89; the price for answer sheets sent by regular mail is $99.

Expiration Date: December 31, 2018

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Nonprofit GAAP—Course 2—Selected Topics Specific to Nonprofit Organizations

Course Acronym: NPGTG172

Your Name (optional): ______________________ Date: ______________

Email: ______________________

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⃠ ⊗ ✓.

Satisfaction Level:	Low (1) . . . to . . . High (10)									
	1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○

Please enter the number of hours it took to complete this course. ______________

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? ________
5. How many employees are in your company? ________
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

For more information on our CPE & Training solutions, visit cl.thomsonreuters.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here ________.