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Companion to PPC's Guide to

Preparing Nonprofit Financial Statements

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Interactive Self-study CPE

Companion to PPC's Guide to Preparing Nonprofit Financial Statements

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INTRODUCTION

Companion to PPC's Guide to Preparing Nonprofit Financial Statements consists of three interactive self-study CPE courses. These are companion courses to *PPC's Guide to Preparing Nonprofit Financial Statements* designed by our editors to enhance your understanding of the latest issues in the field. *PPC's Guide to Preparing Nonprofit Financial Statements* and other PPC products are available for purchase at **tax.tr.com**/**ppcguidance**.

To obtain credit for this course, you must complete the learning process by logging on to our Online Grading System at **cl.tr.com**/**ogs** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **May 31, 2019**. Complete instructions for grading are included below and in the Test Instructions preceding the Examination for CPE Credit.

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Each course is divided into lessons. Each lesson addresses an aspect of nonprofit financial statement preparation. 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.

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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.

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COMPANION TO PPC'S GUIDE TO PREPARING NONPROFIT FINANCIAL STATEMENTS

COURSE 1

FINANCIAL STATEMENT NOTES AND SPECIAL PURPOSE FRAMEWORKS (NFSTG181)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course discusses two aspects of preparing financial statements for nonprofit organizations. Lesson 1 takes a look at the notes that should be included in a nonprofit organization's financial statements. Lesson 2 discusses special purpose frameworks, such as the cash and tax bases, and how they might affect the financial statements of a nonprofit organization.

Note: This course does not discuss disclosures under ASU 2016-14. Future editions of this course will incorporate that information.

PUBLICATION/REVISION DATE: May 2018

RECOMMENDED FOR: Users of *PPC's Guide to Preparing Nonprofit Financial Statements*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of accounting

CPE CREDIT: 7 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 **May 31, 2019**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Notes to the Financial Statements

Completion of this lesson will enable you to:

- Identify the appropriate presentation for a nonprofit organization's financial statement notes, how to determine necessary disclosures, and how to address the summary of significant accounting policies.
- Determine the best way to deal with common problems that arise when preparing frequent disclosures for the notes in a nonprofit organization's financial statements prior to the adoption of ASU 2016-14.
- Determine the best way to address common problems related to general disclosures and other disclosures that appear in a nonprofit organization's financial statement notes.
- Recognize how to approach the disclosure of information about financial instruments and the risks and uncertainties that affect a nonprofit organization's financial statement notes.

Lesson 2—Special Purpose Frameworks

Completion of this lesson will enable you to:

- Determine when a nonprofit organization might use a special purpose framework and what form the financial statements might take.
- Identify specific considerations that apply when nonprofit organizations use the pure cash basis, the modified cash basis, and the tax basis, as well as how to deal with accounting changes.

TO COMPLETE THIS LEARNING PROCESS:

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Lesson 1: Notes to the Financial Statements

INTRODUCTION

Authoritative Basis for Notes

Authoritative standards mandate many types of disclosures but generally do not mandate the manner of presentation. Some disclosures are best presented in separate notes rather than in the basic financial statements. Notes to financial statements are an integral part of financial statements. They should be used to present material disclosures required by generally accepted accounting principles that are not otherwise presented in the statements, that is, on the face of the statements.

Overview of the Guidance for Financial Statement Disclosures in ASU 2016-14

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. Among other items, ASU 2016-14 requires enhanced disclosures about liquidity, net assets with donor restrictions, designations of net assets made by the governing board, methods used to allocate costs among program and support functions, and endowment funds.

ASU 2016-14 makes the following changes to the notes to the financial statements:

- Eliminates the disclosure requirement to reconcile investment return to the amounts on the face of the statement of activities if the investment return is divided into operating and nonoperating components.
- Eliminates the requirement to disclose the composition of investment return (investment income, net realized gains or losses on investments reported at other than fair value, and net gains or losses on investments reported at fair value).
- Eliminates the requirement to disclose investment income separate from net appreciation or depreciation (gains and losses) in the rollforward of the net assets of endowment funds.
- Requires qualitative and quantitative disclosures about the liquidity and availability of financial assets.
- Requires additional disclosures about underwater endowment funds.
- Requires disclosures about governing board designations of net assets.
- Requires an analysis of expenses by functional and natural expense classifications to be included in one location—on the face of the statement of activities, in the notes to the financial statements, or as a separate statement—and a description of the allocation methods and bases used in classifying expenses among the functional expense categories.
- Makes changes throughout the currently required disclosures to correspond with the new net asset classes.

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. The guidance in this lesson does not reflect early implementation of ASU 2016-14. More information about the new requirements in ASU 2016-14 is available in *PPC's Guide to Preparing Nonprofit Financial Statements.*

Organization of This Lesson

Some disclosures may be efficiently provided on the face of the financial statements; for example, the allowance for uncollectible receivables. Other disclosures may be provided either on the face of the financial statements or in notes, depending on considerations such as space limitations. Disclosures that are typically provided on the face of the financial statements are beyond the scope of this course (though more information on such disclosures can be found in *PPC's Guide to Preparing Nonprofit Financial Statements*). This lesson explains disclosures for nonprofit organizations commonly made in the notes. However, this lesson does not attempt to describe all possible disclosures. Therefore, this lesson is not organized by financial statement caption, and there is not a discussion of disclosures related to every possible financial statement caption.

How to Use This Lesson

This lesson provides practical guidance on drafting notes. As noted previously, this lesson does not discuss all disclosures required by GAAP. The guidance covers presentation matters as well as technical requirements for common problem areas.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the appropriate presentation for a nonprofit organization's financial statement notes, how to determine necessary disclosures, and how to address the summary of significant accounting policies.
- Determine the best way to deal with common problems that arise when preparing frequent disclosures for the notes in a nonprofit organization's financial statements prior to the adoption of ASU 2016-14.
- Determine the best way to address common problems related to general disclosures and other disclosures that appear in a nonprofit organization's financial statement notes.
- Recognize how to approach the disclosure of information about financial instruments and the risks and uncertainties that affect a nonprofit organization's financial statement notes.

MATTERS OF PRESENTATION

Comparative Financial Statements

Disclosures for Prior Years Repeated. When comparative financial statements are issued, FASB ASC 205-10-45-4 requires disclosures for prior periods to be repeated if they continue to be of significance. Many accountants believe that disclosures related to the statement of activities and the statement of cash flows generally should be presented for all periods; however, disclosures related to the statement of financial position should be evaluated to determine whether they are still meaningful. For example, information about commitments and contingent liabilities is disclosed primarily because it is helpful in assessing future cash flow. Accordingly, that information as of the date of the preceding statement of financial position generally is not relevant. Exceptions to the general policy also are justified when the authoritative literature requires disclosure only in the current or most recent period. For example, FASB ASC 470-10-50-1 requires disclosure of maturities of long-term debt for the five years following the current statement of financial position.

Disclosures when Summarized Prior-year Information is Presented. When financial statements are presented in a columnar format, presentation of prior-period amounts for each net asset class can be very cumbersome or confusing. Thus, for simplicity, many nonprofit organizations present only summarized information (in a single column) for the prior period in their financial statements. This practice is acceptable, but the summarized financial information usually lacks sufficient detail required by GAAP (for example, reporting of changes in net assets for each net asset class). FASB ASC 958-205-45-8 and 958-205-50-4 note that if the summarized prior-year information does not meet GAAP requirements, the financial statements should be titled to indicate the prior-year information is summarized, and the notes to the financial statements must describe the nature of the summarized prior-year information.

When a nonprofit organization's financial statements present summarized prior-year information that does not meet the requirements in GAAP, nonauthoritative guidance at Paragraph 3.57 of the Audit Guide recommends preparers include all the disclosures required by GAAP for the prior year. However, some preparers prefer that the notes to the financial statements include only current-year information to further emphasize that the prior-year information is not a complete GAAP presentation.

One Financial Statement Presented

Preparers are sometimes asked to present only one basic financial statement; for example, a statement of financial position without a statement of activities and a statement of cash flows. In those situations, the preparer should present only the disclosures that relate to the financial statement presented. For example, if only a statement of financial position is presented, there would be no need to disclose interest expense. Also, preparers are sometimes requested to present a full set of basic financial statements for some users and a single financial statement, such as a statement of financial position, for others. In that situation, different sets of notes also should be prepared to provide a relevant presentation. Because that only involves eliminating some items from the notes for the full set, it should not be costly or time-consuming.

Intermediate Measure of Operations on the Statement of Activities

FASB ASC 958 allows organizations a great deal of flexibility in arranging the statement of activities. FASB ASC 958-220-45-9 through 45-12 note that a nonprofit organization may divide the statement of activities between operating and nonoperating activities. Authoritative literature does not define the term "operations." However, if the organization's use of the term is not apparent from the information on the face of the statement of activities, then the notes to the financial statements should describe how the term is used.

DETERMINING WHICH DISCLOSURES ARE NECESSARY

Determining what is required for a fair presentation in conformity with GAAP involves consideration of both of the following:

a. Specific disclosures required by authoritative pronouncements.

b. Disclosures not specifically required by authoritative pronouncements but that are necessary to keep the financial statements from being misleading.

Determining the disclosures that are necessary in specific circumstances may be complex and requires seasoned professional judgment. The following general advice can help determine which disclosures may be necessary in specific circumstances:

- Assume that the reader is a business person who has a basic knowledge of accounting and is not a part of management.

- Read the statements from the viewpoint of that type of reader and evaluate whether the information would affect the reader's conclusions about the statements.

A reader of the financial statements should not reach the wrong conclusion about financial position and changes in net assets based on a reasonable reading of the statements including the notes. Disclosure checklists are not included in this course, but such resources are available in *PPC's Guide to Preparing Nonprofit Financial Statements.*

THE SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

According to FASB ASC 235-10-50-1, all significant accounting policies followed by an organization should be disclosed in its financial statements. The format of the disclosure, including the location, is flexible. However, it is preferable to use a separate summary that presents the information or to include it in the first note. Many accountants include the nature of an organization as the first item in the summary. FASB ASC 275-10-50-1 requires disclosure of the nature of an organization's activities and is discussed further later in this lesson.

Content

General Requirements. The *accounting policies* of an organization are the specific accounting principles and methods of applying those principles that have been adopted for preparing the financial statements. An accounting policy is significant if it materially affects the determination of financial position, cash flows, or changes in net assets. According to FASB ASC 235-10-50-3, the disclosure of accounting policies should describe accounting principles and methods that involve any of the following:

a. A selection from existing acceptable alternatives.

b. Industry peculiarities.

c. Unusual or innovative applications of GAAP.

Application. If there are existing acceptable alternatives, a specific authoritative pronouncement will normally require disclosure. For example, FASB ASC 360-10-50-1 requires a description of depreciation methods. Also, there generally are authoritative pronouncements that provide guidance on accounting policies peculiar to specific industries, such as nonprofit organizations. However, there is little guidance on disclosure of unusual or innovative applications of GAAP. In general, preparers of financial statements should assume that readers have a fundamental knowledge of accounting principles, but not expert knowledge. That means, for example, that the accounting treatment of donated materials and services might be considered unusual and would be disclosed.

Practice Problems

Methods That Approximate GAAP. If an accounting method approximates a generally accepted principle or method, it is a best practice to use the GAAP description. Describing both the GAAP method and the method that approximates it only serves to confuse the reader. If the difference between methods is not material, the fact that a method is used that only approximates GAAP is not really significant.

Numbers in Policy Notes. Normally, the accounting policies note should only deal with policies, and numbers should be excluded. However, exceptions to that policy may be justified when an additional note would have to be used only to disclose the number. For example, when costs of joint activities that include a fund-raising appeal were incurred and allocated between fund-raising and the appropriate program or management and general function, the types of activities for which joint costs have been incurred would be described in the policy notes. It would also be acceptable for the note to include the total amounts allocated during the period and the portion allocated to each functional expense category.

More Than One Policy for a Caption. In some cases, primarily for inventory and depreciation, more than one accounting method may be used. Generally, the accounting policy note should describe only the primary or dominant method. The accounting policy disclosure is intended to identify the methods that have a significant effect on the financial statements. If one method accounts for most of the effect on the financial statements, only that method need be identified. For example:

> Depreciation is computed using primarily the straight-line method.

If two methods have a significant effect, both should be described. For example:

> Depreciation is computed using primarily the straight-line method, except for automobiles, which are depreciated using the 150% declining balance method.

Accounting Changes. In addition to the other disclosures required for a change in accounting principle, the relevant accounting policy note should be expanded to describe use of different methods during the periods covered by the financial statements. For example:

> Depreciation is computed using primarily the straight-line method, except for automobiles, which have been depreciated using the 150% declining balance method. However, as described in Note X, effective January 1, 20X7, the Organization adopted the straight-line method to determine depreciation on its automobiles.

Specifically Required Accounting Policy Disclosures

Several authoritative standards specifically require disclosure of an accounting policy. Some disclosures that are common for nonprofit organizations are as follows:

- *Inventories.* The basis for stating inventories and the method of determining cost (FASB ASC 210-10-50-1).
- *Long-lived Asset (Property and Equipment) Capitalization.* The policy for capitalizing long-lived assets (FASB ASC 958-360-50-1).
- *Basis for valuation of depreciable assets.* The basis of valuation of property, plant, and equipment (for example, cost for purchased items and fair value for contributed items).
- *Depreciation.* A general description of the methods used in computing depreciation for major classes of depreciable assets (FASB ASC 360-10-50-1).
- *Environmental Remediation Liabilities.* The policy for measuring environmental remediation liabilities either on a discounted or undiscounted basis (FASB ASC 410-30-50-4).
- *Cash Equivalents.* The policy used to determine which short-term investments are treated as cash equivalents in the statement of cash flows (FASB ASC 230-10-50-1).
- *Investments.* The basis for determining the carrying value for other investments not required to be carried at fair value, as well as the methods and significant assumptions used in estimating fair value if those investments are carried at fair value (FASB ASC 825-10-50; 958-320-50; 958-325-50).
- *Contributions.* If applicable, the policy for recording restricted contributions as unrestricted support (support within net assets without donor restrictions after the adoption of ASU 2016-14) when the restrictions are met during the period, and whether the organization implies time restrictions on gifts of long-lived assets (FASB ASC 958-605-50-2 and 50-3; 958-360-50-1).
- *Restricted Investment Income and Gains.* If applicable, the organization's policy to report donor-restricted gains and investment income with restrictions that are met in the same reporting period as unrestricted support (support within net assets without donor restrictions after the adoption of ASU 2016-14) (FASB ASC 958-320-45-3).
- *Endowment Funds.* If applicable, the organization's endowment spending policies and a description of the endowment investment policies including: the return objectives and risk parameters, how those objectives relate to the endowment spending policies, and the strategies employed for achieving those objectives (FASB ASC 958-205-50-1B).
- *Collection Items.* The policy for capitalizing collection items (FASB ASC 958-360-50-1) and whether the organization recognizes contributions of collection items.
- *Advertising.* The policy used for reporting advertising (i.e., whether costs are expensed as incurred or when the advertising first takes place (FASB ASC 340-20-50-1).
- *Noncash Agency Transactions.* If applicable, the organization's policy if it acts as an intermediary or agent and chooses to record the receipt of nonfinancial assets specified for a beneficiary (FASB ASC 958-605-50-4).
- *Intangible assets.* The policy for the treatment of costs incurred to renew or extend the term of a recognized intangible asset (FASB ASC 350-30-50-2).
- *Accounting by creditors for impairment of a loan.* The method used to recognize interest income related to impaired loans, including how cash receipts are recorded (FASB ASC 310-10-50-15).

- *Loans, notes, and trade receivables.* The basis of accounting for loans or accounting for loan and trade receivables, including determination of allowances, charge offs, recognizing interest income, treatment of related fees, and how cash receipts are recorded (FASB ASC 310-10-50-2; 310-10-50-4A; 310-10-50-15).

- *Sales and Similar Taxes.* The policy regarding the presentation of sales and similar taxes; that is, whether such taxes are presented on a gross or net basis (FASB ASC 605-45-50-3 and FASB ASC 606-10-32-2A).

- *Interest and Penalties Associated with Tax Positions* The policy for classifying interest, as income taxes or interest expense, and penalties, as income taxes or another expense (FASB ASC 740-10-50-19).

- *Shipping and Handling Costs.* The policy for classifying shipping and handling costs; that is, whether such costs are included in cost of sales (FASB ASC 605-45-50-2 and FASB ASC 606-10-25-18B).

- *Measurement Date of Defined Benefit Obligation and Plan Assets.* If elected, the policy to measure plan assets and benefit obligations using the month-end closest to the organization's fiscal year-end. (FASB ASC 715-20-50-5)

In addition to the examples listed above, FASB ASC 235-10-50-4 identifies certain other required disclosures; for example, the consolidation policy, if applicable.

Required Disclosure Regarding Subsequent Events. FASB ASC 855-10-50-1 requires reporting entities to disclose the date through which subsequent events have been evaluated and whether that date is the date the financial statements were issued or were available to be issued. That disclosure is required regardless of whether the reporting entity recognizes or discloses a subsequent event in its financial statements. Accordingly, it should be included in all financial statements prepared in accordance with GAAP. Although this disclosure is not actually an accounting policy, some accountants choose to make this disclosure as part of the summary of significant accounting policies note. Other accountants, however, choose to make this disclosure in a separate note (for example, the last note in the financial statements). The following is an example of a note that meets this disclosure requirement:

> Management has evaluated subsequent events through March 25, 20X4, the date the financial statements were available to be issued.

Accounting for and disclosure of subsequent events are discussed further later in this lesson.

Recommended Accounting Policy Disclosures

As mentioned earlier in this lesson, GAAP requires disclosure of all significant accounting policies. In addition to disclosures required by specific pronouncements, it is a best practice to disclose the accounting methods prescribed by GAAP that are relatively complex and other generally accepted disclosures, such as the following:

- The Internal Revenue Code section under which the organization is exempt from federal income taxes or excise taxes and, for a 501(c)(3) organization, classification as either a private foundation or other than a private foundation (public charity).

- The basis for allocating expenses among program and supporting services.

- The use of fund accounting, if applicable.

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 statements most accurately describes an issue related to the presentation of the notes to a nonprofit organization's financial statements?

    a. Most nonprofit organizations present prior-period amounts for each class of net assets in comparative financial statements, so a note is not needed.

    b. If only one financial statement is presented by the nonprofit organization, the notes would include only disclosures related to that specific statement.

    c. A note describing how the nonprofit organization defines "operations" is unnecessary because they must follow specific guidelines in FASB ASC 958.

    d. It is a best practice for a nonprofit organization to omit GAAP disclosures if summarized prior-year information does not meet GAAP requirements.

2. How does a preparer determine which disclosures are necessary in specific circumstances?

    a. By determining whether the information can be understood by an accountant.

    b. By determining whether the information can be understood by a member of management.

    c. By determining whether the information can be understood based on the face of the financial statements.

    d. By determining whether the information would affect readers' conclusions based on their points of view.

3. Which of the following would an organization include about its accounting principles and methods in its note summarizing significant accounting policies?

    a. It is one of multiple acceptable alternatives.

    b. It is standard for the organization's industry.

    c. It adheres to normal interpretations of GAAP.

    d. A number will be included.

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 statements most accurately describes an issue related to the presentation of the notes to a nonprofit organization's financial statements? **(Page 5)**

   a. Most nonprofit organizations present prior-period amounts for each class of net assets in comparative financial statements, so a note is not needed. [This answer is incorrect. When financial statements are presented in a columnar format, presentation of prior-period amounts for each net asset class can be very cumbersome or confusing. Thus, for simplicity, many nonprofit organizations present only summarized information (in a single column) for the prior-period financial statements. If this summarized information does not meet GAAP requirements, the notes to the financial statements must describe the nature of the summarized prior-year information.]

   b. If only one financial statement is presented by the nonprofit organization, the notes would include only disclosures related to that specific statement. [This answer is correct. Preparers are sometimes asked to present only one basic financial statement. In those situations, the preparer should present only the disclosures that relate to the financial statement presented.]

   c. A note describing how the nonprofit organization defines "operations" is unnecessary because they must follow specific guidelines in FASB ASC 958. [This answer is incorrect. FASB ASC 958 allows organizations a great deal of flexibility in arranging the statement of activities. Authoritative literature does not define the term "operations." However, if the organization's use of the term is not apparent from the information on the face of the statement of activities, then the notes to the financial statements should describe how the term is used.]

   d. It is a best practice for a nonprofit organization to omit GAAP disclosures if summarized prior-year information does not meet GAAP requirements. [This answer is incorrect. When a nonprofit organization's financial statements present summarized prior-year information that does not meet the requirements in GAAP, nonauthoritative guidance at Paragraph 3.57 of the Audit Guide recommends that preparers include all the disclosures required by GAAP for the prior year.]

2. How does a preparer determine which disclosures are necessary in specific circumstances? **(Page 5)**

   a. By determining whether the information can be understood by an accountant. [This answer is incorrect. The reader should be assumed to be a business person who has a basic knowledge of accounting.]

   b. By determining whether the information can be understood by a member of management. [This answer is incorrect. The reader of the financial statements should be assumed to be someone who is *not* involved with the entity's management.]

   c. By determining whether the information can be understood based on the face of the financial statements. [This answer is incorrect. A reader of the financial statements should not reach the wrong conclusion about financial position and changes in net assets based on a reasonable reading of the statements *including the notes.*]

   d. By determining whether the information would affect readers' conclusions based on their points of view. [This answer is correct. Assuming the correct assumptions are made about the reader, to determine which disclosures are necessary, the preparer should read the statements from the viewpoint of that type of reader and evaluate whether the information would affect the reader's conclusions about the statements.]

3. Which of the following would an organization include about its accounting principles and methods in its note summarizing significant accounting policies? **(Page 6)**

   a. It is one of multiple acceptable alternatives. [This answer is correct. Under FASB ASC 235-10-50-3, one circumstance under which accounting principles and methods need to be disclosed is when there is a selection of existing acceptable alternatives. If there are existing acceptable alternatives, a specific authoritative pronouncement will normally require disclosure. For example, FASB ASC 360-10-50-1 requires a description of depreciation methods.]

   b. It is standard for the organization's industry. [This answer is incorrect. According to FASB ASC 235-10-50-3, the disclosure of accounting policies should describe accounting principles and methods that involve, among other things, industry peculiarities. Thus, industry standards would not require disclosure.]

   c. It adheres to normal interpretations of GAAP. [This answer is incorrect. If the policy involves unusual or innovative applications of GAAP, disclosure is required under FASB ASC 235-10-50-3. Adhering to the typical applications and interpretations of GAAP would not necessitate a specific disclosure.]

   d. A number will be included. [This answer is incorrect. Normally, the accounting policies note should only deal with policies, and numbers should be excluded. However, exceptions to that policy may be justified when an additional note would have to be used only to disclose the number. Therefore, though there are exceptions, disclosing numbers is not the rule, so there is a better answer to this question.]

COMMON PROBLEMS THAT CAN OCCUR WHEN PREPARING FREQUENT DISCLOSURES BEFORE THE ADOPTION OF ASU 2016-14

Introduction

This section describes this course's recommendations for dealing with common problems that arise in preparing note disclosures related to specific financial statement captions before the adoption of ASU 2016-14. 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. 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. The guidance in this lesson does not reflect implementation of ASU 2016-14. An overview of the new requirements in ASU 2016-14 is available in *PPC's Guide to Preparing Nonprofit Financial Statements.*

Fair Value Disclosure Considerations. In addition to the specific disclosures discussed in this section, some assets and liabilities reported in the financial statements will be subject to the disclosure requirements of FASB ASC 820-10-50. Those standards describe the general requirements for disclosures about fair value measurements. Other disclosures are also required if a nonprofit organization elects the fair value option available under FASB ASC 825-10 for reporting eligible assets and liabilities. These disclosure requirements are discussed later in this lesson.

Investments

The following paragraphs discuss the disclosure requirements for investments commonly held by nonprofit organizations. A discussion of disclosures for investments under the equity method appears later in this lesson.

Carrying Amounts. FASB ASC 958-320 and 958-325 require disclosure of the carrying amounts of each major type of investment, such as equity securities, U.S. Treasury securities, debt securities, certificates of deposit with original maturities of more than three months, and other investments like oil and gas properties and real estate. The organization is also required to disclose the basis used to determine the carrying amount for other investments that are within the scope of FASB ASC 958-325. Additional qualitative and quantitative information is required for investments accounted for using the cost method. In addition, if the organization carries investments other than financial instruments at fair value, the methods and assumptions used to estimate fair value should be disclosed.

Realized and Unrealized Gains and Losses on Investments. FASB ASC 958-320 and 958-325 require disclosure of the components of investment return, including investment income, information about net realized gains or losses on investments carried at other than fair value, and information about net gains or losses on investments carried at fair value. If the organization presents an intermediate measure of operations on the statement of activities and includes only a portion of the investment return in that intermediate measure, a reconciliation showing how the investment return is reported in the statement of activities is also required. In addition, the disclosures should include the policy used to determine the portion of the return that is included in the intermediate measure of operations and, if applicable, the reason for any changes to that policy.

FASB ASC 958-320-45-3 allows an organization to report investment gains and income that are restricted to specific uses by the donor as unrestricted support (support within net assets without donor restrictions after the adoption of ASU 2016-14) if the donor restrictions are met in the reporting period in which the gains and income are recognized. This policy should be followed consistently for all such investment gains and income, and needs to be disclosed. The organization should follow a similar policy for restricted contributions.

If a loss has not been recognized for impaired investments in equity securities accounted for using the cost method, FASB ASC 958-325-50-2 directs the financial statement preparer to FASB ASC 320-10-50-6 that requires certain quantitative information aggregated by category of investment to be 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. A description of the factors considered in reaching the conclusion that the impairments are not other-than-temporary, including the nature of the investment, the cause of the impairment, the number of investment positions in an unrealized loss position, the severity and duration of the impairment, and other evidence considered relevant is required.

Before the effective date of ASU 2016-14, for colleges and universities, FASB ASC 958-325-50-6 also requires that the amount of investment income, and realized and unrealized gains and losses from investments other than debt and equity securities with readily determinable fair values, to be disclosed in the financial statements or in the notes to the financial statements.

Investment Expenses. GAAP allows organizations to report investment income net of related expenses, such as investment management or custodial fees. According to FASB ASC 958-220-50-1, before the effective date of ASU 2016-14, the amount of any such expenses must be disclosed either on the face of the statement of activities or in the notes to the financial statements.

Concentrations of Risk. FASB ASC 825-10 requires disclosures of significant concentrations of credit risk from financial instruments and encourages, but does not require, disclosure of quantitative information about the market risks of financial instruments. FASB ASC 958-320-50-3 also requires information for the most recent statement of financial position about investments with a significant concentration of market risk, including the nature and carrying amount of the investments. These requirements are discussed later in this lesson.

Considerations for Fair Value Disclosures for Investments. Nonprofit organizations frequently hold portfolios of investments for which different measurement objectives apply. For example, an organization may hold equity and debt securities that are required to be measured at fair value at each reporting date. The disclosures about fair value measurements required by FASB ASC 820-10-50 would apply to these investments. The same organization might also hold other investments that are reported at cost or some other measurement objective in subsequent reporting periods, and the requirements of FASB ASC 820-10-50 would not be applicable. Many nonprofit organizations report such dissimilar types of investments separately in the financial statements. For example, the two different types of investments might be reported in the financial statement captions "Investments" and "Other investments" (or a more descriptive caption such as "Oil and gas interests, at cost"). When separate captions are used, the total for investments in the tabular presentation required by FASB ASC 820-10-50 would reconcile with investments reported at fair value in the statement of financial position.

However, the reconciliation from the note containing the fair value disclosures to the statement of financial position, or other note disclosures about investments, might not be straightforward in other cases. For example, certificates of deposit (CDs) with original maturities of more than three months are generally reported at a cost-based measure (that is, original deposit plus accrued interest) and often classified with investments because they cannot be considered cash equivalents. Financial statement preparers may include CDs with the investments described in the note disclosure about recurring fair value measurements even though they are not carried at fair value. How should the financial statement preparer apply the requirements of FASB ASC 820-10-50 when reporting CDs? Although CDs are usually reported using a cost-based measure, they can be disclosed as having been measured using quoted prices in active markets. (That is, Level 1 inputs in the fair value measurement hierarchy.) When CDs are not material, this presentation would likely not be considered misleading, and it has the advantage of simplifying the reconciliation of total investments presented within the notes to investments in the statement of financial position.

If the presentation discussed above is not appropriate because CDs are material to the financial statements, accountants may consider the nonauthoritative guidance at Q&A 2130.38-.40 of the AICPA Technical Questions and Answers that address reporting CDs. The guidance points out that CDs are only subject to the disclosure requirements of FASB ASC 820-10-50 if they are *securities* as defined in FASB ASC 320-10-20. Since most CDs do not meet that definition, Q&A 2130.39 suggests CDs with original maturities of more than three months may be reported in "Investments—other." Accordingly, CDs are exempt from the requirements of FASB ASC 820-10-50 (unless the organization has elected to measure all other investments at fair value). In summary, if CDs that are not cash equivalents are material, the financial statement preparer could—

- Include them in a financial statement caption with other investments that are not within the scope of FASB ASC 820-10-50.

- Include them in a financial statement caption with all investments, some of which are within the scope of FASB ASC 820-10-50, and list them in a reconciliation that begins with investments measured at fair value on a recurring basis and ends with total investments as reported in the statement of financial position.

Endowment Funds

Before the effective date of ASU 2016-14, FASB ASC 958-205-45-28 through 45-32 address the net asset classification of donor-restricted endowment funds for nonprofit organizations that are subject to an enacted version of the Uniform Prudent Management of Institutional Funds Act (UPMIFA). All nonprofit organizations that have endowment funds, regardless of whether they are subject to UPMIFA, are subject to disclosure requirements at FASB ASC 958-205-50-1A through 50-2.

Nonprofit organizations with donor-restricted or board-designated endowment funds are required to disclose the following:

a. A description of the organization's policies for making appropriations for expenditures from endowment funds (i.e., the organization's endowment spending policies).

b. A description of the organization's investment policies for endowment funds. This description should include matters such as return objectives and risk parameters for the funds, how those objectives relate to the spending policies for the funds, and the strategies employed for achieving the objectives.

c. The composition of the organization's endowment by net asset class at the end of the period in total and by type of endowment fund. Donor-restricted endowment funds should be shown separately from board-designated endowment funds.

d. A reconciliation of the beginning and ending balances of endowment funds in total and by net asset class. This reconciliation must include, at a minimum: (1) investment return separated into investment income and net appreciation or depreciation of investments, (2) contributions, (3) amounts appropriated for expenditure, (4) reclassifications, and (5) other changes.

e. A description of the organization's interpretation of the law(s) underlying the net asset classification of donor-restricted endowment funds.

If the fair value of assets held in donor-restricted endowment funds is less than the level required by donors or by law, before the effective date of ASU 2016-14, FASB ASC 958-205-50-2 also requires the total amount of the deficiencies to be disclosed for each statement of financial position presented. The amount disclosed is the sum of any deficiencies in the nonprofit organization's individual donor-restricted endowment funds, not the net deficiency for the nonprofit organization as a whole.

Donor-restricted endowment funds seem to also include perpetual trusts, where the nonprofit organization has an irrevocable right to receive the income from the trust's assets in perpetuity, but the organization will never receive the trust's assets. Accordingly, it is a best practice for the organization to include those trusts when making the disclosures listed above. Since the decisions for investing the assets in perpetual trusts are typically not within the organization's control, the investment policy for such funds could be disclosed using language such as the following: "$XX of the endowment funds are held in perpetual trusts, the investment of which is determined by the trustee rather than the Organization."

ASU 2016-14 amends and expands the presentation and disclosure requirements for endowment funds, including the addition of new required disclosures for underwater endowment funds. More information on this topic is beyond the scope of this course but can be found in *PPC's Guide to Preparing Nonprofit Financial Statements.*

Promises to Give

A promise to give is unconditional if its receipt depends only on the passage of time or demand by the organization and no right of return of any assets transferred exists. Conditional promises generally depend on some future event occurring before the promisor is bound or allow for a right of return of assets depending on some future event. If the chance that such event will not occur is remote, FASB ASC 958-605-25-12 requires that the promise to give be accounted for as an unconditional promise. In addition, if the promise contains vague stipulations that do not clearly indicate an unconditional promise to give, GAAP requires the promise to be treated as a conditional promise. Unconditional promises to give are recorded at their fair value when received, while conditional promises

to give are only recorded when the conditions on which they depend are substantially met. The fair value option available under FASB ASC 825-10 may be adopted by an organization to measure unconditional promises to give subsequent to their initial recording.

Unconditional Promises to Give. The following disclosures related to unconditional promises to give are required:

- Unconditional promises to give pledged as collateral or otherwise limited as to use.
- The amounts receivable in less than one year, in one to five years, and in more than five years.
- The amount of the allowance for uncollectible promises receivable.
- The amount of the unamortized discount, if there is a discount associated with unconditional promises to give.
- The effective interest rate and the total amount of the contribution receivable.

Conditional Promises to Give. FASB ASC 958-310-50-4 requires the following disclosures about conditional promises to give:

- The total of amounts promised.
- A description and amount for each group of promises having similar characteristics. For example, separate groups having similar characteristics might include those promises conditioned on establishing new programs, on completing a new building, or on raising matching gifts by a specified date.

FASB ASC 958-605-55-51 notes these disclosures should be made when the organization is the recipient of a conditional promise to give in a valid will.

Property and Equipment

General Disclosure Requirements. FASB ASC 360-10-50-1 requires disclosure of depreciation expense, the balances of major classes of depreciable assets by nature or function at the date of the statement of financial position, and a general description of depreciation methods by major classes. (Accumulated depreciation generally is disclosed in total rather than by major classes; however, disclosure by major classes is permitted.) Two common questions about preparing notes to meet those requirements are:

- How do you group major classes of depreciable assets by nature and function?
- Is it necessary or desirable to also disclose the bases, lives, and repairs and maintenance practices for the major classes of assets?

The following steps can help with the development of major classes of property and equipment:

- The accounts should be grouped by type (land, buildings, leasehold improvements, and equipment).
- If equipment consists of items with essentially the same characteristics, no further detail should be provided.
- If equipment consists of material amounts of items with significantly different characteristics, such as automobiles and furniture, it should be distinguished by those characteristics.
- Immaterial amounts should be presented either in an "Other" caption or combined with the material components.

Although sometimes disclosed on the face of the statement of financial position, the information may be conveniently presented in a table in the notes to the financial statements.

Although not required by professional standards, some preparers also disclose the estimated useful lives of property and equipment, typically by disclosing a range of years. Others choose not to disclose estimated useful lives because they think it is not useful information.

FASB ASC 360-10 and 205-10 require a number of disclosures relating to both impaired assets held for disposal and assets that will continue to be used in operations.

Requirements Specific to Nonprofit Organizations. In addition to the general requirements discussed previously, FASB ASC 958 includes disclosure requirements that are specific to nonprofit organizations. The following paragraphs discuss those disclosure requirements.

FASB ASC 958-360-50-1 requires that the nonprofit organization's policy regarding the implying of time restrictions on gifts of long-lived assets be disclosed. The organization should disclose if it reports donor-restricted contributions of property and equipment as unrestricted contribution revenue (revenue or support without donor restrictions after the adoption of ASU 2016-14) if the donor restrictions are met in the same reporting period in which the contributions are recognized and if that policy is followed consistently for all such contributions. See discussion of restricted assets below.

FASB ASC 958-360-50-1 requires organizations to describe their policy for capitalizing property and equipment and the basis of valuation of the property and equipment. Sometimes preparers of financial statements omit disclosing the capitalization policy of the organization.

FASB ASC 835-20-50-1, FASB ASC 840-30-50-1, FASB ASC 958-210-50-3, and FASB ASC 958-360-50-2 require that the following components of property and equipment be separately disclosed on the statement of financial position or in the notes to the financial statements:

- Nondepreciable assets.
- Property and equipment not held for use, such as construction in progress or assets held for sale or investment.
- Donor-restricted assets that are to be used to invest in property and equipment.
- Improvements to leased facilities and equipment.
- Capital lease assets (and related abilities).
- Capitalized interest.

In addition, FASB ASC 958-360-50-3 and 50-4 require disclosure of information about the liquidity of the property and equipment, including any limitations on the organization's use of the property and equipment. These limitations may include:

- Property and equipment pledged as collateral or subject to a lien.
- Property and equipment acquired with restricted assets and whose title may revert to a third party.
- Donor-imposed or legal restrictions on the use of property and equipment or the proceeds from the disposition of property and equipment.
- Terms of arrangements with resource providers, that are not lease transactions, in which although the resource provider retains title to the property or equipment during the term of the arrangement, it is probable the organization will be permitted to keep the assets at the end of the arrangement.

Collections

FASB ASC 958 discusses the treatment of collections. Information about capitalized collections is generally included in the statement of financial position. Under FASB ASC 958, organizations that elect not to capitalize their collections or to capitalize them prospectively (that is, all items acquired after a stated date) are required to describe such collections in the notes to the financial statements, including their relative significance, and their accounting and stewardship policies for collections. Disclosure also should be made of the fair value or description of collection items that are given away, damaged, destroyed, lost, or otherwise disposed of during the period. Those disclosures should be referenced from a statement of financial position caption. FASB ASC 958-360-50-5 also requires separate disclosure in the notes to the financial statements or on the statement of financial position for capitalized works of art, historical treasures, and other similar items that do not meet the definition of a collection.

Restricted Assets

Normally, only a nonprofit organization's net assets are restricted. However, there are instances when a donor may restrict the use of a particular asset. For example, a donor may contribute a building to a nonprofit organization with the restriction that it be used as a library, or the donor may donate investments that are to be sold and used to purchase certain equipment. FASB ASC 958-210-45-6 notes that if the organization has cash or other assets either (a) designated for long-term purposes or (b) limited to long-term purposes by donor-imposed restrictions, the notes to the financial statements should describe the kind (or type) of asset if its nature is not clear from the description on the face of the statement of financial position (for example, cash restricted for investment in property and equipment).

There may be restrictions on assets other than those imposed by donors. There may be contractual limits (such as compensating balances) or there may be self-imposed limitations. FASB ASC 958-210-50-3 requires contractual limits on the use of assets to be disclosed in the statement of financial position or the notes to the financial statements. FASB ASC 958-210-45-11 permits, but does not require, organizations to disclose self-imposed limitations on the use of unrestricted net assets [net assets without donor restrictions after the adoption of ASU 2016-14) (for example, a board designated endowment fund or a portion of unrestricted net assets (net assets without donor restrictions after the adoption of ASU 2016-14) designated for a specific future expenditure] if total unrestricted net assets are displayed on the statement of financial position. A discussion of disclosure requirements for board-designated endowment funds appeared earlier in this lesson. After the adoption of ASU 2016-14, information about the amounts and purposes of board-designations of net assets without donor restrictions are required to be provided in the notes to or on the face of the financial statements. While beyond the scope of this course, more information about ASU 2016-14 is available in *PPC's Guide to Preparing Nonprofit Financial Statements.*

FASB ASC 958-210-45-7 lists additional disclosure requirements specifically related to restrictions on cash and cash equivalents. First, the organization should disclose any requirements to hold cash in separate accounts. Also, the organization should disclose if significant liquidity problems exist, or if the organization has not maintained necessary amounts of cash (or equivalents) to comply with donor restrictions. ASU 2016-14 requires additional qualitative or quantitative information about how the organization manages its liquid resources to meet cash needs for general expenditures within one year of the date of the statement of financial position and whether its financial assets are available to meet those cash needs. While beyond the scope of this course, more information about ASU 2016-14 is available in *PPC's Guide to Preparing Nonprofit Financial Statements.*

Deferred Revenue and Refundable Advances

Nonprofit organizations may receive various types of deferred revenue. For example, revenue from exchange transactions may need to be deferred when subscription revenue is received in advance. Also, unexpended *conditional* grant awards are reported as refundable advances until they are spent for the purposes of the grants because conditional grant awards are not unconditional promises to give. While there is no requirement to do so, many nonprofit organizations present a description or reconciliation of the deferred revenue or refundable advances accounts in the notes to the financial statements when the amounts are material and the information will be useful to the reader.

Promises to Give to Others

If the organization has made an unconditional promise to give, as described in FASB ASC 720-25-25-1, the organization must record a liability (or reduce an asset if a liability is being forgiven). According to FASB ASC 958-405-50-1, organizations should disclose the total amount promised, separated into amounts payable in each of the next five years, the aggregate due in more than five years, and the unamortized discount (if a present value technique was used to initially measure the fair value of the payable). In addition, disclosures related to contingencies, fair value measurement, and long-term obligations may be necessary.

Long-term Debt

In practice, the following terms of long-term debt are usually disclosed:

a. Timing of payments.

b. Amount of scheduled payments and whether it includes interest.

c. Interest rate.

In addition, FASB ASC 958-210-50-2 requires disclosure of any special borrowing arrangements. An example of a special borrowing arrangement for a nonprofit organization could be a below-market interest rate or no-interest loan.

Common questions that arise in preparing note disclosure of the preceding information are as follows:

- Is all that detail really necessary?
- How do you disclose payment terms for combined categories of debt?
- Does the schedule of long-term debt need to be apportioned between current and noncurrent?
- Is it necessary to identify the creditor?
- How are the costs of obtaining a loan presented (that is, should the deferred costs be reported as an asset or as a reduction of the liability)?

Need for Detail on Rates, Dates, and Payments. Some preparers question whether all of the detail normally presented is really necessary. They note that the reader can generally assess the effect of debt on cash flows through the following:

- FASB ASC 470-10-50-1 requires disclosure of principal reductions during each of the next five years.
- FASB ASC 835-20-50-1 requires disclosure of interest costs.

Information on payment terms and interest rates of long-term debt can help readers more accurately assess the effect of debt (including interest) on cash flows. Because the information must be gathered to compute the five years' maturities, disclosing it requires little additional time.

Presentation of Debt Issuance Costs. FASB ASC 835-30-45 requires debt issuance costs to be presented in the statement of financial position as a reduction of the carrying amount of the debt rather than as an asset, and the associated amortization to be presented in the statement of activities as interest expense. The guidance in FASB ASC 835 does not address how much of the unamortized debt issuance costs should be presented as current versus noncurrent in a classified statement of financial position. It seems logical that all of the debt issuance costs may be netted against the noncurrent portion of the debt, or the following year's amortization may be netted against the current portion of long-term debt and the remaining debt issuance costs netted against the noncurrent debt. It is a best practice to choose an appropriate rationale and apply it consistently from year to year.

Disclosing Payment Terms for Combined Debt. If notes payable have been combined because of immateriality, the preparer of the financial statements has the following alternatives in disclosing payment terms:

a. Disclose only that the notes are payable in periodic installments, for example, "Notes payable in monthly installments."

b. Disclose the current total of installments and a range of current interest rates, for example, "Notes payable in monthly installments currently totaling $1,000, including interest ranging from 8% to 12%."

If the second alternative is used, the total of installments will normally be of greater interest to a reader than a range of installments because it helps in the assessment of cash flows. Similarly, current amounts are more useful than comparative amounts.

Need to Apportion Debt Schedule between Current and Noncurrent. If a classified statement of financial position is presented, it is a best practice to use captions that indicate that the current portion of long-term debt is included in current liabilities, such as "Current portion of long-term debt" and "Long-term debt, less current portion."

Is It Necessary to Identify the Creditor? There is no requirement in authoritative literature to identify the lender by name, and this course recommends against providing such detail unless the additional information would be useful to the reader; for example, when statements are prepared primarily for management's use.

Noncash Contributions

Many nonprofit organizations receive significant amounts of gifts-in-kind (tangible and intangible personal property) for the organization to sell or use in its programs or supporting services. Volunteers may provide significant amounts of free services, including administrative services, participation in fund-raising drives, and program services rendered to charitable beneficiaries of the organization. In addition, nonprofit organizations may receive free use of facilities, such as free office space. An accountant may have difficulty determining which donations should be recorded in the financial statements and the proper valuation of those donations.

Disclosure considerations for noncash contributions include the following:

- The disclosures for promises to give are required when noncash contributions have been recognized as unconditional promises to give and the receivables have not been collected at the date of the financial statements.

- The activities or programs for which donated services were used, the nature and extent of those services, and the amount recognized as revenue during the period should be disclosed. For example, the contributed services of an architect when a new facility is being constructed should be disclosed.

- If practical, the fair value of donated services received but not recognized as revenues in the financial statements needs to disclosed. For example, a nonprofit organization may want to disclose the number of volunteer hours received during the year and their estimated fair value, even though the donated services do not meet the criteria for recognition.

- If donated services that directly benefit the organization are received from personnel of an affiliate, the applicable related party disclosures should be made. Paragraph 5.221 of the Audit Guide notes that related party disclosures also could be required for certain gifts-in-kind received as contributions.

- If organizations report contributions (including noncash contributions) with donor-imposed restrictions as unrestricted support (support within net assets without donor restrictions after the adoption of ASU 2016-14) when the restrictions are met in the same reporting period, that policy should be disclosed.

- Prior to the effective date of ASU 2016-14, when gifts of long-lived assets are received without donor stipulations about how long the assets must be used, the organization may adopt a policy of implying time restrictions on those contributions. This policy should be disclosed if applicable.

An organization may also choose to disclose the unrecorded donated goods it receives as an agent for other entities.

When gifts-in-kind are significant, Paragraph 5.221 of the Audit Guide provides nonauthoritative recommendations for additional disclosures that would include the following:

- Accounting policies for gifts-in-kind.
- The general sources of gifts-in-kind (for example, government entities, other nonprofit organizations, and private donors).
- Amounts of gifts-in-kind received from contributions and from agency transactions.
- Amounts of gifts-in-kind used by the organization for its programs and donated to other nonprofit organizations.

An example of a disclosure that includes these items is provided in Paragraph 5.222 of the Audit Guide.

Restricted Contributions

Donors may make gifts to nonprofit organizations and restrict the time or manner of the gifts' use. Common questions that arise in preparing note disclosures for restricted contributions are as follows:

- What disclosures are required in addition to how restricted contributions are shown in the financial statements?
- What disclosures are required if a significant amount of restricted contributions or grants are from a particular donor or grantor or a small number of donors or grantors?
- What disclosures are required if a significant amount of restricted contributions are from a particular geographic area?
- What disclosures are required if the nonprofit organization does not comply with the restrictions?

There is only one disclosure unique to restricted contribution revenue, which is discussed below. There are several disclosures that are required of the net assets that are created by restricted contributions or that are required about contributions in general, as follows:

- FASB ASC 958-210-50-3 requires disclosure of information about the nature and amount of the different types of donor-imposed restrictions that affect how and when, if ever, the resources (net assets) can be used.
- FASB ASC 958-205-50 requires disclosures about endowment funds.
- FASB ASC 958-30-50 requires disclosures about split-interest gifts.
- FASB ASC 275-10-50 requires disclosures about vulnerability when contributions are from a single or small group of donors or grantors, or are concentrated in a particular geographic region.

A disclosure is also required if the organization fails to comply with donor restrictions.

Donor Restrictions Met in the Same Reporting Period. According to FASB ASC 958-605-45-4, nonprofit organizations may report restricted contributions for which the restrictions are met in the same reporting period in which the contribution is made as unrestricted contribution revenue (revenue within net assets without donor restrictions after the adoption of ASU 2016-14), if that accounting policy is followed consistently for all such contributions and is disclosed. An organization that adopts this policy is required to have a similar policy for donor-restricted investment income and gains. Contributions of donor-restricted long-lived assets were discussed previously.

Disclosing Noncompliance with Donor Restrictions before the Adoption of ASU 2016-14. As discussed in Chapter 11 of the Audit Guide, the receipt of contributed assets imposes a fiduciary responsibility on an organization's management to use the resources effectively and efficiently in pursuit of the organization's mission; a donor's restriction on contributed resources focuses that fiduciary responsibility on a particular use for the contributed resources. The existence of donor-imposed restrictions affects the types and levels of service a nonprofit organization can provide, therefore the nonprofit organization's ability to maintain and report net assets may be more important to the user of the financial statements than reporting total net assets. Depending on the circumstances, noncompliance with donor-imposed restrictions may require disclosure or accrual.

If a nonprofit organization fails to comply with donor-imposed restrictions, one or more of the following disclosures is necessary:

- FASB ASC 958-450-50-2 requires disclosure of noncompliance with donor-imposed restrictions if there is (a) a reasonable possibility a material contingent liability has been incurred at the financial statement date or (b) at least a reasonable possibility 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 958-450-50-3 states that if the noncompliance results from the organization's failure to maintain an appropriate composition of assets in amounts necessary to comply with donor restrictions, the amounts and circumstances should be disclosed.

- FASB ASC 958-210-50-2 also indicates the organization should disclose if it lacks sufficient amounts of cash and cash equivalents to maintain compliance with donor-imposed restrictions.

Noncompliance with donor restrictions should be evaluated as a contingent liability. Thus, as discussed later in this lesson, if it is probable that a liability to a donor or grantor has been incurred, a liability should be recognized. If it is reasonably possible that a loss may have been incurred, the organization should disclose the nature of the contingency and the estimate of the loss. Additional information about contingencies that result from noncompliance with donor-imposed restrictions is provided later in this lesson.

When it is apparent the organization is using contributed resources in a manner inconsistent with the restrictions on them without the ability to restore the resources promptly, it may be necessary to disclose that the organization has not maintained an appropriate composition of assets to comply with donor-imposed restrictions.

An Appropriate Composition of Assets. The composition of assets held by an organization depends upon the nature and extent of donor restrictions on the organization's net assets. For example, a donor restriction that requires the organization to invest a gift in perpetuity and use the income to support one of the organization's programs requires that the organization own income-generating investments. A donor restriction that requires the organization to purchase a particular long-lived asset or support the expenses of a particular program requires that the organization have cash, cash equivalents, or other assets that can be easily liquidated to make the expenditure. Because many assets, especially the more liquid assets, are fungible, to determine the appropriate composition of assets, the organization needs to "inventory" its temporarily and permanently restricted net assets (net assets with donor restrictions after the adoption of ASU 2016-14) and decide what types of assets are necessary to comply with donor restrictions. It is only by equating assets with restricted net assets (net assets with donor restrictions after the adoption of ASU 2016-14) that an organization can understand the limitations on the expendability of its resources and maintain an appropriate composition of assets to comply with donor restrictions.

Determining If There Is an Appropriate Composition of Assets. The first step in determining whether there is an appropriate composition of assets is to analyze the organization's fiduciary responsibilities to comply with donor-imposed restrictions. As noted in the Audit Guide, Paragraphs 11.06–.07, an organization needs to maintain documentation about the activities and other purposes for which its net assets can be used. That documentation is needed not only for this purpose, but also to support the disclosure required by FASB ASC 958-210-50-3 of the nature and amounts of restrictions on net assets—either on the face of the statement of financial position or in the notes to the financial statements. More information about that documentation appears later in this lesson.

In addition to understanding its donor-imposed restrictions, an organization must also understand any additional legal restrictions that make assets unavailable for meeting donor restrictions. For example, if an organization is legally required by its bond agreement to maintain a portion of the bond proceeds in a trust for sinking fund or capital improvement purposes, the assets of that trust cannot be used to meet donor restrictions. Likewise, if a bank requires the organization to maintain a compensating balance, that amount of cash may not be available to meet donor restrictions. Its availability depends upon the penalty if the compensating balance is not maintained. For example, if the only penalty for not maintaining a compensating balance is payment of a fee, the cash is available as long as the organization is able to pay the fee. However, if failure to maintain the compensating balance is an act of default on a loan which triggers a requirement for the near-term payment of that loan, the cash is not available to meet a donor restriction requiring a current expenditure. The cash might be available to meet a donor restriction for an event that is planned to take place at a future date (that is, after the loan has been repaid). In some cases, it is clear that a legal restriction on an asset is inconsistent with a donor restriction, and, therefore, the assets are not available to be used to meet the donor restriction; in other cases judgment is required.

Once the organization understands its donor and legal restrictions, it can use that information to assess the relationship between restricted net assets and the composition of assets and liabilities that relate to them.

Organizations that still use fund accounting in their general ledgers will have an easier time assessing whether they have maintained an appropriate composition of assets in amounts needed to comply with all donor restrictions. Fund accounting segregates assets, liabilities, and fund balances into separate accounting entities, each of which has its own balance sheet and statement of changes in fund balance. The individual funds are associated with specific activities, donor-imposed restrictions, or objectives; thus, fund accounting tracks an organization's fiduciary responsibilities to use assets in accordance with donor-imposed restrictions, legal and contractual limitations, and internal designations. If an appropriate composition of assets is not maintained, it is likely that a legally restricted or donor-restricted fund will have a "due from funds without donor restrictions" as its primary asset or the unrestricted operating fund will have a large cash overdraft even though the actual bank account has a positive balance.

If the organization does not use fund accounting, one way of determining whether it holds an appropriate composition of assets in amounts needed to comply with all donor restrictions is to dissect the statement of financial position using a spreadsheet. This process involves assigning the assets, liabilities, and net assets on the financial statement into separate columns according to the nature of restrictions or the lack thereof. In this type of analysis, the first columns should reflect the organization's legal requirements, and fiduciary responsibilities to use assets in accordance with any donor and board restrictions. Examples of the types of column headings that might be used (before the adoption of ASU 2016-14) include the following:

- Donor-restricted endowment.
- Split-interest trusts for which the organization is trustee.
- Beneficial interests in trusts.
- Restricted loan funds.
- Other temporarily restricted net assets.
- Other permanently restricted net assets.
- Board-designated amounts and charitable gift annuities.
- Legal restrictions, such as sinking funds.
- Investment in plant.
- Other unrestricted operations.

The illustration in Example 1-1 provides a general format for setting up the analysis. The amounts for each line item on the statement of financial position would be split apart with the applicable portions of the balance assigned first to the legal and donor-restricted net asset categories, then to categories for internal designations, with the remainder assigned to the other unrestricted operations column.

As discussed in the Audit Guide, Paragraph 3.14, in some cases, assets held to meet a donor restriction are easily identified. In other cases, the identification process is subjective. The Audit Guide explains that unconditional promises to give received in response to a fund-raising campaign to build a new building are easily identified as assets held to meet a donor restriction for the purchase of a building. But if cash gifts to the same campaign are invested with the organization's other investments until needed to make expenditures for the new building, a portion of the investments may need to be assigned as assets held to meet a donor restriction for purchase of a building.

Other examples of analyzing the statement of financial position line items, before the adoption of ASU 2016-14, for the purpose of assigning assets, liabilities, and net assets to the columns in the spreadsheet described above include the following:

- If the organization has donor-restricted endowment funds, typically there are long-term investments in an amount approximating the sum of the net assets that are temporarily and permanently restricted for endowment purposes. There may also be unconditional promises to give for endowment purposes and small amounts of cash awaiting investment. Accordingly, the line items for cash, promises to give, and investments in the statement of financial position may all contain amounts that would be classified in the endowment column of the spreadsheet and matched with the respective net assets. Remaining balances in those line items may be unrestricted, or may need to be categorized in other columns that represent additional restrictions.

- In an uncommon situation, an endowment gift instrument may specify that a gift be invested in a specific type of asset or it may even restrict the investment to particular assets. If that is the case, the restrictions would be considered in categorizing the assets. For example, a gift instrument might require that the endowment be used to purchase land to be used as a botanical garden, and that, if the land is sold, the proceeds should be used to purchase additional land for a botanical garden. In that case, the land would be assigned in the donor-restricted endowment column of the spreadsheet. In most cases, however, long-lived assets are not assets of permanently restricted funds because they are unable to provide income or benefits in perpetuity, as discussed in the Audit Guide, Paragraph 5.81.

- If the organization has entered into unitrusts or annuity trusts, the trust agreements require identification of the investments of the trust that are used to determine the amount of the distributions (for unitrusts) and whether the trust is exhausted by the distributions (for annuity trusts). There should be trust assets, typically investments, equal to the sum of the split-interest obligation and the amounts of the temporarily or permanently restricted net assets associated with these split-interest gifts. In some cases, donors ask that the trust be invested in a specific manner, such as in municipal bonds. If that is the case, those specific trust investments would be matched with the net assets.

- If the organization has charitable gift annuities that are the general obligations of the organization, there often is not a legal requirement to hold the investments, but many organizations do so by designating investments to be held until the death of the annuitant. Those investments and the charitable gift annuity obligation would be included in a column for board-designated temporarily-restricted amounts because there is no legal or donor-imposed restriction on these net assets. In other jurisdictions, the organization may be required by insurance laws to hold certain investments until the death of the annuitant, and in that case, the investments would be included in a column for legally-restricted net assets.

- If the organization is the beneficiary of a trust held by a third party, there will be an asset (beneficial interest in trust) and a similar amount of temporarily restricted or permanently restricted net assets (depending upon the type of trust) that will be included in a column for restrictions due to beneficial interests in trusts.

- Some organizations receive grants that require the organization to make loans to students, other nonprofit organizations, or individuals. The loans, any grants receivable or refundable grant amounts, and the temporarily or permanently restricted net assets related to the loan programs established by the grantor are assigned to a column for net assets restricted for loan programs.

After assigning assets, liabilities, and net assets to columns for specific types of restrictions, the unassigned temporarily and permanently restricted net assets should be placed into the columns for other temporarily restricted net assets and other permanently restricted net assets (the latter type is unlikely, but possible). The nature of the restrictions on these net assets will determine which assets will be assigned in this column. For example, if the organization has unconditional promises to give for operating or capital purposes and the payments on those promises are not yet due, the promises receivable and an equal amount of temporarily restricted net assets would be included. Similarly, in the uncommon case in which an organization elects to release restrictions on long-lived assets over their useful lives, there will be an amount of temporarily restricted net assets and property, plant, and equipment assigned to the other temporarily restricted column.

Although it is unnecessary for the purpose of determining whether there is an appropriate composition of assets in amounts needed to comply with all donor restrictions, it is also helpful to assign assets and liabilities to columns for net assets associated with board-designated endowment and investment in plants. By doing so, the organization can determine whether it actually has set aside assets consistent with the board designations and how much of unrestricted net assets is unavailable for meeting current needs because it is invested in illiquid assets.

The final column, other unrestricted operations, should be completed by calculating the unassigned amounts remaining for each line item of the statement of financial position.

Example 1-1 discusses and illustrates the completion of an analysis in a spreadsheet that relates the composition of assets and liabilities to the related net assets.

Example 1-1: Relating assets and liabilities to net assets to determine compliance with donor restrictions before the adoption of ASU 2016-14.

The initial draft of Cares for Kids' statement of financial position is entered into a spreadsheet as the far left column. Using information about the various restrictions on net assets and the nature of the assets and liabilities, the amounts are spread across the columns, with unrestricted resources available for operating purposes calculated in the far right column as the amount needed to balance. The following illustrates the format of the spreadsheet and the analysis of the data:

Cares for Kids
Analysis of the Composition of Assets

	Reported in the Statement of Financial Position	Endowment	Long-Lived Assets	Investment in Plant	Other Temporary Restrictions	Other Unrestricted Operations
Cash and cash equivalents	$ 1,274,678	$ 453,565	$ 63,000	$ —	$ 9,444	$ 748,669
Receivables	88,780	—	—	—	—	88,780
Contributions receivable	10,000	5,000	—	—	5,000	—
Prepaid expenses	83,790	—	—	—	—	83,790
Investments	369,637	369,637	—	—	—	—
Plant, property, and equipment	2,055,380	—	—	2,055,380	—	—
	$ 3,882,265	$ 828,202	$ 63,000	$ 2,055,380	$ 14,444	$ 921,239
Accounts payable	$ 31,920	$ —	$ —	$ —	$ —	$ 31,920
Accrued expenses	110,582	—	—	—	—	110,582
Line of credit	200,000	—	—	—	—	200,000
Notes payable	1,625,807	—	—	1,625,807	—	—
	1,968,309	—	—	1,625,807	—	342,502
Unrestricted net assets—board designated	158,000	100,000	58,000	—		—
Unrestricted net assets	1,008,310	—	—	429,573	—	578,737
Temporarily restricted net assets	218,645	199,201	5,000	—	14,444	—
Permanently restricted net assets	529,001	529,001	—	—	—	—
	1,913,956	828,202	63,000	429,573	14,444	578,737
	$ 3,882,265	$ 828,202	$ 63,000	$ 2,055,380	$ 14,444	$ 921,239

Note: The shaded amounts represent areas for further analysis. Also, this analysis does not reflect implementation of ASU 2016-14, *Not for Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities.*

Endowment: Cares for Kids endowment is entered into the next column. The temporarily and permanently restricted net assets, as well as the board-designated endowment net assets, are entered using the organization's internal records or the donor-restricted net asset information from the endowment note prepared in accordance with FASB ASC 958-205-50-1B, which was discussed previously. The portion of investments related to endowments (in this case, all investments) are entered after analyzing the reasons the investments are held. Cares for Kids also has an unconditional promise to give that will create an endowment, which is entered as well. However, in accordance with FASB ASC 958-205-55-7, that promise to give should be sequenced closer to investments and described as endowment contributions receivable.

Upon initial assessment, it appears that Cares for Kids may not have the proper composition of assets to meet the endowment restrictions and designations because endowments require the gift to be invested and the investment income to be used for the purpose(s) specified by the donor(s). Further analysis is needed. For example, it could be that a large endowment gift came in shortly before the end of the fiscal year, and it has not yet been invested. Similarly, an investment could have been sold shortly before the end of the fiscal year, and the proceeds from the sale were not reinvested yet. In both of those cases, a reclassification is necessary to display that cash with investments, as required by FASB ASC 958-205-55-7. Cares for Kids may also have money market accounts or other cash equivalents identified as part of its endowment investments, but

improperly displayed them as cash, which would also require a reclassification in accordance with FASB ASC 958-205-55-7.

Analysis could also show that Cares for Kids does not have the necessary amount of investments to comply with its donor-imposed endowment restrictions and that it has not funded (by investing cash) its board-designated endowment. The governing board could act to reverse its previous decision to create a quasi-endowment fund, which would reduce the amount of investments needed to match the net assets by $100,000. If after reversing the board designation, there is still an insufficient level of investments to match the donor-restricted net assets of the endowment, two concerns remain: (1) Care for Kids does not have the proper amount of investments; and (2) Cares for Kids does not have adequate investment returns to be used for the purposes specified by the endowment gift agreements, which is also noncompliance with its fiduciary responsibilities to its endowment donors. Both the failure to maintain the appropriate composition of assets and the resulting failure to have investment income for the purposes specified are required to be disclosed in accordance with FASB ASC 958-210-50-2 and FASB ASC 958-450-50-3.

Long-Lived Assets: This column includes the net assets that are temporarily restricted for the purchase of property, plant, and equipment (which is identified using the internal records or the note disclosure required by FASB ASC 958-210-50-3, discussed previously) as well as the governing board's designation of $58,000 for that same purpose. Cares for Kids does not have any contributions receivable restricted for this purpose, and the internal records don't identify any other assets or liabilities associated with these net assets; thus, the assets associated with these net assets must be cash. In accordance with FASB ASC 958-205-55-7, the cash associated with a donor-imposed restriction to purchase long-lived assets should not be included with cash available for current purposes. Further, in accordance with FASB ASC 210-10-45-4 and the Audit Guide, Paragraph 3.21, the assets associated with the governing board's designation should not be included with cash that is available for current use. The amounts of cash for both purposes should be aggregated and reported as a line on a statement of financial position sequenced closer to property, plant, and equipment and described using a title such as cash held for purchase of property, plant, and equipment.

Investment in Plant: This column includes the property, plant, and equipment and any debt that is associated with the purchase or refinancing of those long-lived assets. Cares for Kids elects to release restrictions related to long-lived assets when the assets are placed in service; thus, the net assets associated with the investment in plant are unrestricted.

Temporary Restrictions: This column is for the remaining temporarily restricted net assets and is calculated by excluding the amount of temporarily restricted net assets included in the columns to the left of this column. Review of the internal records and the note disclosure required by FASB ASC 958-210-50-3 reveal that there are $5,000 of contributions receivable that are temporarily restricted because payments are not yet due. The internal records don't identify any other assets or liabilities associated with these net assets; thus, the assets associated with the remaining temporarily restricted net assets must be cash.

Other Unrestricted: The amounts in this column are determined by subtracting the amounts included in the other columns from the amounts in the far left column (the initial draft of the statement of financial position). Negative amounts in this column for lines other than cash typically are caused by errors in determining which assets or liabilities are associated with the net assets and should be reviewed. A negative amount in the cash line indicates a potential disclosure about the failure to maintain an adequate composition of assets. Whether that disclosure is necessary is discussed below.

Note: Cares for Kids did not have any split-interest gifts, beneficial interests in trusts, legally restricted assets, or other items that would use the column headings listed previously. If it had, the worksheet would have included columns for those purposes as well.

Determining Whether Disclosure Is Required. When the analysis of the composition of assets such as the one described in Example 1-1 is completed, credit amounts in the cash and cash equivalents line of the other unrestricted operations column may indicate the organization has not maintained a composition of assets consistent with donor restrictions and board designations. If that is the case, the organization needs to consider whether the disclosure described in FASB ASC 958-450-50-3 is needed. Judgment is required in making that determination.

For example, a deficit amount (credit) in the cash and cash equivalents line of the other unrestricted operations column would not require a disclosure if one or more of the following circumstances are true:

- If the investments in the other unrestricted operations column are greater than the deficit, those investments could be sold to generate cash to comply with donor restrictions.
- If the unused portion of an existing line of credit may be accessed to eliminate the deficit amount in the asset section, the organization is able to meet its donor restrictions by borrowing, and a disclosure is unnecessary.
- If contributions receivable, due soon after the fiscal year end, are greater than the deficit, and the contributions are otherwise unrestricted (that is, the only restriction on the promise is the time restriction because the promise is not yet due), a disclosure is unnecessary.
- If the cash and cash equivalents line of the other unrestricted operations column would be positive if assets had not been included in the board-designated net assets column, then the organization has not funded its board designations. A board designation that is not funded may not be operational, and the governing board may need to consider removing the designation. For example, a designation of net assets as a self-insurance reserve provides no protection if the organization does not have assets set aside that can be used in the case of a loss, and a designation of net assets as a quasi-endowment fund cannot support operations if there are no investments generating a return.
- If the deficit amount in the asset section of the other unrestricted operations column is the result of a temporary condition that is likely to be resolved soon after the fiscal year-end, a disclosure is unnecessary.

If the organization determines there is a possibility it has not maintained an appropriate composition of assets in amounts needed to comply with all donor restrictions and no circumstances mitigate that possibility, the disclosure in FASB ASC 958-450-50-3 should be made. In addition, if the noncompliance is so significant that a material contingent liability exists, or 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, the disclosures in FASB ASC 958-450-50-2 also should be made. Although not required, the disclosure could include management plans to remedy the situation. Contingencies, including going concern contingencies, are discussed later in this lesson.

Organizations that Raise or Hold Contributions for Others

If an organization transfers assets to a recipient organization and specifies itself or its affiliate as the beneficiary, FASB ASC 958-605-50-6 states the organization should disclose the following information for each period for which it presents a statement of financial position:

a. The recipient organization receiving the transfer.

b. Whether the organization granted variance power to the recipient organization, and if so, a description of the variance power.

c. How the recipient organization will distribute the assets to the organization or its affiliates.

d. The aggregate amount of the transfers reflected in the statement of financial position and whether that amount is shown as an interest in the net assets of the recipient organization or as another asset.

If the organization acts as an intermediary or agent and chooses to record the receipt of nonfinancial assets specified for a beneficiary, FASB ASC 958-605-50-4 states the organization should disclose that policy. Organizations also should consider whether the related party disclosure requirements included in FASB ASC 850-10 apply. See discussion of related party disclosures later in this lesson.

Nonprofit organizations may also choose to disclose information about total amounts raised for others.

Net Assets

The following disclosure and presentation requirements relate to net assets:

- FASB ASC 958-210-50-3 requires a description and presentation of the dollar amount of the different types of restrictions on net assets, either in the notes or on the face of the statement of financial position.
- FASB ASC 958-220-45-3 requires that reclassifications between net asset classes be reported separately from other transactions in the statement of activities.
- FASB ASC 958-210-50-2 states disclosure of the following is usually made in the notes to the financial statements:
  - Limits on unrestricted net assets (net assets without donor restrictions after the effective date of ASU 2016-14) resulting from loan covenants.
  - Limits on unrestricted net assets (net assets without donor restrictions after the effective date of ASU 2016-14) in contracts with suppliers, creditors, and others.
- Before the effective date of ASU 2016-14, FASB ASC 958-210-45-11 suggests disclosure of information regarding self-imposed limits, such as resolutions of the board of directors to designate a portion of unrestricted net assets for a specific future expenditure or to function as an endowment. These amounts are often described as board designated restrictions. ASU 2016-14 adds new requirements for information about self-imposed limits on the use of assets and net assets and how those self-imposed limits affect liquidity.

Information about the Types of Restrictions on Net Assets. Chapter 11 of the Audit Guide states that to support the disclosure made in accordance with FASB ASC 958-210-50-3, an organization should be able to produce a listing of the amounts and purposes for which its net assets are restricted. That information emanates from the records an organization keeps to meet its fiduciary responsibilities to use gifts for the purposes for which they are given. The Audit Guide, Paragraph 11.05, states that an organization needs a method of tracking restrictions on net assets and when those restrictions are satisfied. One way of tracking restricted net assets and their use is fund accounting, which facilitates tracking by segregating resources into funds that are consistent with the restricted use of the contribution. Other ways of tracking restricted net assets and their uses are via a subsidiary ledger or a project accounting system.

The Audit Guide, Paragraphs 11.06-.07, states that no matter which system is used, an organization needs to maintain documentation about the activities and other purposes for which the net assets can be used. The end result should be that the organization is able to produce a listing of the amounts and purposes for which its net assets are restricted. The Audit Guide suggests that the documentation include information about the following:

- The restrictions on purposes for which the gift can be spent.
- Any restrictions on periods in which the gift can be spent.
- Any restrictions on the use of a specific contributed asset.
- Any limitations on investing.
- Any other donor restrictions that limit the use of the resources.

The Audit Guide also suggests that if gifts have complex restrictions, a copy of the gift agreement be retained as part of the documentation. Some organizations also include donor names, donor contact information, and the amount(s) and date(s) of the contribution(s) in the documentation.

The documentation should be kept at least until the audit is complete for the fiscal year in which the final restriction is met and the net assets have been reclassified to unrestricted net assets (net assets without donor restrictions after the effective date of ASU 2016-14). For perpetual endowment funds, the documentation would be maintained in perpetuity.

A disclosure is typically more useful if the reader can do the following:

- Identify the purposes for which the resources can be spent.
- Identify the availability of the resources (that is, whether or not the amounts can support current operations or instead must be maintained until some future date).
- Identify the endowments and the programs that they support, as well as agree to the amounts in the disclosures required by FASB ASC 958-205-50-1B, which were discussed earlier in this lesson.
- Relate the amounts disclosed to the major programs used in the statement of activities and in the organization's solicitation materials.

This course recommends that donor and grantor names not be used in the disclosure. In addition to privacy concerns, identification by donor or grantor name is useful only to readers who are so familiar with the organization they know what programs are supported by the net assets from that donor or grantor.

Prior to the effective date of ASU 2016-14, Notes B and C in FASB ASC 958-205-55-21 illustrate the required disclosures about the nature and amounts of temporary and permanent restrictions on the use of net assets.After the effective date of ASU 2016-14, Note B in FASB ASC 958-205-55-21 illustrates the required disclosures about the nature and amounts of net assets with donor restrictions. Examples of required disclosures after the adoption of ASU 2016-14 are beyond the scope of this course, but more information can be found in *PPC's Guide to Preparing Nonprofit Financial Statements.*

Information about Reclassifications. The broad requirements for the presentation of items in the statement of activities, including reclassifications of net assets, is provided at FASB ASC 958-220-45-4, which states that information about reclassifications is generally provided by aggregating items with similar characteristics into reasonably homogeneous groups. Paragraph 11.54 of the Audit Guide points out, however, that the implementation guidance at FASB ASC 958-205-55-21 includes additional information that nonprofit organizations are encouraged to disclose in the notes to the financial statements. The disclosure illustrated as note D in FASB ASC 958-205-55-21 provides disaggregated information about net asset reclassifications in the period. In that example, a tabular format presents the different kinds of restrictions that expired during the period (that is, time, purpose, or other restrictions), and the nature and extent of purpose restrictions satisfied in the period.

Information About Board-designated Endowments. The disclosure requirements for board-designated endowment funds were discussed earlier in this lesson.

Expenses

Classifications. Expenses of nonprofit organizations can be classified by a natural expense classification or a functional expense classification. The natural expense classification groups expenses according to the kinds of economic benefits received in incurring the expenses, e.g., salaries and employee benefits, professional fees, occupancy, postage and shipping, supplies, telephone, travel, etc. The expense functional classification involves grouping expenses according to the purpose for which they are incurred (i.e., expenses for program services and supporting services). Common questions relating to disclosure of expenses are:

- When should functional expenses be disclosed?
- What disclosures are required about expenses incurred in fund-raising activities?

Disclosing Expenses. Contributors, funding sources, governing boards, and regulatory groups are usually more interested in functional expenses than they are in natural expense classifications. They want to know the costs of providing the organization's program services and the relationship of program expenses to supporting expenses. Accordingly, GAAP requires expenses to be reported by their functional expense classification either on the face of the statement of activities or in the notes to the financial statements. After the effective date of ASU 2016-14, FASB ASC 958-205-45-6 requires all nonprofit organizations, not just voluntary health and welfare entities, to present an analysis of expenses by both nature and function in one location—either on the face of the statement of activities, as a separate statement, or in the notes to the financial statements. In addition, FASB ASC 958-720-45-5 requires

an organization to disclose total program costs if its components are not evident from the captions used on the face of the statement of activities and information about why the amount disclosed does not agree with the statement of activities or cannot be easily determined from amounts on the statement of activities. FASB ASC 958-205-50-1 also requires a description of the organization's activities, including its major classes of programs. An organization could include disclosure of its activities in the note required on nature of activities.

A change in the method used to allocate expenses is generally a change in accounting principle unless the rationale behind the basis for allocating the expenses has changed. For example, the organization's operations changed significantly and the method used to calculate the expense allocation is no longer reasonable and logical. In these instances, the change may need to be disclosed, but not as an accounting change. See discussion of the disclosure requirements for a change in accounting principle required by FASB ASC 250-10 later in this lesson.

Disclosing Information about Fund-raising Activities. Fund-raising expenses include all costs of inducing contributions, such as salaries, rent, printing, postage, etc. Some costs can be directly identified as fund-raising expenses, while others must be allocated to the category. For example, nonprofit organizations often incur costs for materials or activities that include elements of both program services and a fund-raising appeal. The financial statements of nonprofit organizations should disclose information about fund-raising costs that allows financial statement users to evaluate the amount of fund-raising costs incurred compared to the related proceeds received and to total program costs. Required disclosures include:

- The total cost of all fund-raising activities, whether expenses are classified by function or object (required by FASB ASC 958-720-50-1).

- The method used to compute the ratio of fund-raising expenses to funds raised if such a ratio is disclosed in the organization's financial statements (required by FASB ASC 958-205-50-3).

FASB ASC 958-720-50-2 requires disclosures related to the following:

- The types of activities for which joint costs have been incurred.

- A statement that joint costs have been allocated.

- The amount of total costs allocated.

- The amount allocated to each functional expense category.

GAAP also encourages, but does not require, the disclosure of the amount of joint costs for each joint activity.

Split-interest Agreements

FASB ASC 958-30-50-1 requires assets and liabilities from all split-interest agreements to be disclosed separately in the notes to the financial statements or on the statement of financial position. Also, any contributions or changes in value of the split-interest agreements are required to be (a) reported as separate line items in the statement of activities or (b) disclosed in the notes to the financial statements. In addition, FASB ASC 958-30-50-1 specifically requires the following disclosures related to split-interest agreements:

a. A summary of the terms of the agreements.

b. The basis that the organization used for recognizing assets related to the split-interest agreements in the financial statements.

c. If present value techniques are used in reporting the assets and liabilities relating to split-interest agreements, information about the discount rates and actuarial assumptions that the organization used in determining present value amounts.

d. Legally mandated reserves arising from split-interest agreements.

e. For charitable gift annuity agreements, any limitations imposed by state law, such as limitations on the manner in which some net assets are invested.

Sometimes preparers of financial statements omit disclosing the discount rates used in calculating the present value amounts.

SELF-STUDY QUIZ

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

4. Which of the following nonprofit organizations has correctly dealt with an issue related to its investments prior to the adoption of ASU 2016-14?

    a. Taken to Heart aggregates the carrying amounts of its investments and discloses them as a single number in its financial statements.

    b. The Melman Group reports donor-restricted investment gains as unrestricted because the restrictions will be met within 60 days of the financial statement date.

    c. Knitting a Cure reports its investment income net of the related investment management fees and discloses the fee amount.

    d. Literacy and Love makes the fair value disclosures required by FASB ASC 820-10-50 separately for all investment types.

5. Which of the following disclosures is needed for a conditional promise to give prior to the adoption of ASU 2016-14?

    a. The total of the amounts that were promised.

    b. Whether the amount promised was pledged as collateral.

    c. The amounts receivable in more than five years.

    d. The amount of any unamortized discount associated with the promise.

6. Which of the following nonprofit organizations has correctly made a disclosure about its noncash distributions prior to the adoption of ASU 2016-14?

    a. The Red Organization discloses promises to give in the financial period in which the receivables are collected.

    b. The Blue Organization does not disclose donated services from an affiliate as coming from a related party since the organization does not make a profit off those services.

    c. The Green Organization discloses the activities for which it used donated services and the nature and extent of the services that were donated.

    d. The Yellow Organization implies time restrictions on gifts of long-lived assets with donor stipulations and includes those implications in its disclosures.

7. Prior to the adoption of ASU 2016-14, a disclosure about net assets would typically be considered more useful if it allowed the reader to do which of the following?

    a. Identify what the organization spent the resources on.

    b. Identify specific donors and grantors for specific asset amounts.

    c. Identify the amount of assets still needed to support operations.

    d. Identify endowments and the programs such endowments support.

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.)**

4. Which of the following nonprofit organizations has correctly dealt with an issue related to its investments prior to the adoption of ASU 2016-14? **(Page 13)**

   a. Taken to Heart aggregates the carrying amounts of its investments and discloses them as a single number in its financial statements. [This answer is incorrect. FASB ASC 958-320 and 958-325 require disclosure of the carrying amounts of each major type of investment, such as equity securities, U.S. Treasury securities, debt securities, certificates of deposit with original maturities of more than three months, and other investments like oil and gas properties and real estate. Therefore, Taken to Heart needs to split these carrying amounts up by type and not aggregate them together in a single amount to be compliant with the authoritative guidance.]

   b. The Melman Group reports donor-restricted investment gains as unrestricted because the restrictions will be met within 60 days of the financial statement date. [This answer is incorrect. FASB ASC 958-320-45-3 allows an organization to report investment gains and income that are restricted to specific uses by the donor as unrestricted support (support within net assets without donor restrictions after the adoption of ASU 2016-14) if the donor restrictions are met in the reporting period in which the gains and income are recognized. Because that is not the case in this situation, the Melman Group should report the gains as restricted.]

   c. Knitting a Cure reports its investment income net of the related investment management fees and discloses the fee amount. [This answer is correct. GAAP allows organizations to report investment income net of related expenses, such as investment management or custodial fees. According to FASB ASC 958-220-50-1, before the effective date of ASU 2016-14, the amount of any such expenses must be disclosed either on the face of the statement of activities or in the notes to the financial statements.]

   d. Literacy and Love makes the fair value disclosures required by FASB ASC 820-10-50 separately for all investment types. [This answer is incorrect. Nonprofit organizations frequently hold portfolios of investments for which different measurement objectives apply. For example, an organization may hold equity and debt securities that are required to be measured at fair value for each reporting date. The disclosures about fair value measurements required by FASB ASC 820-10-50 would apply to these investments. The same organization might also hold other investments that are reported at cost or some other measurement objective in subsequent reporting periods, and the requirements of FASB ASC 820-10-50 would not be applicable. Therefore, Literacy and Love needs to determine for which of its investments the disclosure requirements are applicable.]

5. Which of the following disclosures is needed for a conditional promise to give prior to the adoption of ASU 2016-14? **(Page 15)**

   a. The total of the amounts that were promised. [This answer is correct. FASB 958-310-50-4 requires the following disclosures about conditional promises to give: (1) the total of amounts promised and (2) a description and amount for each group of promises having similar characteristics.]

   b. Whether the amount promised was pledged as collateral. [This answer is incorrect. Disclosing whether promises to give were pledged as collateral or otherwise limited as to use is required for *unconditional promises to give,* not conditional promises to give.]

c. The amounts receivable in more than five years. [This answer is incorrect. When dealing with *unconditional promises to give* (not conditional promises to give), one of the required disclosures is the amounts receivable in less than one year, in one to five years, and in more than five years.]

d. The amount of any unamortized discount associated with the promise. [This answer is incorrect. One required disclosure for *unconditional promises to give* is the amount of the unamortized discount, if there is a discount associated with unconditional promises to give. This disclosure is not required for conditional promises to give.]

6. Which of the following nonprofit organizations has correctly made a disclosure about its noncash distributions prior to the adoption of ASU 2016-14? **(Page 19)**

a. The Red Organization discloses promises to give in the financial period in which the receivables are collected. [This answer is incorrect. The disclosures for promises to give are required when noncash contributions have been recognized as unconditional promises to give and the receivables have not been collected at the date of the financial statements. Therefore, the Red Organization will need to make its disclosures in an earlier financial period.]

b. The Blue Organization does not disclose donated services from an affiliate as coming from a related party since the organization does not make a profit off those services. [This answer is incorrect. If donated services that directly benefit the organization are received from personnel of an affiliate, the applicable related party disclosures should be made. Paragraph 5.221 of the Audit Guide notes that related party disclosures could also be required for certain gifts-in-kind received as contributions. Therefore, the Blue Organization should not omit such disclosures if it wants to be consistent with GAAP.]

c. The Green Organization discloses the activities for which it used donated services and the nature and extent of the services that were donated. [This answer is correct. For noncash donations, a nonprofit organization should disclose, among other things, the activities or programs for which donated services were used, the nature and extent of those services, and the amount recognized as revenue during the period. Therefore, by making this disclosure, the Green Organization has correctly followed GAAP guidelines.]

d. The Yellow Organization implies time restrictions on gifts of long-lived assets with donor stipulations and includes those implications in its disclosures. [This answer is incorrect. Prior to the effective date of ASU 2016-14, when gifts of long-lived assets are received without donor stipulations about how long the assets must be used, the organization may adopt a policy of implying time restrictions on those contributions. This policy should be disclosed if applicable. However, because Yellow Organization's gifts of long-term assets have donor stipulations, such implications would not be appropriate and also would not be disclosed.]

7. Prior to the adoption of ASU 2016-14, a disclosure about net assets would typically be considered more useful if it allowed the reader to do which of the following? **(Page 29)**

a. Identify what the organization spent the resources on. [This answer is incorrect. Such disclosures would be considered more useful if they identify purposes for which resources can be spent (not what assets were spent on in the past).]

b. Identify specific donors and grantors for specific asset amounts. [This answer is incorrect. This course recommends that donor and grantor names not be used in the disclosure. In addition to privacy concerns, identification by donor or grantor name is useful only to readers who are so familiar with the organization they know what programs are supported by the net assets from that donor or grantor.]

c. Identify the amount of assets still needed to support operations. [This answer is incorrect. The disclosure would be considered more useful if it identified the availability of the resources (that is, whether or not the amounts can support current operations or instead must be maintained until some future date). Identifying assets needed would not be helpful for this type of disclosure.]

d. Identify endowments and the programs such endowments support. [This answer is correct. A disclosure is typically more useful if it, among other things, identifies the endowments and the programs that they support, as well as agreeing to the amounts in the disclosures required by FASB ASC 958-205-50-1B.]

COMMON PROBLEMS THAT CAN OCCUR WHEN PREPARING GENERAL DISCLOSURES

General disclosures in financial statements are disclosures concerning matters that do not relate to a financial statement caption (such as contingencies) or that relate to several captions (such as related parties).

Related Party Transactions

General. A common problem for preparers of financial statements for nonprofit organizations is identifying related parties and determining which related party transactions should be disclosed. A related party is an entity that can control or significantly influence the management or operating policies of another entity to the extent one of the entities may be prevented from pursuing its own interests. A related party may be any party the entity deals with that can exercise that control. Examples of related parties include (a) affiliates, (b) investments accounted for under the equity method, (c) trusts for the benefit of employees (for example, pension or profit-sharing trusts), and (d) members of management, the governing board, and their immediate families.

For material transactions with related parties, FASB ASC 850-10-50-1 requires the following disclosures:

a. The nature of the related party relationship.

b. A description of the transactions, including those that involve zero or nominal amounts, for each of the periods for which statements of activities are presented, and any other information necessary to an understanding of the effects of the transactions on the financial statements.

c. For each of the periods for which statements of activities are presented, the amount of the transaction and the effects of any change in the method of establishing the terms from that used in the preceding period.

d. Amounts due from or to related parties and the terms of settlement, if not apparent, as of the date of each statement of financial position presented.

Compensation arrangements, expense allowances, and other similar items in the ordinary course of business are not required to be disclosed as related party transactions.

FASB ASC 850-10-50-6 also requires disclosure of the nature of the control relationship between the reporting entity and one or more entities under common ownership or management control if the existence of the control could cause changes in net assets or financial position of the reporting entity significantly different from those that would have been obtained if the entities were autonomous, even though there are no transactions between the entities. GAAP also requires consolidated financial statements in certain situations involving control. See further discussion later in this lesson.

Related party disclosures generally should not imply that transactions were equivalent to arm's length because such representations usually cannot be substantiated. In addition, disclosures may also be affected by a requirement to recognize the economic substance of leasing arrangements with related parties rather than the legal form.

In addition to the disclosures listed above, guarantees between related parties are subject to the disclosures requirements of FASB ASC 460 for guarantees, as discussed later in this lesson.

Considerations for Related Party Disclosures by Nonprofit Organizations. As discussed in Paragraph 3.182 of the Audit Guide, the nonprofit sector can use related party disclosures as a response to regulators' concerns about whether governing board members are meeting their stewardship responsibilities. Accordingly, when nonprofit organizations apply the definition of related parties discussed above, the Audit Guide suggests that related parties may include the following:

a. Officers, board members, founders, substantial contributors, and their immediate family members.

b. Members of any related party's immediate family.

c. Parties that provide concentrations in revenues and receivables.

d. Supporting organizations [such as 509(a)(3) organizations].

e. Financially interrelated entities.

f. Certain national and local affiliates that don't necessarily meet the definition of an affiliate in GAAP.

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

Paragraph 3.184 of the Audit Guide describes common related party transactions or situations that illustrate the guidance discussed above as follows:

- Leases with members of the governing board.
- Legal or other professional services provided by a firm in which an officer's immediate family member is a person of influence, such as a partner.
- Goods or services purchased from an entity owned by a board member or for which one of the organization's board members is a governing board member.
- Grants to an unaffiliated nonprofit organization whose executive director is a member of the organization's board.
- Loans to a founder or significant donor or the spouse or immediate family member of a founder or significant donor.
- Material contributions from related parties.
- Significant concentrations of revenues and receivables from related parties.

Nonprofit organizations often benefit from services that are performed by personnel employed by affiliated entities. When the affiliated entity requires payment from the nonprofit organization, FASB ASC 958-605-25-17 requires nonprofit organizations to recognize those services in the financial statements and disclose the arrangement for the donated services as a related party transaction. For nonprofit organizations that benefit from services that are performed for no cost by personnel employed by affiliated entities, the nonprofit organization should follow FASB ASC 958-720-25-9.

Other less common circumstances or transactions involving related parties that may require disclosure are described in Paragraph 3.184 of the Audit Guide as follows:

- Obligations associated with contributions from related parties (for example, gift annuities payable to related parties or environmental remediation liabilities associated with donated real estate).
- Consulting services provided for a fee by a national (parent) nonprofit organization (or a brother-sister organization).
- A for-profit entity establishes a nonprofit foundation whose bylaws provide that the foundation's board is appointed by the for-profit entity.

As discussed in item c. above, the nonauthoritative guidance in the Audit Guide states an individual or entity that provides significant contributions may be considered a related party. Although an organization may be economically dependent on significant contributors, those contributors are not considered related parties solely because of the organization's economic dependency on them. As previously discussed, a significant contributor would be a

related party if it can significantly influence the management or operating policies of an organization through restrictions on its contributions (or by other means) to an extent that the organization is prevented from pursuing its interests. Thus, a significant contributor of resources, might not be considered a related party; whereas a significant contributor of restricted resources might be considered a related party if the restrictions constitute significant influence on management or operating policies.

Common questions that arise in preparing related party disclosures are:

- What is meant by the nature of the relationship?
- How much detail is necessary about settlement arrangements?
- How do you account for the substance of a verbal lease arrangement?

Nature of Relationship. Disclosure of the relationship and amounts often may be conveniently provided through captions in the statement of financial position. This course interprets "nature of the relationship" to mean position rather than an individual's name. Accordingly, captions usually may simply refer to "officers" or "affiliates." However, FASB ASC 850-10-50-3 requires related parties to be identified by name if that is necessary to an understanding of the effects of the transactions on the financial statements.

Settlement Arrangements. Using separate captions in the statement of financial position for related party open accounts and informal loans is normally sufficient to meet the requirement to disclose settlement arrangements. However, it is a best practice to disclose the settlement terms of notes to conform with GAAP and an efficient way to make sure that disclosure is in a note.

Leasing Arrangements with Related Parties. Some nonprofit organizations have lease arrangements with related parties. Although some of the leases may be under written agreements, others are verbal. In addition, some of the written agreements are cancelable. FASB ASC 840-10-25-26 notes that in some leasing arrangements it is clear that the terms of the transactions have been significantly affected by the fact that the parties are related. In those cases, GAAP requires accounting for the substance rather than the form of the transaction. In practice, it is extremely difficult to account for the substance of such related party arrangements. As an example, if a nonprofit organization leases its offices from the chairman of the board of directors under a cancelable arrangement, it is difficult to define a capitalization period even if the nonprofit organization will probably not move from the location. A similar problem exists with a written noncancelable lease that does not provide for renewals. Accordingly, disclosure of the nature of the arrangement would likely be sufficient.

Guarantees with Related Parties. Although transactions between related parties ordinarily are recorded in the same manner as transactions between unrelated parties, guarantees between parents and their subsidiaries and organizations under common control, including a parent's guarantee of its subsidiary's debt to a third party or a subsidiary's guarantee of its parent's or another subsidiary's debt to a third party, are not subject to the recognition and measurement provisions for guarantees. However, related party guarantees are subject to the disclosure requirements discussed later in this lesson.

Pension Plans, Postretirement Benefits, and Postemployment Benefits

A common practice problem is to determine which compensation arrangements are classified as pension plans, postretirement benefits, and postemployment benefits. The following paragraphs define those arrangements and note their disclosure requirements.

Pension Plans. FASB ASC 715-30-20 defines pension benefits as "periodic (usually monthly) payments made pursuant to the terms of the pension plan to a person who has retired from employment or to that person's beneficiary." Pension plans *include* the following:

a. Written plans as well as plans whose existence may be implied from a well-defined, although unwritten, organization policy.

b. Unfunded plans as well as insured plans and trust fund plans.

c. Defined benefit and defined contribution plans.

d. Deferred compensation contracts with individual employees if the contracts taken together are equivalent to a pension plan.

Pension plans *exclude* the following:

a. Death and disability payments under a separate arrangement.

b. Payments of retirement benefits to selected employees in amounts determined on a case-by-case basis or after retirement.

Postretirement Benefits. Postretirement benefits are accounted for in accordance with FASB ASC 715. Postretirement benefits include health care benefits (such as dental, hearing, and vision coverage) and life insurance benefits provided to retirees, their dependents, or survivors.

General Disclosure Requirements. Disclosure requirements for pension plans and postretirement benefits are relatively complex. FASB ASC 715 includes disclosure requirements for pensions and other postretirement benefit plans. Those disclosure requirements are described in the following paragraphs.

Required Disclosures for Defined Benefit Plans. Nonprofit organizations are required to disclose information on investment strategies; plan asset allocations, which may be available from the trustee's statement of plan assets; expected benefit payments in the next 10 fiscal years; and estimated contributions in the next fiscal year. Disclosures about defined benefit pension plans cannot be combined with disclosures about defined benefit postretirement plans, except for certain multiemployer plans. However, an employer with two or more defined benefit plans may combine the disclosures for all of the employer's defined benefit pension plans and separately combine the disclosures for all of the employer's defined benefit postretirement plans.

FASB ASC 715-30-35-63A allows an entity to elect to adopt an accounting policy to measure plan assets and benefit obligations using the month-end closest to its fiscal year end. If adopted, the policy election must be disclosed.

ASU 2015-04, *Compensation-Retirement Benefits (Topic 715): Practical Expedient for the Measurement Date of an Employer's Defined Benefit Obligation and Plan Assets*, provides a practical expedient for organizations with a fiscal year-end that does not coincide with a month-end. FASB ASC 715-30-35-63A allows an entity to elect to adopt an accounting policy to measure plan assets and benefit obligations using the month-end closest to its fiscal year end. If adopted, the policy election must be disclosed.

Required Disclosures for Defined Contribution Plans. FASB ASC 715-70-50-1 requires employers to disclose the amount of cost recognized for all periods presented for defined contribution pension or other postretirement benefit plans separately from the cost recognized for defined benefit plans. The disclosures must describe the nature and effect of any significant changes during the period affecting comparability (such as a change in the rate of employer contributions, a business combination, or a divestiture). GAAP does not require employers to provide a general description of their defined contribution plans. However, such information may often be useful, so it is a best practice for employers to provide general plan descriptions.

Required Disclosures for Multiemployer Pension Plans. FASB ASC 715-80-50 includes disclosure requirements for employers that participate in multiemployer pension plans. A multiemployer plan is a pension or postretirement benefit plan to which unrelated employers contribute. Such plans are typically established by collective bargaining between one or more unions and more than one employer; they typically are not common among nonprofit organizations, although some organizations participate in such plans because of union membership by some employees or affiliations with national organizations.

Postemployment Benefits. Postemployment benefits consist of benefits paid after employment but before retirement to former or inactive employees, their beneficiaries, and their covered dependents. They include, among others:

- Salary continuation.
- Supplemental unemployment benefits.
- Severance benefits.
- Disability-related benefits (including workers' compensation).
- Job training and counseling.
- Continuation of health care benefits and life insurance coverage.

The disclosure requirements for postemployment benefit plans are described in FASB ASC 712-10-50.

Commitments

Commitments may require disclosure because of their effect on current financial position or future changes in net assets. They are contractual obligations for a future expenditure and include the following:

- Long-term leases with required fixed payments for several years.
- Significant commitments for outstanding purchase orders and other commitments for materials or services not received as of the date of the statement of financial position. For example, a performing arts organization may have contracts related to guest performers for future years or an organization's employees may be covered by a union contract with set salary increases for future years.
- Commitments to purchase large quantities or at prices in excess of market prices prevailing at the date of the statement of financial position.
- Commitments related to expansion or rehabilitation of facilities or to acquire investments or other noncurrent assets.
- Commitments for grants to others that are payable over future periods and are accounted for as exchange transactions. (A discussion of grants recorded as promises to give to others appeared earlier in this lesson.)

Certain disclosures for commitments are required. In addition to such disclosures, FASB ASC 840 requires general disclosures on leases in the financial statements of lessees as well as specific disclosures for operating leases and capital leases.

Contingencies—General

The existence of contingencies must also be considered by accountants. Contingencies are existing conditions that may create a legal obligation in the future but that arise from past transactions or events. They may require disclosure because of their effect on current financial position or future changes in net assets. Examples of contingencies are:

- Litigation, claims, and assessments pending, threatened, or unasserted.
- Possible claims for disallowed costs or expenditures incurred under a governmental grant or other third-party reimbursement arrangement.
- Possible reimbursement to donors for noncompliance with restrictions on contributions.

- IRS examinations in progress related to tax-exempt status, taxes on unrelated business income, or excise or other taxes on private foundations.

- Arrangements with financial institutions, such as oral or written guarantees, endorsements, etc.

- Expiration of union contracts that could lead to strikes by unionized employees.

Under FASB ASC 450, the proper accounting treatment of contingencies depends on the likelihood (probable, reasonably possible, or remote) that a future event will confirm that a gain or loss has occurred and on the ability to make a reasonable estimate of the outcome. GAAP requires accrual of loss contingencies if information available prior to financial statement issuance indicates that it is *probable* that an asset had been impaired or a liability incurred at the date of the financial statements and the amount of the loss is reasonably estimable. If an accrual is not made for a loss contingency because one or both of these conditions are not met, but there is a *reasonable possibility* that a loss may have been incurred, the notes to the financial statements must disclose the nature of the contingency and give an estimate of the loss or range of loss or state that such an estimate cannot be made. Gain contingencies may need to be disclosed but should not be accrued.

Contingencies—Noncompliance with Donor Restrictions

FASB ASC 958-450-50-2 and 50-3 specifically note that contingencies related to noncompliance with donor restrictions should be disclosed, and that the amounts and circumstances be disclosed if the noncompliance is the result of the organization's failure to maintain adequate funds to comply with donor restrictions. See the discussion about disclosing a failure to maintain an appropriate composition of assets in amounts needed to comply with donor restrictions earlier in this lesson.

The Audit Guide, Paragraph 3.174, further explains that material noncompliance with donor restrictions also could result in a material contingent liability, a material loss of future revenue, or could cause the organization to be unable to continue as a going concern. Examples of noncompliance that could require disclosure or accrual include:

- A donor requests a refund because the contribution was not used as the donor intended.

- A donor requests a refund because too much time has passed since the gift was made, and the organization has not undertaken the actions required by the donor's restriction.

- The nonprofit organization abandons plans to conduct an activity for which it has specifically raised contributions (for example, because of a failed campaign, the organization abandons plans to build or remodel a building or to start a new program).

- An audit of a grant identifies disallowed costs, and there are additional grants or restricted contributions (or both) under management by the same individual(s), which could have similar instances of noncompliance.

- A bequest or a distribution from a trust held by a third party is received, and the purpose specified by the decedent or the trust agreement is inconsistent with the organization's mission.

- Income from endowment funds is used for current operating purposes without an appropriation by the governing board (that is, outside the organization's spending policy).

Nonprofit organizations generally are able to comply with the restrictions placed by their donors on contributed resources. An organization usually does not accept a contribution if the gift's purpose is inconsistent with the organization's mission or if fulfilling the restriction would harm the organization's reputation. However, if an organization is facing a situation that is similar to those listed above, it is a best practice for the organization to seek legal counsel.

If the nonprofit organization has restricted contributions for which it has no foreseeable future use, in many cases, the donors can be contacted and the restriction removed or changed to a restriction with which the organization is able to comply. If the donor can no longer be contacted, the nonprofit organization can request that the court issue a *cy pres* ruling to change the restriction on the resources. Sometimes, however, even after communicating with a donor or approaching the court, the organization remains unable to comply with a restriction. In those cases, the nonprofit organization should evaluate whether it is necessary to record a liability or disclose the possibility that the restricted resources will have to be refunded to the donor (which may result in tax consequences to the donor) or will have to be contributed to another nonprofit organization that can fulfill the restriction.

The situation is much more serious if the nonprofit organization has already used the restricted resources for other purposes. Not only is the nonprofit organization unable to meet the restriction, it also does not have assets on hand to resolve the situation via refund or a contribution to another organization. Further, if the organization tries to resolve the situation via a *cy pres* ruling, the court may not look favorably on the request because the organization has demonstrated fiduciary irresponsibility. A disclosure for failure to maintain a composition of assets to comply with donor restrictions may be necessary.

Whenever the organization evaluates a contingency for noncompliance with donor-imposed restrictions, not only does it need to consider the specific gift(s) in question, but it must also consider the potential for any additional implications, such as the effects of any publicity about the noncompliance or a breakdown in the organization's relationship with its current or future donors. Bad publicity or a breakdown in donor relations can result in a material loss of future revenue or the inability to continue as a going concern, which must also be considered when determining the required disclosure for noncompliance.

Contingencies—Restrictive Debt Covenants

General. A debtor loan agreement may contain several complicated restrictive covenants. If the borrower does not comply with the requirements, it will be in default and the debt will come due immediately. Thus, violations of debt covenants affect the classification of debt as current or noncurrent, if a classified statement of financial position is presented, and also may have a significant effect on cash flows. The requirements of debt agreements (restrictive covenants) may be grouped in the following broad categories:

a. *Transactions*. For example, a borrower may be required to obtain lender approval before acquiring vehicles above a certain dollar amount.

b. *Conditions*. For example, the borrower may be required to obtain approval from the lender before additional debt is incurred.

If a violation of a restrictive covenant occurs, a waiver should be obtained. Violations of restrictions related to transactions are normally waived unconditionally; however, for violations of restrictions related to conditions, the lender often will only waive the right to accelerate the due date subject to some caveat, such as no significant adverse changes in cash position or for a specific period of time.

Common questions that arise about preparing note disclosures related to restrictive covenants include:

- If there are no violations of covenants, does the note describing the covenants need to disclose compliance?

- If there are violations of covenants, how does the existence and type of waiver affect disclosure?

No Violations of Covenants. The notes do not have to disclose compliance. However, if the preparer wishes to address compliance, positive assurance should normally be avoided. Instead, wording such as "management is not aware of any violations of the covenants" would be appropriate.

Violation of Covenants. The existence of a waiver and the type of waiver obtained could affect disclosure as follows:

a. If an unconditional waiver has been obtained (including those waiving the right to demand payment for more than one year from the statement of financial position date), there is no contingent liability, and no

disclosure is required. However, nonauthoritative guidance at Q&A 3200.17 of the AICPA Technical Questions and Answers states disclosure of the existing violation and the waiver period should be considered. That information may be important to financial statement users.

b. If an unconditional waiver has not been obtained, disclosure of the condition and classification as a current liability (if a classified statement of financial position is presented) is required. However, normally the financial statements should not be issued before the waiver is obtained.

Contingencies—Pledging Assets and Other Collateral Arrangements

General. Authoritative pronouncements require disclosure of the following collateral arrangements:

- FASB ASC 850-10-05-4 includes guarantees in its definition of related party transactions, and FASB ASC 850-10-50 requires disclosures of related party transactions.

- FASB ASC 440-10-50-1(c) requires disclosure of an organization's assets that are pledged as collateral for loans.

- FASB ASC 860-30-50-1A requires disclosure of the carrying amounts and classifications of assets pledged as collateral but not separately reported in the statement of financial position and the related liabilities and disclosure of qualitative information about the relationship between those assets and liabilities.

Some nonprofit organizations have debt that is affected by these requirements because it is secured by the organization's assets, the personal assets of officers or directors, or because officers or directors personally guarantee the debt.

The following paragraphs provide recommendations on common questions that arise in preparing note disclosures on pledged assets and other collateral arrangements.

How Much Detail Should Be Provided? Collateral arrangements are specified in legal documents that are often detailed. Accordingly, problems arise in determining how much information about the arrangements should be disclosed in the notes to the financial statements. In developing the necessary disclosures, the following limitations of financial statements should be considered:

- The statement disclosures are not intended to be a substitute for legal agreements. At best they can notify readers of the key provisions that may affect their evaluation of the financial statements. Readers interested in further details (for example, prospective lenders assessing collateral) should look to the agreements.

- The statements are not intended to provide an evaluation of whether the lender's investment is protected.

- The statements are not intended to disclose assets available for pledging.

Some nonprofit organizations pledge assets as security for obligations. The security interest may be in specific assets, such as lending arrangements based on levels of promises to give or inventories, or in all assets. These arrangements give the creditor the right to foreclose on these assets if the organization defaults on the loan. GAAP requires disclosing the carrying amount and classification of any assets pledged as collateral that are not reported separately in the statement of financial position. For some small and midsize organizations, all of the assets in a specific statement of financial position category may be pledged as collateral on debt. In those cases, the description of the category should enable the reader to relate the asset to a statement of financial position caption. For example, a note describing borrowing arrangements might say "the note is secured by the School's tuition accounts receivable" or "substantially all of the Organization's assets are pledged as security for the loan." Some agreements are secured by a lien on assets "now owned and hereafter acquired." In practice, if an organization wants to finance the future acquisition of an asset, it usually can obtain a waiver of such a provision. Accordingly, it seems unnecessary to disclose the commitment related to future acquisitions.

Does Pledging of Daily Cash Receipts Have to Be Disclosed? Some collateral arrangements are secured by daily receipts and require the borrower to establish an account with the lender. Clients are directed to send remittances to that account, which is monitored by the lender. The substance of such an arrangement is that cash is pledged, thus meeting the requirements for disclosure. Normally, wording such as "secured by a lien on daily receipts" is sufficient.

Does the Absence of Pledging Have to Be Disclosed? GAAP only deals with assets that are pledged, and it does not require disclosure of the fact that some debt is unsecured. Some preparers believe that disclosure is unnecessary because the absence of security disclosures should be sufficient notification that the debt is unsecured. Others believe the disclosure may be readily provided (e.g., using a caption such as "Unsecured debt") and that it may avoid some confusion. Either approach seems to be acceptable. However, the second alternative has an additional practical advantage in that it forces the preparer to reconsider whether there are collateral arrangements.

What Terminology and Format Should Be Used? To describe collateral arrangements, it is a best practice to use the terms "secured" and "unsecured." Since "secured" may imply that the value of the collateral is sufficient to permit full recovery of the asset, "collateralized" is sometimes used. If collateral arrangements are simple (for example, secured only by assets), they usually may be disclosed in the table describing long-term debt. However, more complex arrangements usually are best disclosed in separate paragraphs of the debt note.

Contingencies—Obligations under Guarantees

The issuance of a guarantee obligates the guarantor in two ways:

- The guarantor is contingently obligated to make future payments if specified triggering events or conditions occur (i.e., the contingent element).

- 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 (i.e., the noncontingent element).

FASB ASC 460 provides guidance on requirements for a guarantor's accounting for and disclosures of certain guarantees issued and outstanding.

Disclosures. The following disclosures should be made about each guarantee or group of similar guarantees (even if the likelihood of loss is remote):

a. The nature of the guarantee, including the guarantee's approximate term, how it arose, the events or circumstances that would require the organization to perform under the guarantee and the current status, as of the date of the statement of financial position, 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.)

b. The maximum potential amount of future payments the organization 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. (This disclosure is not applicable to product warranties or other guarantees related to the functionality of nonfinancial assets owned by the guaranteed party.)

c. The carrying amount of the liability, if any, for the organization's obligations under the guarantee, including amounts recognized under FASB ASC 450-20-30 or FASB ASC 326-20.

d. The recourse provisions that would enable the organization 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.)

Contingencies—Going Concern

FASB ASC 205-40 addresses the issue of the going concern assessment within GAAP and establish that the evaluation of an organization's ability to continue as a going concern is *management's* responsibility. In addition, it establishes when management is required to disclose certain matters related to going concern.

For each reporting period, FASB ASC 205-40-50-1 requires management to evaluate whether conditions or events indicate there is substantial doubt about the organization's ability to continue as a going concern for the year subsequent to the date the *financial statements are issued* or the date the *financial statements are available to be issued.* Substantial doubt about an organization's ability to continue as a going concern exists when aggregate conditions and events indicate it is *probable* that the organization will not be able to meet its obligations as they are due during the year following the date the financial statements are available to be issued. Because the definition is one year from the date the financial statements are available to be issued, the GAAP definition prevents organizations, auditors, and accountants from waiting long enough after the financial statement date for the substantial doubt to be cured before issuing the financial statements. In defining substantial doubt, FASB ASC 205-40 uses the term *probable,* which means likely to occur.

If conditions and events that raise doubt about an organization's ability to continue as a going concern exist, management would consider mitigating plans and whether those plans alleviate the substantial doubt. Management's plans may be considered to alleviate the substantial doubt if it is probable the plans (a) will be implemented effectively within one year of the date the financial statements are available to be issued *and* (b) mitigate the conditions and events that raised substantial doubt. Certain disclosures are required depending on whether management's plans alleviate the substantial doubt.

a. If the plans are found to alleviate substantial doubt, FASB ASC 205-40-50-12 requires management to disclose the following:

   (1) The conditions or events that raised the doubt.

   (2) Management's evaluation of the conditions and events relevant to the organization's obligations and ability to meet them.

   (3) Management's mitigating plans, which alleviate the substantial doubt.

b. If management's plans do not alleviate substantial doubt, FASB ASC 205-40-50-13 requires management to disclose the following:

   (1) A statement that there is substantial doubt about the organization's ability to continue as a going concern for the year following the date the financial statements are available to be issued.

   (2) Conditions and events that raised substantial doubt.

   (3) Management's evaluation of those conditions and events relevant to the organization's obligations and ability to meet them.

   (4) Management's plans intended to mitigate the substantial doubt.

Contingencies—Lawsuits

If there are material lawsuits against the nonprofit organization, FASB ASC 450-20-50-4 requires disclosure of the following information unless the possibility of the loss is remote: (As previously noted, a liability should be accrued whenever it is probable that an asset has been impaired or a liability incurred as of the date of the statement of financial position and the amount can be reasonably estimated.)

a. Nature of the contingency.

b. Estimate of the potential loss or range of loss or an indication that such an estimate cannot be made.

A statement asserting that the contingency is not expected to be material does not satisfy the disclosure requirement if there is at least a reasonable possibility that a material loss exceeding amounts already recognized may have been incurred. In that case, the financial statements must either disclose the estimated loss or range of loss that is reasonably possible or state that such an estimate cannot be made.

Often an accountant will request that the client send a letter of inquiry to its attorneys to obtain the preceding information. (Such a letter is required to be obtained in audit engagements.) Although the lawyers' description of the litigation and the progress of the case to date may be used as a basis for the note to the financial statements, lawyers' evaluations may be unclear about the likelihood of an unfavorable outcome. In such cases, the accountant should request clarification either in a follow-up letter or in a conference with the lawyer and the client. Lawyers' evaluations should enable the accountant to classify the outcome of lawsuits as either "probable," "reasonably possible," or "remote" (as defined by FASB ASC 450-20-20) because the accounting standards for accrual and disclosure are based on those terms.

It is a best practice not to quote or refer to lawyers' responses to inquiry letters in the financial statements without first consulting with the lawyers.

A practice problem that sometimes occurs is whether to disclose a nuisance suit. Nuisance suits generally arise when anyone remotely connected with an event is sued in an attempt to collect as much money as possible. Generally, the damages claimed are clearly out of proportion with the damages suffered, and ultimately a settlement will be reached for a much smaller amount. The following are examples of nuisance suits:

- In traffic accidents involving a chain collision, a driver may sue everyone involved instead of the person that initiated the collision.

- In malpractice suits, a patient may sue the nonprofit clinic as well as the care providers actually involved with the case.

In nuisance suits, lawyers are often willing to state that the chance of an adverse outcome is remote, and thus disclosure would not be required under GAAP.

Environmental Remediation Costs

FASB ASC 410-30-50 provides guidance for disclosing environmental remediation liabilities and contingencies. The following paragraphs explain the disclosure requirements for accounting policies, accrued liabilities, unaccrued contingencies, and unasserted claims, as well as optional disclosures. The disclosure requirements of FASB ASC 275-10-50 also apply to environmental remediation liabilities. In addition, FASB ASC 450-20-50 provides the primary guidance relevant to disclosures of environmental remediation loss contingencies.

Disclosure of Accounting Policies. FASB ASC 410-30-50-4 requires financial statements to disclose whether environmental remediation liabilities are measured on a discounted basis. In addition, FASB ASC 410-30-50-8 indicates that an organization is encouraged, but not required, to disclose (a) the circumstances that generally trigger accrual of environmental remediation liabilities (such as completion of the feasibility study) and (b) the organization's policy for recognizing recoveries.

Accrued Liabilities. The following disclosures should be made for accrued environmental remediation liabilities:

a. The nature and amount of the accrual (if necessary for the financial statements not to be misleading).

b. If any part of the accrued obligation is discounted, the discount rate used and the undiscounted amount of the obligation.

c. An indication that it is at least reasonably possible that the estimate of the accrued obligation (or any related third-party receivables) will change in the near term, if the criteria of FASB ASC 275-10-50-8 for certain significant estimates are met.

Unaccrued Contingencies. For reasonably possible loss contingencies (including reasonably possible losses in excess of accrued amounts), FASB ASC 450-20-50-4 indicates 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).

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 275-10-50-8 are met.

For probable but not reasonably estimable loss contingencies that may be material, the following disclosures should be made:

a. A description of the remediation obligation.

b. The fact that a reasonable estimate cannot be currently made.

Unasserted Claims. Under FASB ASC 410-30-50-13, if assertion of a claim is probable or if existing laws require the organization to report the release of hazardous substances and begin a remediation study, a loss contingency should be disclosed subject to the disclosure provisions in GAAP (FASB ASC 450-20-50-3 and 50-4).

Optional Disclosures. According to FASB ASC 410-30-50-10 through 50-12, organizations are encouraged, but not required, to disclose the following:

a. The estimated time frame for making environmental remediation disbursements (if expenditures are expected to occur over a long period).

b. The estimated time frame for realizing recognized recoveries (if realization is not expected in the near term).

c. The factors that cause the estimate of accrued environmental remediation liabilities, unaccrued contingencies, or third-party receivables to be sensitive to change if the criteria for significant estimates are met.

d. The reasons why an estimate of the loss (or range of the loss) cannot be made for probable or reasonably possible losses.

e. The estimated time frame for resolving the uncertainty as to the amount of a probable but not reasonably estimable loss.

f. The following information related to an individual site, if relevant to the understanding of an organization's financial position, cash flows, or change in net assets:

- Total environmental remediation liability accrued for the site.
- Nature and estimated amount of any reasonably possible loss contingency.
- Involvement of other potentially responsible parties.
- Status of regulatory proceedings.
- Estimated time frame for resolving the contingency.

g. The amount recognized in the statement of activities for environmental remediation loss contingencies in each period.

h. The amount of any third-party recovery credited against environmental remediation costs in the statement of activities in each period.

i. The statement of activities caption that includes environmental remediation costs and related recoveries.

Organizations sometimes make the following additional note disclosures:

- A conclusion about whether the total unrecorded exposure to environmental remediation obligations is material to the financial statements. This conclusion is not a substitute for the disclosures required by GAAP. If management asserts that the unrecorded exposure is not material, that assertion must be supportable.

- A description of the general applicability and impact of environmental laws and regulations on their activities and how those laws and regulations may result in loss contingencies for future remediation. These disclosures often acknowledge the uncertainty of the effect of possible future changes in environmental laws and their application. These disclosures are normally made on an organization-wide basis, considering exposures from all the organization's sites.

Fair Value

FASB ASC 820 provides a common definition of fair value, establishes a framework to measure fair value within GAAP, and requires certain disclosures about fair value measurements. It generally applies under other accounting standards that require or permit fair value measurements. FASB ASC 820 also applies to determining the fair value information that must be disclosed under other GAAP, such as the disclosure of fair value information for financial instruments.

However, FASB ASC 820 does not apply in accounting for leases and other matters that address fair value measurements for purposes of lease classification or measurement. This scope exception does not apply to acquired assets and assumed liabilities in a business combination that are required to be measured at fair value, even if those items are related to leases.

The disclosures required by FASB ASC 820-10-50 are generally designed to provide information about the subjectivity of the fair value measurements and are required in addition to any other disclosures required about fair value measurements. GAAP encourages combining the fair value disclosures required by FASB ASC 820-10-50 with fair value disclosures required by other accounting standards.

FASB ASC 820-10-50 requires disclosures about the valuation approaches and inputs used to develop fair value measures. The disclosures are intended to provide users of financial statements with information about the extent to which fair value is used to measure recognized assets and liabilities, the inputs used to develop the measurements, and the effect of certain of the measurements on changes in net assets for the period.

There are no required disclosures in FASC ASC 820-10-50 for assets or liabilities that are measured upon recognition at fair value unless those assets or liabilities are also subsequently remeasured at fair value; thus, FASB ASC 820-10-50 does not require any additional disclosures for most contributed assets. However, if assets or liabilities are measured at fair value in periods subsequent to initial recognition, the organization is required to disclose the following information, with quantitative disclosures presented in a tabular format for each major class of assets and liabilities. The disclosures should provide sufficient detail to permit users of its financial statements to reconcile the fair value measurement disclosures for the various classes of assets and liabilities to the respective line items in the statement of financial position:

- The fair value measurements at the reporting date.

- For nonrecurring fair value measurements, the fair value measurement at the relevant measurement date and the reasons for the measurement. For measurements made at a date other than the end of the reporting period, disclosures should clearly indicate that the fair value information is not as of the end of the period and should provide the date or period that the measurement was made. (Disclosures for derivative assets and liabilities should be presented gross.)

- The level within the fair value hierarchy into which the fair value measurements in their entirety fall, segregating fair value measurements using Level 1 inputs, Level 2 inputs, and Level 3 inputs. Additional disclosures related to measurements categorized within Level 3 of the fair value hierarchy are discussed below.

- The policy for determining when transfers between levels are recognized. The policy about the timing of recognizing transfers into the levels should be the same as the policy for transfers out of the levels.

- For measurements categorized within Level 2 and Level 3 of the fair value hierarchy, a description of the valuation techniques used and the inputs used in determining the fair values of each class of assets or liabilities.

- For measurements categorized within Level 2 and Level 3 of the fair value hierarchy, a discussion of any changes in either the valuation approach or the valuation techniques and the reason for the change.

For recurring fair value measurements which rely on significant unobservable inputs (categorized within Level 3 of the fair value hierarchy), the organization also is required to disclose certain information to help users assess the effect of the measurements on changes in net assets for the period. The organization must provide:

- A reconciliation of the beginning and ending balances for each major class of assets and liabilities that are categorized within Level 3 of the fair value hierarchy. The reconciliation must separately present changes during the period attributable to the each of following:

  - Total gains or losses for the period (realized and unrealized) and a description of where those gains or losses are reported in the statement of activities.

  - Purchases, sales, issuances, and settlements (each type disclosed separately).

  - Transfers in and/or out of Level 3 and the reasons for those transfers, separately disclosing significant transfers into and out of Level 3, and policies for determining the timing of when transfers between levels are recognized.

- Quantitative information about the significant unobservable inputs the organization used in the fair value measurement; however, the organization is not required to create quantitative information to comply with this disclosure requirement if it does not develop quantitative unobservable inputs when measuring fair value. For example, if the organization uses third-party pricing information without adjusting that pricing information, it has not developed its own quantitative input for the fair value measurement.

- The amount of the total gains or losses for the period included in change in net assets that are attributable to a change in unrealized gains or losses on assets and liabilities still held at the reporting date, and a description of where those unrealized gains or losses are reported in the statement of activities.

- A description of the valuation processes used by the organization for measurements categorized within Level 3 of the fair value hierarchy. The following are examples of items that might be disclosed; additional items are suggested in FASB ASC 820-10-55-105:

  - How an organization decides its valuation policies and procedures.

  - The identity of the group within the organization that decides its valuation policies and procedures.

  - How an organization analyzes changes in fair value measurements from period to period.

  - How an organization determines that fair value information provided by third parties, such as broker quotes or pricing services, was developed in accordance with the standards for fair value measurement.

- If applicable, the fact that the highest and best use of a nonfinancial asset is different from its current use and why the organization is using the nonfinancial asset in a manner that is different from its highest and best use. This might be the case if a donor placed restrictions on the way in which an organization can use the nonfinancial asset.

The information listed in the previous two paragraphs must be reported separately for each class of assets and liabilities. For equity and debt securities, the class of asset and liability should be determined on the basis of the nature, characteristics, and risks of the investments. FASB ASC 820-10-50-2B states that judgment is required when determining appropriate classes of assets and liabilities for which disclosures about fair value measurements should be provided. Fair value measurements categorized within Level 3 may need a larger number of classes because a greater degree of uncertainty and subjectivity is included in those measurements.

Fair value measurement disclosures for each class of assets and liabilities often will require greater disaggregation than the organization's line items in the statement of financial position. An organization should determine the appropriate classes for those disclosures on the basis of the nature and risks of the assets and liabilities and their classification in the fair value hierarchy (that is, Levels 1, 2, and 3).

Investments in Entities That Calculate Net Asset Value per Share. GAAP allows entities to measure certain investments at net asset value (NAV) per share as a practical expedient for estimating fair value. The following minimum information should be disclosed for each class of investment for those investments that (a) do not have a readily determinable fair value and (b) are in investment companies within the scope of FASB ASC 946 or real estate funds that measure their investment assets at fair value on a recurring basis and issue financial statements similar to those required by FASB ASC 946:

a. The fair value measurement of the investments in the class at the reporting date and a description of the significant investment strategies of the investee.

b. For investments that can never be redeemed with the investee but provide distributions from liquidations of the underlying assets, an estimate of the time period over which the underlying assets are expected to be liquidated by the investee.

c. Amount of unfunded commitments related to investments.

d. General description of the terms and conditions under which investments may be redeemed.

e. Circumstances under which redeemable investments might not be redeemable.

f. For redeemable investments that are restricted from redemption at the measurement date, an estimate of when the restriction might lapse (or if not known, that fact and how long the restriction has been in effect).

g. Any other significant restrictions on the ability to sell the investment.

h. If it is probable that investments will be sold for an amount different than net asset value per share, the total fair value of such investments and remaining actions necessary to complete the sale.

i. If it is probable that a group of investments will be sold but still meet the criteria permitting fair value measurement using net asset value per share, the plans to sell the investments and remaining actions necessary to complete the sale.

Simplified Disclosures after Adoption of ASU 2015-07. For fiscal years (and their interim periods) beginning after December 15, 2016, ASU 2015-07, *Fair Value Measurement (Topic 820): Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*, amends the guidance in the previous paragraph. After those dates, the disclosure requirement in item h. above is eliminated for investments measured at NAV per share as a practical expedient. In addition, the disclosure requirements in FASB ASC 820-10-50-2, as discussed above, do not apply to those investments. Although the investment is not categorized within the fair value hierarchy, the amount measured using the NAV practical expedient should be disclosed to permit reconciliation of the fair value of investments that are required to be classified and reported in accordance with the fair value hierarchy to the respective line item(s) presented in the statement of financial position.

Some investments are measured using net asset value per share (or its equivalent), but the practical expedient cannot be used because the investment has a readily determinable fair value. For example, mutual funds and structures similar to mutual funds that determine and publish their fair values per share (unit), which are the basis for current transactions, will continue to be included in the disclosure of investments within the fair value hierarchy described previously.

When adopted, ASU 2015-07 should be applied retrospectively to all periods presented. In addition, the nature of and reason for the change in accounting principle, including why the new guidance is preferable, should be disclosed in the first interim and annual period ASU 2015-07 is applied.

Common Errors in Fair Value Disclosures. The following are common errors that occur in fair value disclosures:

- Including fair value disclosures for assets that are not measured at fair value, such as inventory and cash surrender value of life insurance.
- Including descriptions of Level 2 and Level 3 of the fair value hierarchy when only Level 1 measurements were used (for example, when reporting marketable securities).
- Presenting tables with columns for all three levels of the fair value hierarchy when only Level 1 is applicable and thus, presenting a table that was not required.

While it is not wrong to disclose information about all levels of the fair value hierarchy or to present multiple columns with zeros, presenting unnecessary information makes financial statements more difficult for users to understand. The FASB has also indicated in a public meeting that disclosure of information about Level 2 or Level 3 fair value measures is not required when it is not relevant.

Fair Value Option

FASB ASC 825-10 provides the option of electing to account for financial assets and liabilities at fair value. For example, nonprofit organizations might elect to measure a significant long-term promise to give under the fair value option because it may simplify recordkeeping. Whenever the fair value option is elected, fair value measurements should be made following the guidance in FASB ASC 820.

Assets and liabilities measured at fair value under the *fair value option* should be reported separately from the carrying amounts of similar assets and liabilities measured using another measurement attribute by either:

- Presenting the aggregate of fair value and non-fair-value amounts in the same line-item in the statement of financial position and parenthetically disclosing the amount measured at fair value included in the aggregate amount, or
- Presenting two separate line items to display the fair value and non-fair-value carrying amounts.

Organizations are encouraged to present the disclosures required by FASB ASC 825-10 in combination with other fair value disclosures required by other pronouncements. FASB ASC 825-10-55-13 provides illustrative disclosures.

The disclosures required by FASB ASC 825-10 are generally designed to provide information about assets and liabilities that, absent the election, would have been reported under the historical cost model or, as in the case of long-term promises to give, would not otherwise be required to be revalued at each measurement date.

Subsequent Events

FASB ASC 855-10-50 includes accounting and disclosure standards on subsequent events. It does not apply to subsequent events specifically addressed in other applicable GAAP, including FASB ASC 740-10-55 or FASB ASC 450-30-25-1.

FASB ASC 855-10-25 identifies two types of subsequent events. The first type is *recognized subsequent events* (called type I in prior standards) and the second type is *nonrecognized subsequent events* (called type II in prior standards). The key to proper treatment of subsequent events is identifying the event or condition and determining when the event or condition arose.

Recognized (Type I). Recognized (type I) subsequent events are those that *provide additional evidence* about conditions that existed at the date of the statement of financial position, including the estimates inherent in preparing the financial statements. The proper accounting treatment for those events is to recognize the effects of the events in the financial statements. For example, a litigation accrual would be recognized at the settlement amount if the event that gave rise to the litigation took place before the statement of financial position date and settled after the statement of financial position date but before the financial statements are available to be issued.

Most subsequent events that affect the realization of recorded assets (for example, promises to give) or the settlement of estimated liabilities (for example, reserves for compensated absences) fall into the category that requires recognition in the financial statements. That is often true because the subsequent events represent the culmination of conditions that existed over a relatively long period, and the recorded amounts are simply adjusted as new information provides a better basis for the estimates that were used. In some cases, assets and liabilities recorded at the date of the statement of financial position are not adjusted since the event or changed condition clearly did not exist at that date. For example, settlement of litigation arising after the date of the statement of financial position but before the financial statements are available for issuance would not allow adjustment of any litigation accrual that had been established for other litigation. Instead, that is a nonrecognized (type II) subsequent event whose treatment is discussed below.

Nonrecognized (Type II). Nonrecognized (type II) subsequent events are events that provide evidence about conditions that *did not* exist at the date of statement of financial position; they arose after that date but before the financial statements are available to be issued. Such events should not be recognized in the financial statements but, nevertheless, should be disclosed if disclosure is considered necessary to keep the financial statements from being misleading. If required, disclosure should include the nature of the event and an estimate of its financial effect, or disclosure that such an estimate cannot be made. For some events, disclosure may best be made by presenting pro forma financial data. Examples of the events include:

a. Incurrence of material debt.

b. Loss or suspension of tax-exempt status.

c. Loss of grant funding.

d. Loss of physical assets in a fire or flood.

e. Adoption of new pension or compensation plans.

f. Incurrence of a significant commitment.

When Financial Statements are *Issued* and *Available to be Issued*. FASB ASC 855-10-50-1 requires nonpublic entities to evaluate subsequent events through the date that the financial statements are available to be issued. (In contrast, SEC filers and certain conduit bond obligors are required to evaluate subsequent events through the date the financial statements are issued.) GAAP also requires disclosure of the date through which events were evaluated and whether that was the date the financial statements were issued or available to be issued.

According to FASB ASC 855-10-20, financial statements are issued when they are widely distributed to shareholders and other financial statement users for general use and reliance in a form and format that complies with GAAP. Financial statements are available to be issued when they are complete in a form and format that complies with GAAP and all approvals necessary for their issuance have been obtained, such as from management and the board of directors. Generally, nonprofit organizations will evaluate subsequent events through the date that the financial statements are available to be issued. Accordingly, this course refers to the date that the financial statements are available to be issued when discussing the evaluation of subsequent events.

Related Entities

Under FASB ASC 958-810, certain disclosures are required regarding investments in for-profit entities and related but separate nonprofit organizations in the following circumstances:

a. A nonprofit organization may control another nonprofit entity, with control evidenced through a contract document or affiliation agreement (i.e., not through ownership or a voting interest), and have an economic interest in that entity. In such cases, consolidation is permitted but not required. If the organization may present consolidated financial statements but chooses not to, the nonprofit organization's financial statements must include the following disclosures:

   - The related nonprofit entity and the nature of the relationship resulting in control.
   - A summary of the related nonprofit entity's financial information, including total assets, liabilities, net assets, revenue, and expenses.
   - The related nonprofit entity's resources that are held for the benefit of (or under the control of) the nonprofit organization.
   - The related party disclosures required by FASB ASC 850.

b. If either control or an economic interest exists, but not both, the financial statements of the other nonprofit entity should not be consolidated. Instead, the reporting nonprofit organization should provide the disclosures required by FASB ASC 850-10-50. Organizations that previously presented consolidated financial statements under SOP 78-10 are permitted to continue to present those statements, although the statements otherwise would not be allowed under FASB ASC 958-810.

c. If consolidated financial statements are presented, they should disclose any external restrictions on distributions from the related nonprofit entity to the reporting organization and any resulting unavailability of the net assets of the related nonprofit entity for use by the reporting nonprofit organization.

COMMON PROBLEMS THAT CAN OCCUR WHEN PREPARING OTHER DISCLOSURES

Other disclosures concern matters that do not necessarily occur every year, such as accounting changes or prior-period adjustments, or that are not common for nonprofit organizations.

Accounting Changes

Accounting changes include (a) changes in accounting estimates, (b) changes in the reporting entity, and (c) changes in accounting principle. The following is a summary of disclosure requirements for accounting changes based on FASB ASC 250-10-50:

a. *Changes in Accounting Estimates.* The effect of the change on the change in net assets should be disclosed if the change affects future years (such as the estimated useful lives of depreciable assets). Disclosure generally is not required for routine changes (such as changes in classification) unless they are material. If the change in estimate has no material effect in the period of change but is reasonably certain to have a material effect in later periods, a description of the change should be disclosed whenever the financial statements of the period of change are presented. Also, if a change in accounting estimate has been affected by changing an accounting principle, the disclosures in item c. should also be made.

b. *Changes in Reporting Entity.* Disclosure of the nature of the change and the reason for it should be made in the period of change. The effect of the change, in total and by class, on the change in net assets also should be disclosed for all periods presented. If the change has no material effect in the period of change but is reasonably certain to have a material effect in later periods, the nature of the change and the reason for it should be disclosed whenever the financial statements of the period of change are presented.

c. *Changes in Accounting Principles.* Disclosure should include the following:

(1) The nature of the change, the reason for it, and why the new principle is preferable. If the change has no material effect in the period of change but is reasonably certain to have a material effect in later periods, this disclosure is required whenever the financial statements of the period of change are presented.

(2) The method of applying the change, including (a) a description of any prior-period information that has been retrospectively adjusted, (b) the effect of the change on the change in net assets, in total and by class, and on the operating measure (if any), and any other affected financial statement line item for the current and prior periods retrospectively adjusted, (c) the cumulative effect of the change on total net assets and on each class of net assets as of the beginning of the earliest period presented, and (d) the reasons for and a description of the alternative method used to report the change when retrospective application to all prior periods is impracticable.

(3) If the indirect effects of a change in accounting principle are recognized, a description of the indirect effects of the change, including amounts that have been recognized in the current period, and the amount of the total recognized indirect effects of the accounting change that are attributable to each prior period presented, unless impracticable.

(4) For interim periods subsequent to the date of adoption of the change in accounting principle, the effect of the change on the change in net assets and on the operating measure (if any) for the post-change interim periods.

Income Taxes

Nonprofit organizations generally are exempt from income taxes on all revenue except for certain unrelated business income. Private foundations are subject to excise taxes on net investment income. The Audit Guide, Paragraph 15.44, notes that FASB ASC 740-10 provides guidance for recognizing current and deferred taxes payable or refundable.

FASB ASC 958-720-50-1 requires organizations to disclose the amount of income taxes in the notes to the financial statements. Organizations also are required to disclose the nature of the activities resulting in the taxes. Although not specifically required, it is a best practice for private foundations to disclose the amount of excise taxes in the notes to the financial statements.

Uncertainty in Income Taxes. Tax positions represent positions taken in a previously filed return or expected to be taken in a future return that are reflected in current or deferred income tax assets and liabilities. As a result of a tax position, taxes payable might be permanently reduced, a current payable may be deferred to a future year, or the realizability of a deferred tax asset may be changed.

The implementation guidance at FASB ASC 740-10-55-225 describes tax positions that may apply to organizations with activities that could be subject to income tax on unrelated business income. The tax positions that should be considered would include both an organization's characterization of its activities (as related or unrelated to its exempt purpose) and its allocations of revenues and expenses between exempt activities and those subject to unrelated business income tax. The guidance goes on to state that even if an organization does not engage in activities that are subject to unrelated business income taxes, it still has a tax position related to whether it qualifies under the Internal Revenue Code as a tax-exempt nonprofit entity.

Some organizations choose to disclose they have no material uncertain tax positions even though such a disclosure is not required by GAAP. Nonpublic entities are exempt from the requirement in FASB ASC 740-10-50 to provide a tabular reconciliation of the total amount of unrecognized tax benefits at the beginning and end of the years presented.

Open Tax Years. FASB ASC 740-10-50-15 requires disclosure of tax years that remain subject to examination by major tax jurisdictions. However, accountants have differed as to whether open tax years should always be disclosed or should only be disclosed when an entity has significant uncertain tax positions and whether the requirement applied to nonprofit organizations. FASB members indicated that the disclosure of open tax years is only necessary when an entity has uncertain tax positions, and, as a result, the disclosure of open tax years is only required when an entity has significant tax positions that do not meet the more-likely-than-not criterion. While including open tax years in the income tax disclosure when there are no uncertain tax positions is not wrong, it creates additional information in the note for a user to read and comprehend that adds little to no value.

Penalties and Interest. FASB ASC 740-10 also requires providing for the effect of penalties and interest on the liability for tax benefits that have been realized but have not been recognized. Guidance for uncertainty in incomes taxes notes that some entities include penalties and interest related to income taxes in the tax provision and other entities include them in expenses; either approach is permitted, but disclosure is required of the approach used. FASB ASC 740-10 also requires disclosure, either in the financial statements or in a note to the financial statements, of the *amounts* of penalties and interest related to income taxes that are recognized in the statement of activities and in the statement of financial position.

Nonmarketable Equity Securities—The Equity Method

A nonprofit organization may own such a large percentage of the stock of a company that accounting using the equity method might be appropriate; other accounting methods may also be available as described earlier in this lesson. The significance of an investment accounted for by the equity method to the investor's financial position and change in net assets should be considered in deciding the nature of disclosures (such as whether information about more than one investment should be combined) and their extent. According to FASB ASC 323-10-50-3, the following disclosures generally apply:

a. Parenthetically on the financial statements, in a note, or a separate schedule, the following information should be disclosed:

   (1) Investee's name and percentage of ownership.

   (2) Investor's accounting policies for the investments, including the names of investee corporations in which the investor holds 20% or more of the voting stock but that are not accounted for on the equity method and the reasons why the equity method is not considered appropriate and the names of investee corporations in which the investor holds less than 20% of the voting stock that are accounted for on the equity method and the reasons why the equity method is considered appropriate.

   (3) Any difference at the date of the statement of financial position between the carrying amount of the investment and the amount of underlying equity in net assets and the manner of accounting for the difference.

b. In a note or in a separate schedule, summarized information about assets, liabilities, and results of operations for *material* investments in unconsolidated subsidiaries or other investments of 50% or less owned entities accounted for by the equity method. A material investment may be an investment in either a single unconsolidated subsidiary or a group of unconsolidated subsidiaries (or a single 50% or less owned entity or group of 50% or less owned entities) that is material in the aggregate.

c. Material effects of potential conversion of securities, exercise of outstanding stock options and warrants, or contingent issuances.

d. Market value of investment if a quoted market price is available (not required for investments in subsidiaries).

FASB ASC 958-810 allows nonprofit organizations the option of fair value reporting in certain circumstances in which FASB ASC 323 would otherwise require the equity method of reporting.

An organization might also choose the fair value option, subject to certain conditions, for investments that would otherwise be accounted for by the equity method. For items where the *fair value option* is elected, unrealized gains and losses are reported in the changes in net assets at subsequent reporting dates. The general disclosures required by the fair value option, as prescribed by FASB ASC 825-10 were described earlier in this lesson. If an organization chooses to apply the *fair value option* to an investment that would otherwise be accounted for using the equity method, FASB ASC 825-10 requires the disclosures in items a.(1), a.(2), and b. listed above to be made for each date a statement of financial position is presented.

Discontinued Operations

FASB ASC 205-20-50 requires the following disclosures for discontinued operations:

a. The facts and circumstances resulting in the disposal (or expected disposal).

b. The timing and manner of disposal.

c. The carrying amount of the major classes of assets and liabilities of the disposal group for the current and prior period(s). If the major classes are not presented on the face of the statement of financial position, the notes should include a reconciliation of the major classes of assets and liabilities to the totals presented on the face of the statement.

d. The amount of any gain or loss recognized and where that amount is included in the statement of activities, if not disclosed on the face of the statement of activities.

e. Major classes of line items constituting the change in net assets (or pretax profit or loss) of the discontinued operation for all statement of activity periods in which the discontinued operation is disposed of or classified as held for sale. If the major classes are not presented on the face the statement of activities, the notes should include a reconciliation of the major classes of line items of the change in net assets (or pretax profit or loss) to the total change in net assets (or after-tax profit or loss) presented on the face of the statement.

f. The total operating and investing cash flows of the discontinued operation or the depreciation, amortization, capital expenditures, and significant noncash operating and investment items of the discontinued operation for all periods the discontinued operation is presented in the statement of activities.

g. Description of any changes to the plan of disposal and the effects of the changes on the change in net assets for all periods presented.

Additional disclosures are required in discontinued operations involving equity method investments, situations where the reporting entity has significant continued involvement with the discontinued operation after disposal, and where the reporting interest has a noncontrolling interest in the discontinued operation.

Costs to Retire Long-lived Assets/Asset Retirement Obligations

FASB ASC 410-20 provides guidance on accounting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. FASB ASC 410-20 applies to retirements due to acquisition, construction, development, or the normal operation of assets. Disclosure requirements, including disclosures in the year of implementation, are discussed in the following paragraphs.

FASB ASC 410-20-50-1 and 50-2 require that the following information be disclosed about asset retirement obligations:

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.

In addition, 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.

Prior-period Adjustments

GAAP permits only corrections of errors in previously issued financial statements to be accounted for as prior-period adjustments. Disclosure of prior-period adjustments as required by FASB ASC 250-10-50-8 and 50-9 consist of the effects of the adjustment, in total and by class, on the change in net assets for all periods presented. For single period financial statements, disclosure should include the effects of the adjustment on beginning net assets and on the change in net assets of the preceding period. The disclosures should be made in the year in which the adjustment is made and need not be repeated in subsequent years.

In addition, FASB ASC 250-10-50-7 requires the following disclosures when financial statements are restated to correct an error:

a. A statement indicating that the previously issued financial statements have been restated.

b. A description of the nature of the error.

c. For each prior period presented, the effect of the error correction on each affected financial statement line item.

d. The cumulative effect of the change, in total and by class, on net assets as of the beginning of the earliest period presented.

SELF-STUDY QUIZ

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

8. A nonprofit organization's related party disclosures should include which of the following?

    a. A description of material transactions.

    b. A description of compensation arrangements.

    c. A statement that the transaction was equivalent to an arm's length transaction.

    d. The amount of the transaction and the amount due from related parties.

9. Which of the following statements best describes the disclosures that are required for a nonprofit organization's pension and postretirement plans?

    a. Unwritten plans qualify as pension plans, and so disclosures will be necessary.

    b. Disclosures required in this area are typically simple and take up little time.

    c. Organizations must disclose expected defined benefit payments for the next 20 years.

    d. Disclosures about the cost recognized for defined contribution pension plans should be combined with those for defined benefit plans.

10. Which of the following is an example of a contingency?

    a. An agreement to purchase large quantities of materials.

    b. Threatened litigation against the organization.

    c. Promises to give in the form of grants payable in the future.

    d. Outstanding purchase orders not yet received.

11. A material lawsuit is filed against the Holland Organization, but it has not been resolved as of the financial statement date. The possibility of loss is greater than remote. How will the organization's financial statement disclosures be affected?

    a. A statement should be included that the contingency is not expected to be material.

    b. The nature of the contingency should be disclosed.

    c. A statement that the organization will not estimate the potential loss for confidentiality reasons.

    d. A statement that the likelihood of the outcome is the opinion of the organization.

12. Which of the following statements best describes a common problem that occurs when nonprofit organizations prepare disclosures that are not made every year?

    a. They have to calculate and disclose the amount of income taxes they would have paid as a for-profit entity.

    b. If a reasonable estimate of the fair value of an asset retirement obligation cannot be made, they can omit that disclosure.

    c. If the correct circumstances apply to nonmarketable securities, the organization must use equity accounting and include related disclosures.

    d. When an accounting principle changes, they must include in the disclosure a description of information that was retrospectively adjusted.

13. When might a nonprofit organization need to include a reconciliation about discontinued operations in its financial statement notes?

    a. Major classes of assets and liabilities of the disposal group are not on the face of the statement of financial position.

    b. The disposal of related assets held by the organization for the activity is expected but has not yet occurred.

    c. The organization has operating and investing cash flows for the discontinued operation.

    d. A tax year related to the discontinued activity is still open to examination by major tax jurisdictions.

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. A nonprofit organization's related party disclosures should include which of the following? **(Page 37)**

    a. A description of material transactions. [This answer is incorrect. According to FASB ASC 850-10-50-1, the description of the transactions should include those that involve zero or nominal amounts.]

    b. A description of compensation arrangements. [This answer is incorrect. Compensation arrangements, expense allowances, and other similar items in the ordinary course of business are not required to be disclosed as related party transactions.]

    c. A statement that the transaction was equivalent to an arm's length transaction. [This answer is incorrect. Related party disclosures generally should not imply that transactions were equivalent to arm's length because such representations usually cannot be substantiated.]

    d. The amount of the transaction and the amount due from related parties. [This answer is correct. FASB ASC 850-10-50-1 requires specific disclosures for material transactions with related parties. Those disclosures include (1) for each of the periods for which statements of activities are presented, the amount of the transaction and the effects of any change in the method of establishing the terms from that used in the preceding period and (2) amounts due from or two related parties and the terms of settlement, if not apparent, as of the date of each statement of financial position presented.]

9. Which of the following statements best describes the disclosures that are required for a nonprofit organization's pension and postretirement plans? **(Page 39)**

    a. Unwritten plans qualify as pension plans, and so disclosures will be necessary. [This answer is correct. According to FASB ASC 715-30-20, pension plans include written plans as well as plans whose existence may be implied from a well-defined, although unwritten, organizational policy. Therefore, the organization would need to make disclosures for such an unwritten plan.]

    b. Disclosures required in this area are typically simple and take up little time. [This answer is incorrect. Disclosure requirements for pension plans and postretirement benefits are relatively complex, as laid out in FASB ASC 715.]

    c. Organizations must disclose expected defined benefit payments for the next 20 years. [This answer is incorrect. Among the required disclosures for defined benefit plans is the requirement to disclose expected benefit payments in the next 10 fiscal years (not 20).]

    d. Disclosures about the cost recognized for defined contribution pension plans should be combined with those for defined benefit plans. [This answer is incorrect. FASB ASC 715-70-50-1 requires employers to disclose the amount of cost recognized for all periods presented for defined contribution pension or other postretirement benefit plans separately from the cost recognized for defined benefit plans.]

10. Which of the following is an example of a contingency? **(Page 41)**

    a. An agreement to purchase large quantities of materials. [This answer is incorrect. Agreements to purchase large quantities of something or make purchases at excess of market prices prevailing at the date of the statement of financial position are commitments, not contingencies.]

    b. Threatened litigation against the organization. [This answer is correct. Litigation, claims, and assessments pending, threatened, or unasserted are examples of contingencies. Contingencies are existing conditions that may create a legal obligation in the future but that arise from past transactions or events. They may require disclosure because of their effect on current financial position or future changes in net assets.]

c. Promises to give in the form of grants payable in the future. [This answer is incorrect. An agreement to provide grants to others that are payable over future periods and are accounted for as exchange transactions (e.g., grants recorded as promises to give to others) are commitments, not contingencies.]

d. Outstanding purchase orders not yet received. [This answer is incorrect. An example of a commitment (not a contingency) is a significant commitment for outstanding purchase orders and other commitments for material or services not received as of the date of the statement of financial position. For example, a performing arts organization may have contracts related to guest performers for future years.]

11. A material lawsuit is filed against the Holland Organization, but it has not been resolved as of the financial statement date. The possibility of loss is greater than remote. How will the organization's financial statement disclosures be affected? **(Page 46)**

a. A statement should be included that the contingency is not expected to be material. [This answer is incorrect. A statement asserting that the contingency is not expected to be material does not satisfy the disclosure requirement if there is at least a reasonable possibility that a material loss exceeding amounts already recognized may have been incurred. In that case, the financial statements must either disclose the estimated loss or range of loss that is reasonably possible or state that such an estimate cannot be made. Therefore, Holland needs to determine the likelihood of the lawsuit and its materiality before determining whether this statement could be sufficient.]

b. The nature of the contingency should be disclosed. [This answer is correct. If there are material lawsuits against the nonprofit organization, FASB ASC 450-20-50-4 requires disclosure of specific information unless the possibility of the loss is remote. Since that is not the case for Holland, the organization should meet these disclosure requirements, which includes disclosing the nature of the contingency.]

c. A statement that the organization will not estimate the potential loss for confidentiality reasons. [This answer is incorrect. Under FASB ASC 450-20-50-4, the organization should disclose an estimate of the potential loss or range of loss or an indication that such an estimate cannot be made. Choosing not to make such an estimate solely for confidentiality reasons would make Holland out of compliance with this requirement.]

d. A statement that the likelihood of the outcome is the opinion of the organization. [This answer is incorrect. Lawyer's evaluations should enable the accountant to classify the outcome of lawsuits as either "probable," "reasonably possible," or "remote" (as defined by FASB ASC 450-20-20) because the accounting standards for accrual and disclosure are based on those terms. If the lawyer's evaluation does not, then the organization should request clarification. Holland's disclosures would not be in line with professional guidance if it determines the likelihood instead of the lawyers.]

12. Which of the following statements best describes a common problem that occurs when nonprofit organizations prepare disclosures that are not made every year? **(Page 54)**

a. They have to calculate and disclose the amount of income taxes they would have paid as a for-profit entity. [This answer is incorrect. Nonprofit organizations are generally exempt from income taxes on all revenue except for certain unrelated business income. This is the only income tax they will need to disclose under FASB ASC 958-720-50-1.]

b. If a reasonable estimate of the fair value of an asset retirement obligation cannot be made, they can omit that disclosure. [This answer is incorrect. Under these circumstances, organizations would need to disclose that fact and the reasons for the inability to make the estimate.]

c. If the correct circumstances apply to nonmarketable securities, the organization must use equity accounting and include related disclosures. [This answer is incorrect. FASB ASC 958-810 allows nonprofit organizations the option of fair value reporting in certain circumstances in which FASB ASC would otherwise require the equity method of reporting.]

d. When an accounting principle changes, they must include in the disclosure a description of information that was retrospectively adjusted. [This answer is correct. According to FASB 250-10-50, when there is a change in accounting principle, disclosure should include the method of applying the change, including (a) a description of any prior-period information that has been retrospectively adjusted; (b) the effect of the change on the change in net assets, in total and by class, and on the operating measure (if any), and any other affected financial statement line item for the current and prior periods retrospectively adjusted; (c) the cumulative effect of the change on total net assets and on each class of net assets as of the beginning of the earliest period presented; and (d) the reasons for and a description of the alternative method used to report the change when retrospective application to all prior periods is impractical.]

13. When might a nonprofit organization need to include a reconciliation about discontinued operations in its financial statement notes? **(Page 57)**

a. Major classes of assets and liabilities of the disposal group are not on the face of the statement of financial position. [This answer is correct. FASB ASC 205-20-50 requires certain disclosures for discontinued operations, including the carrying amount of major classes of assets and liabilities of the disposal group for the current and prior period(s). If the major classes are not presented on the face of the statement of financial position, the notes should include a reconciliation of the major classes of assets and liabilities to the totals presented on the face of the statement.]

b. The disposal of related assets held by the organization for the activity is expected but has not yet occurred. [This answer is incorrect. According to FASB ASC 205-20-50, the facts and circumstances resulting in the disposal (or expected disposal) should be disclosed, but no reconciliation is required for this information.]

c. The organization has operating and investing cash flows for the discontinued operation. [This answer is incorrect. Per FASB ASC 205-20-50, an organization should disclose the total operating and investing cash flows of the discontinued operation or the depreciation, amortization, capital expenditures, and significant noncash operating and investment items of the discontinued operation for all periods the discontinued operation is presented in the statement of activities. However, no reconciliation is required for this information.]

d. A tax year related to the discontinued activity is still open to examination by major tax jurisdictions. [This answer is incorrect. FASB ASC 740-10-50-15 requires disclosure of tax years that remain subject to examination by major tax jurisdictions. However, this is an issue that would affect the organization as a whole, not just a discontinued operation. Also, no reconciliation is required for this type of disclosure.]

DISCLOSING INFORMATION ABOUT FINANCIAL INSTRUMENTS

FASB ASC 825-10 provides broad guidance that applies to all financial instruments with respect to, among certain things, (a) certain disclosure requirements, and (b) the fair value option for measuring eligible assets and liabilities. Identifying financial instruments and determining the related disclosure requirements are often difficult. The following aspects of financial instruments are discussed in this section:

- Defining financial instruments and identifying those financial instruments for which specific disclosures are required.
- Credit risk and market risk disclosures.
- Fair value disclosures.
- Disclosures required for derivatives and hedging activities.

Identifying Financial Instruments

There are three major categories of financial instruments: cash, evidence of an ownership interest in an entity, and a contract that requires the exchange of cash or other financial instruments. Identifying cash and ownership interests is straightforward, while identifying a contract that requires the exchange of cash or other financial instruments is more complicated.

Some characteristics of the three major categories of financial instruments are as follows:

a. *Cash.* This course suggests that cash for this purpose is the same as for the statement of cash flows. Therefore, it includes currency on hand, demand deposits, and other kinds of accounts that have the general characteristics of demand deposits in that the customer may deposit or withdraw additional funds at any time. Although cash equivalents are not cash, they are normally financial instruments because they are contracts with the characteristics described below.

b. *Evidence of an Ownership Interest in an Entity.* Evidence of an ownership interest in an entity includes common stock, preferred stock, certificates of interest or participation, and warrants and options to subscribe to or purchase stock from the issuing entity.

c. *Contracts That Require the Exchange of Cash or Other Financial Instruments.* Under FASB ASC 825-10-20, a contract is a financial instrument if it both:

   (1) Imposes on one entity a contractual obligation to (a) deliver cash or another financial instrument to a second entity or (b) exchange other financial instruments on potentially unfavorable terms with the second entity, and

   (2) Conveys to that second entity a contractual right to (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.

Generally, if the conditions for a financial instrument are met for the issuer, they will also be met for the holder. Likewise, if they are met for the holder, they will also be met for the issuer.

Considering the Definition of an Asset or a Liability. The definition of a financial instrument in item c. above requires a contractual right and a contractual obligation. Since contractual rights and obligations meet the definitions of assets and liabilities provided in FASB Concepts Statement No. 6, *Elements of Financial Statements*, an agreement that does not meet the definitions of an asset and a liability is not a financial instrument.

The definition of assets and liabilities contained in FASB Concepts Statement No. 6 requires the occurrence of a transaction or event. It further notes that when the transaction occurs depends on the agreement. Therefore, if the transfer is based on future performance, there is no obligation prior to that performance. Accordingly, that agreement is not a financial instrument. The *unexpired or future portions* of the following common agreements are not financial instruments because they do not meet the definition of an asset or a liability:

- *Deferred Compensation and Pension Plan Agreements.* Deferred compensation and pension plan agreements often provide benefits based on past and future service. There is no contractual right or obligation related to payments for future service until that service is provided, and the agreement for that service is not a financial instrument.

- *Operating Lease.* A noncancelable operating lease requires payments based on the passage of time. Since there is no contractual right or obligation related to payments for the unexpired term of the lease, the agreement for those periods is not a financial instrument.

For each of those agreements, however, a contractual right or obligation exists for the expired portion. Therefore, that portion is a financial instrument with the characteristics discussed below.

Using the Fundamental Financial Instrument Approach to Identify Financial Instruments. In August 1990, the FASB issued a discussion memorandum, *Distinguishing between Liability and Equity Instruments and Accounting for Instruments of Both*. The discussion memorandum uses the fundamental financial instrument approach to identify financial instruments. Although not authoritative, that approach could be useful in determining whether an agreement that meets the definition of an asset or a liability is a financial instrument.

The approach defines six basic categories of financial instruments. Five of the categories deal with contracts and the sixth deals with equity instruments. (Cash is excluded because the discussion memorandum focuses on financial instruments with liability and equity characteristics.) The five contract categories are distinguished primarily by whether they involve a one-way transfer of financial instruments or an exchange of financial instruments and whether future performance is contingent or fixed. The discussions below illustrate how the approach may be used to identify common agreements that are financial instruments.

Unconditional Receivable-payable Contract. An unconditional receivable-payable contract both:

a. Imposes on one entity an unqualified contractual obligation to deliver a specified amount of cash or other financial instrument to a second entity on demand or on or before a specified date, and

b. Conveys to that second entity an unqualified contractual right to receive a specified amount of cash or other financial instrument from the first entity on demand or on or before a specified date.

That category includes the items considered to be cash equivalents, some short-term investments, loans receivable and payable, and the contractual rights and obligations under expired portions of the contracts discussed above. The following are common examples for nonprofit organizations:

- Cash equivalents, such as U.S. Treasury bills, commercial paper, and money market accounts that are not classified as cash.

- Short-term investments with original maturities of three months or less.

- Accounts receivable and notes receivable that will be settled in cash.

- Unconditional promises to give cash or other financial instruments.

- Trade account payable and short-term and long-term notes payable.

- Accrued receivables and payables related to grants, program and receivables, and for operating items such as vacation pay, bonuses, and interest that will be settled in cash.

- Receivables and payables related to the expired portion of a deferred compensation agreement, an operating lease, and a retirement plan. (However, as discussed later in this lesson, a deferred compensation agreement and a retirement plan are excluded from all of the requirements of FASB ASC 825-10-50.)

- Leases that effectively transfer the benefits and risks of ownership of an asset from the lessor to the lessee at the inception of the lease, such as a capital lease or a direct financing lease. (As discussed later in this lesson, that type of lease is excluded from the fair value disclosure requirements but is not excluded from the requirement to disclose concentrations of credit risk.)

Each of the preceding examples involves a one-way transfer of a financial instrument, usually cash, either on demand or at specified dates.

If the transfer is other than through a financial instrument, the requirements for a financial instrument are not met. The following are common examples:

- A prepayment under a liability insurance contract or under a membership agreement is a contractual right and obligation to provide services. It is not a financial instrument, however, because it will be settled by providing services rather than transferring a financial instrument.

- A prepayment to a supplier is a contractual right and obligation to provide merchandise. It is not a financial instrument, however, since it will be settled through the shipment of merchandise rather than the transfer of a financial instrument.

Conditional Receivable-payable Contract. A conditional receivable-payable contract both:

a. Imposes on one entity a contractual obligation to deliver a specified amount of cash or other financial instrument to a second entity if a specified event beyond the control of either entity occurs, and

b. Conveys to that second entity a contractual right to receive a specified amount of cash or other financial instrument from the first entity if a specified event beyond the control of either entity occurs.

Future performance under the contract is contingent, but the event is outside the control of both the holder and the issuer. All insurance policies are financial instruments under that category. As an example, under a life insurance policy, the holder receives cash and the issuer pays cash if the insured dies during the term of the policy; otherwise, no cash is transferred. However, as discussed later in this lesson, certain insurance contracts are excluded from the disclosure requirements.

Financial Option Contract. A financial option contract both:

a. Imposes on an entity (the option writer) a contractual obligation to exchange other financial instruments with a second entity (the option holder) on potentially unfavorable terms if an event within the control of the holder occurs, and

b. Conveys to the option holder a contractual right to exchange other financial instruments with the option writer on potentially favorable terms if an event within the control of the holder occurs.

The holder will typically only exercise the option if it is favorable, and that situation is typically unfavorable to the option writer. Common examples are a fixed-rate loan commitment and a mortgage loan with a prepayment right. Each of those involves an exchange of financial instruments.

A financial option contract is a financial instrument only if the option is potentially unfavorable to the option writer. To illustrate, a fixed-rate loan commitment gives the holder the right to demand that the option writer provide a loan at a specified rate. Typically, the holder pays a fee for the commitment. If market interest rates decline, the holder has the option of exercising the commitment or finding a loan at current rates. However, if market rates increase, the holder has the option of exercising the commitment at the lower fixed rate.

Although the option could be favorable to the option writer (for example, if rates decline but the holder exercises the option because other sources of financing cannot be located), the option is potentially unfavorable and is therefore a financial instrument. However, if the loan commitment is for a market rate, it seems logical that it would not be considered a financial instrument because the option is not potentially unfavorable to the option writer.

If the option involves an exchange of assets other than financial instruments, it is not a financial instrument. An example is an option sold by a shopping center developer to a nonprofit day care center that permits the organization to buy a developed lot at a fixed price. That option is not a financial instrument because exercising the option causes an exchange of cash for real estate, and real estate is not a financial instrument.

Financial Guarantee or Other Conditional Exchange. A financial guarantee or other conditional exchange contract both:

a. Imposes on one entity a contractual obligation to exchange other financial instruments with a second entity on potentially unfavorable terms if an event outside the control of either party to the contract occurs, and

b. Conveys to that second entity a contractual right to exchange other financial instruments with the first entity on potentially favorable terms if an event outside the control of either party to the contract occurs.

This definition requires that the event causing the transfer be outside the control of either the holder or the guarantor. As an example, assume that a developer acquires a performance bond covering its responsibility to construct a building for a nonprofit day care center. If the developer does not perform within a certain time, the nonprofit organization can hire another developer to complete the building, and the bonding company will pay the nonprofit organization for the costs it incurs. The bond is a financial instrument of the nonprofit organization (the holder) and the bonding company (the guarantor). The bond is not a financial instrument of the developer since performance is within its control.

FASB ASC 460-10 addresses the initial recognition and measurement of a guarantee, as well as disclosure requirements, for a guarantor that issues a guarantee. The provisions of FASB ASC 460-10 were discussed earlier in this lesson.

Financial Forward Contract. A financial forward contract both:

a. Imposes on each of two entities an unconditional obligation to exchange other financial instruments with the other entity on potentially unfavorable terms, and

b. Conveys to each of those entities an unconditional right to exchange other financial instruments with the other entity on potentially favorable terms.

If the forward contract is not limited to the exchange of financial instruments, it is not a financial instrument. As an example, a commitment to acquire inventory at a fixed price is not a financial instrument because it requires an exchange of cash for inventory instead of for a financial instrument.

Credit Risk and Market Risk Disclosures

The following summarizes this course's general approach to determining the credit and market risk disclosures required by FASB ASC 825-10-50:

a. Identify the financial instruments of the entity. Financial instruments consist of cash, an ownership interest in another entity, and certain contracts. All entities have financial instruments. Some financial instruments are recorded as assets or liabilities, but others are not.

b. Determine whether the financial instruments are specifically excluded from the credit risk disclosure requirements.

c. Identify whether the remaining financial instruments are subject to credit or market risks of loss.

d. If the credit risk for those instruments relates to the actions of parties that are similarly affected by changes in economic or other conditions (referred to as concentrations of credit risk), make required GAAP disclosures.

It seems likely that, for many small to medium-sized nonprofit organizations, additional disclosures will be limited to the amounts of contractual obligations under guarantees and to concentrations of credit risk, including concentrations of credit risk arising from cash deposits in excess of insured amounts.

Financial Instruments Excluded from the Concentrations of Credit Risk Disclosures. FASB ASC 825-10-50-8 and 50-22 specifically exclude the following financial instruments that nonprofit organizations may hold from its disclosure requirements for concentrations of credit risk:

- Certain insurance contracts.
- Unconditional purchase obligations subject to the disclosure requirements of FASB ASC 440-10-50-2. (Those requirements generally only apply to noncancelable agreements negotiated in connection with arranging financing for the facilities that will provide the contracted goods or services.)
- Employers' and plans' obligations for pension benefits, postretirement health care and life insurance benefits, postemployment benefits, and other forms of deferred compensation arrangements.
- Warranty obligations and rights.

Determining Whether a Financial Instrument Is Subject to Credit Risk or Market Risk. Credit and market risk disclosures relate to the risk of an accounting loss. Accounting loss is essentially a charge to net assets that would result from losing the contractual right or settling the contractual obligation of a financial instrument. Three types of risk could cause an accounting loss: credit risk, market risk, and the risk of theft or physical loss. These disclosures only deal with credit and market risks. Preparers should note that FASB ASC 815-10 encourages, but does not require, disclosure of quantitative information about the market risks of financial instruments.

a. Credit risk is the possibility that a loss may occur from the failure of another party to perform according to the terms of a contract.

b. Market risk is the possibility that future changes in market prices may make a financial instrument less valuable or more onerous.

In general, it does not seem like credit risk affects an evidence of ownership interest or a contractual obligation other than under a financial guarantee. Ownership interests are generally affected only by market risk, and, since there are only two parties to a contractual obligation, a loss cannot result from the failure of another party to perform. The following illustrates why credit risk does not apply to contractual obligations:

- Assume that a nonprofit organization has a note payable to a bank (an unconditional payable contract). The note is a contractual right of the bank and a contractual obligation of the organization. The bank has no performance responsibilities. Thus, there is no credit risk to the organization.

However, credit risk would affect cash, contractual rights, and contractual obligations under financial guarantees as illustrated by the following:

- The contractual right to cash deposits is subject to the risk that the financial institution will not pay when the cash is requested.
- A contractual right under an unconditional receivable contract (such as a cash equivalent, accounts receivable, or note receivable) is subject to the risk that the other party will not pay the balance due.
- A contractual right under a financial guarantee is subject to the risk that the issuer of the financial guarantee will not pay in the event of a default.
- A contractual obligation under a financial guarantee is subject to the risk that the party whose debt is guaranteed will default.

The following illustrate consideration of market risk:

- The holder of an ownership interest is subject to the risk of a loss from a decrease in value, for example, because of a decline that is other than temporary or from a sale. However, the issuer of the interest does not recognize a loss from a decrease in value and, therefore, is not subject to market risk.

- The holder of a contractual right under a fixed rate loan commitment is unaffected by changes in market rates of interest and thus has no market risk. However, the issuer of the commitment has market risk since it is subject to the risk of a loss that results from issuing a loan at a lower rate than market and then selling it.

Disclosures Required for Credit or Market Risk. FASB ASC 825-10-50-23 encourages but does not require disclosure of quantitative information about the market risks of financial instruments. Such optional disclosure should be consistent with the way the organization manages or adjusts market risks. For example, market risk disclosures could include (a) more details about current positions and activity during the period, (b) the duration of the financial instruments, or (c) an analysis of interest rate repricing or maturity dates.

Disclosures Required for Concentrations of Credit Risk. Concentrations of credit risk of financial instruments are considered to occur if their holders would be similarly affected by changes in economic or other conditions in meeting their contractual obligations. FASB ASC 825-10-50-21 requires the following to be disclosed about each significant concentration of credit risk:

a. Information about the activity, region, or economic characteristic that identifies the concentration.

b. The maximum amount of the accounting loss due to credit risk the entity would incur if parties to the financial instruments that make up the concentration failed completely to perform according to the terms of the contracts and the collateral or other security, if any, for the amount due proved to be of no value.

c. The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments.

d. The entity's policy of entering into master netting arrangements to mitigate the credit risk of financial instruments. That disclosure should include information about the master netting arrangements for which the entity is a party and a brief description of their terms, including the extent to which they would reduce the organization's maximum amount of loss due to credit risk.

These disclosure requirements about concentrations of credit risk apply to derivative instruments accounted for under FASB ASC 815.

For example, if a significant portion of a nonprofit organization's promises to give are receivable from one corporate sponsor, that concentration of credit risk should be disclosed.

Disclosing Concentrations of Credit Risk for Cash Deposits

Cash deposits with banks, broker-dealers, and other financial entities are financial instruments with credit risk. Significant concentrations of credit risk can result when cash is deposited in a single financial entity or in two or more financial entities that are based in the same geographic region. (Maintaining deposits in two or more financial entities based in the same geographic region concentrates credit risk because the financial entities are similarly affected by changes in economic conditions.)

To increase the yield on deposits, many banks offer accounts with certain investment characteristics. To enable depositors to use these as interest-bearing checking accounts, the funds typically are invested in repurchase agreements, commercial paper, and similar financial instruments that mature quickly, usually overnight. Bank statements for such accounts may indicate that they are not deposits or other obligations of the bank. Because of such descriptions and the nature of the investment vehicles themselves, some accountants question whether such accounts should be viewed as cash. Using the definition of cash discussed previously, it seems logical that such accounts be viewed as cash. Therefore, they are subject to credit risk.

As discussed above, GAAP requires nonprofit organizations to disclose information about significant concentrations of credit risk. In practice, however, accountants disagree as to whether the amount of credit risk disclosed should be based on financial statement or bank statement balances and whether credit risk can be reduced by deposit insurance.

Should Disclosures Be Based on Financial Statement or Bank Statement Balances? The amount of credit risk that should be disclosed is the cash balance reported by the financial entity (i.e., the bank statement balance). The objective of the disclosure requirement is to disclose concentrations of credit risk that result from maintaining cash deposits in financial entities. Therefore, the amount of that risk is the amount for which the financial entity is responsible. Generally, the financial entity is not responsible for:

- *Deposits in Transit.* Undeposited receipts are a reconciling item between financial statement and bank statement balances. Although undeposited receipts can be misplaced, destroyed, or stolen, normally the payors are required to replace them because the payor's responsibility for a check is not eliminated until the bank on which the check was drawn has reduced its deposit obligation. The credit risk that exists related to undeposited receipts is the possibility that the debtor will not replace the receipt, not the risk that the financial entity will fail to perform.

  Deposits made, including wire transfers, also will be a reconciling item between financial statement and bank statement balances if they are received by the bank after its daily cutoff. Generally, the bank has no performance responsibility until it recognizes a deposit obligation. If the bank were to close, it probably would deny any responsibility for deposits made after its closing time for the day. The credit risk for those deposits is the same as for undeposited receipts.

- *Outstanding Checks.* Checks that have been released but have not cleared the bank will be a reconciling item between financial statement and bank statement balances because the bank does not reduce its deposit liability until the checks clear. In the event of a bank failure, the bank would be responsible for its deposit liability, not its deposit liability reduced by outstanding checks. The nonprofit organization would be required to satisfy outstanding checks with other funds.

Should Deposit Insurance Be Considered? Some, but not all, cash deposits are insured. For example:

- The Federal Deposit Insurance Corporation (FDIC) is a federal agency that insures the deposits of many banks. It currently covers up to $250,000 of a depositor's regular checking accounts, interest-bearing checking accounts, money market accounts, and certificates of deposit in a bank. More information related to the deposit insurance coverage can be found on the FDIC's website at **www.fdic.gov**. This limit generally applies to the depositor's combined deposits in the bank.
- Repurchase agreements are uninsured, but they are secured by pools of marketable securities of federal agencies.
- Commercial paper is uninsured and normally is unsecured.
- The Securities Investor Protection Corporation (SIPC) provides insurance for deposits with broker-dealers that is similar to that provided by the FDIC. The SIPC was created by federal law, but it is not a federal agency. Instead, it is a nonprofit organization funded by its broker-dealer members. Although the certainty of coverage and ease of collection are not as assured when compared to the FDIC, SIPC insurance seems to be similar to FDIC insurance for purposes of this discussion.

GAAP does not address whether the credit risk for cash deposits can be reduced by insurance. Some accountants argue that it should not. They believe that insurance merely decreases the likelihood of loss but does not affect the overall amount of credit risk (i.e., there is still a risk that the insurance may not be collected). While that may be conceptually correct, this course suggests that credit risk for cash deposits be reduced by amounts that are federally insured. Federal insurance will fail only in the event of a national financial catastrophe, and such a negligible risk should be ignored for purposes of disclosing concentrations of credit risk. Furthermore, nonauthoritative guidance at Q&A 2110.06 of the AICPA Technical Questions and Answers states *bank statement* balances in *excess* of FDIC-insured amounts represent a credit risk, and the *uninsured* cash balances should be disclosed if they represent a significant concentration of credit risk. The Q&A further states that while a material uninsured cash balance with a single bank should generally be disclosed, numerous immaterial uninsured cash balances on

deposit with several banks may not require disclosure. Judgment must be used in determining the threshold for significance, which will vary with individual circumstances. The financial statement preparer should use judgment to determine the aggregate materiality of numerous immaterial uninsured cash balances on deposit with several banks.

Disclosure Considerations. Financial statements should disclose the information discussed above in the "Disclosures Required for Concentrations of Credit Risk" paragraph about each significant concentration of credit risk for cash deposits at each date for which a statement of financial position is presented. The disclosures may be made in a manner that is most effective and efficient for the reporting entity. Therefore, many entities will disclose all concentrations of credit risk (e.g., for cash deposits, accounts receivable, notes receivable, etc.) in a single note such as "Significant Concentrations of Credit Risk." Assume that an organization's cash balance at the end of 20X7 consists of the following:

	Bank Statement Balance	Financial Statement Balance
Allen Fidelity Bank money market account	$ 43,500	$ 43,500
Bailey Bank interest-bearing checking account	310,300	310,300
Commonwealth Bank		
Regular checking account	31,500	(340,600)
Unsecured commercial paper	332,600	332,600
Regal Bank		
Regular checking account	10,600	20,500
Repurchase agreement collateralized by a GNMA pool	244,600	244,600
	$ 973,100	610,900
Petty cash		900
		$ 611,800

Assume further that all of the banks are local, and, with the exception of the commercial paper and the Regal Bank repurchase agreement, all of the deposits are federally insured. The concentration of credit risk is calculated as follows:

Allen Fidelity Bank (None, since all of the balance is federally insured)	$ —
Bailey Bank ($310,300 bank statement balance less $250,000 maximum federal insurance)	60,300
Commonwealth Bank	
Checking account (None, since all of the balance is federally insured)	—
Commercial paper (All of the balance is subject to credit risk since none of it is federally insured.)	332,600
Regal Bank	
Checking account (None, since all of the balance is federally insured)	—
Repurchase agreement (All of the balance is subject to credit risk since none of it is federally insured.)	244,600
	$ 637,500

The organization's 20X7 statement of financial position reports cash of $611,800. The concentrations of credit risk for cash deposits may be disclosed as follows (20X6 amounts are assumed):

> NOTE X—SIGNIFICANT CONCENTRATIONS OF CREDIT RISK
>
> The Organization has concentrated its credit risk for cash by maintaining deposits in banks located within the same geographic region. The maximum loss that would have resulted from that risk totaled $637,500 at the end of 20X7 and $428,200 at the end of 20X6 for the excess of the deposit liabilities reported by the banks over the amounts that would have been covered by federal insurance. Shares of a pool of mortgage-backed securities were pledged as collateral for $244,600 of that excess in 20X7 and $195,000 in 20X6.
>
> Credit risk for accounts and notes receivable is concentrated as well because substantially all of the balances are receivable from individuals located within the same geographic region.

Disclosures about the Fair Value of Financial Instruments

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 exempts nonprofit organizations from certain fair value disclosure requirements for financial instruments. Organizations may early adopt the amendments to FASB ASC 825-10-50 as of the beginning of the fiscal year for any financial statements not yet available to be issued. Because of the cost associated with the disclosure of fair value for these financial instruments, it seems likely that many organizations will elect to early adopt this exemption. As a result of the amendments in ASU 2016-01, the disclosures discussed below are not applicable to organizations that choose to early adopt the amendments to FASB ASC 825-10-50, or to years beginning after December 15, 2018, for those that do not early adopt these amendments. A discussion of that new guidance appears later in this lesson.

Exclusions from the Fair Value Disclosure Requirements. FASB ASC 825-10-50-10 through 50-19 require disclosure of the fair value of all financial instruments (as defined earlier in this lesson) for which it is practicable to estimate that value. Those requirements do not affect disclosure requirements under other GAAP that require disclosure of fair value information. However, for annual reporting periods, the disclosure requirements about the fair value of financial instruments are *optional* for nonpublic entities that have total assets of less than $100 million on the statement of financial position date and that have no instrument that, in whole or in part, is accounted for as a derivative instrument, except for commitments related to the origination of mortgage loans to be held for sale during the reporting period.

The fair value disclosure requirements in FASB ASC 825-10-50 are discussed below. As a result of the exemption for nonpublic entities described in the previous paragraph, many nonprofit organizations omit those disclosures. However, some nonprofit organizations voluntarily provide the disclosures.

FASB ASC 825-10-50-8 specifically excludes the following financial instruments from the fair value disclosure requirements in FASB ASC 825-10:

- Employers' and plans' obligations for pension benefits, other postretirement benefits including health care and life insurance benefits, and other forms of deferred compensation arrangements.
- Substantively extinguished debt subject to the disclosure requirements of FASB ASC 405-20.
- Certain insurance contracts.
- Lease contracts.
- Warranty obligations and rights.
- Unconditional purchase obligations as defined in FASB ASC 10-50-2.
- Investments accounted for under the equity method in accordance with the requirements of FASB ASC 323.

- Noncontrolling interests in consolidated subsidiaries.
- Equity investments in consolidated subsidiaries.
- Fully benefit-responsive investment contracts, which are held by an employee benefit plan.
- Trade accounts receivable and payable due in one year or less.
- Equity security investments without readily determinable fair values.

Disclosures Required for Fair Value of Financial Instruments. When it is cost effective to estimate the fair value of a financial instrument, FASB ASC 825-10-50-10 requires disclosure of—

a. The fair values of financial instruments either in the body of the financial statements or in the notes.

b. The methods and significant assumptions used to estimate the fair value of financial instruments. For fair value measurements that fall within Levels 2 or 3 of the fair value hierarchy, a description of the valuation technique and inputs used in the fair value measurement is required; also, any change in the valuation technique and the reason for the change should be disclosed.

c. A description of any changes in methods or assumptions used to estimate fair value during the period.

d. For financial instruments reported at fair value in the financial statements, the level of the fair value hierarchy within which the fair value measurements are categorized in their entirety (Level 1, 2, or 3).

The following considerations apply when preparing the disclosures described in the previous paragraph:

- If the information is disclosed in more than one note, one of the notes must include a summary table that includes the fair value and related carrying amounts of all financial instruments. The table also should include cross-references to the other fair value disclosures.
- Fair value disclosures should be presented in a manner that makes it clear whether the reported amounts represent assets or liabilities and how the carrying amounts relate to what is reported in the statement of financial position.
- Fair values of nonderivative financial instruments should not be combined, aggregated, or netted with fair values of derivative financial instruments except where netting is allowed under FASB ASC 210-20-45-1 and 815-10-45-5 or FASB ASC 210-20-45-11 through 45-17.
- GAAP encourages, but does not require, the combination of fair value disclosures required by FASB ASC 820-10-50 with those required by other standards such as FASB ASC 825-10-50.

When it is not cost effective to disclose the fair value of a financial instrument, the pertinent information about the financial instrument (such as the carrying amount, effective interest rate, and maturity) and the reasons why estimating fair value is not cost effective should be disclosed. In some cases, it may be cost effective to disclose the fair value of a class or portfolio of financial instruments when it is not cost effective to disclose the fair value of an individual instrument.

As a practical matter, many organizations do not have enough financial instruments to prevent the users of their financial statements from readily assessing the effects of fluctuations in financial instrument values without a table. Accordingly, in those situations, a separate table seems to be unnecessary. Deciding when a table is necessary depends on the facts and circumstances. To illustrate: if an organization discloses the fair value of notes receivable and notes payable in separate notes, and a separate note for an investment in a limited partnership discloses that determining fair value is impractical, the reader can easily assess the impact of fluctuations in financial instrument values without a summary table.

New Guidance Available for Immediate Adoption in ASU 2016-01 on Financial Instruments. The FASB issued ASU 2016-01 as a result of a long-term project to enhance the reporting model for financial instruments. ASU 2016-01 applies to all organizations that hold financial assets or owe financial liabilities. In general, the amendments in ASU 2016-01 are effective for nonprofit organizations for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Because of the delayed effective dates for ASU 2016-01, this course has not been fully updated to incorporate the requirements in the new and amended standards.

However, ASU 2016-01 contains certain amendments that the FASB made available to be applied immediately in financial statements that have not been issued or made available for issuance. The transition and effective date information at FASB ASC 825-10-65-2 describes those items as follows:

- The scope for the applicability of the requirements in FASB ASC 825-10-50 to disclose fair value information for financial instruments is narrowed to apply only to *public business entities*. Amendments in ASU 2016-01 supersede the criteria discussed previously that determine when the disclosures are required for larger nonpublic entities. Thus, the new guidance allows all nonprofit organizations to elect to omit the disclosures from FASB ASC 825-10-50-10 described above.
- Entities that are not public business entities are allowed the option to adopt new guidance in FASB ASC 825-10-45-5 through 45-7 for the presentation of financial liabilities for which the fair value option has been elected. This new guidance allows a nonprofit organization to present the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk outside of an intermediate measure of operations, if one is presented.

Derivative Financial Instruments and Hedging Activities

FASB ASC 815-10-50 requires disclosure of the objectives for holding hedging instruments, the risk management policy for each type of hedge, and the purpose of derivatives not designated as hedging instruments. It also requires disclosing information about changes in a derivative's fair value that relate to its ineffectiveness as a hedge and are excluded from the assessment of hedge ineffectiveness.

Presentation and Disclosure Considerations for Receivables

ASU 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments,* amends the disclosure requirements for receivables. For nonprofit organizations, the ASU is effective for years beginning after December 15, 2020, and interim periods within years beginning after December 15, 2021. The following paragraphs discuss the disclosure requirements for receivables prior to the implementation of ASU 2016-13. An in-depth discussion of ASU 2016-13 is beyond the scope of this course, but more information is available in *PPC's Guide to Preparing Nonprofit Financial Statements.* Future editions of this course will more fully integrate the requirements of ASU 2016-13 provide further guidance as the effective date nears.

Receivables may result from programs of the organization, fees and dues from members, or receivables from related parties. The disclosure requirements in FASB ASC 310-10-50 apply to any entity, including a nonprofit organization, that lends to or finances the activities of others.

Many of the required disclosures may not be applicable to nonprofit organizations because—

a. The organization does not engage in the types of transactions underlying the disclosure requirement. For example, the organization may not engage in any activities that would generate trade receivables. Or, for example, if the organization only holds short-term noninterest bearing receivables, few disclosure requirements apply; and if it only grants unsecured credit, it will not have any foreclosed or repossessed assets to disclose.

b. The type of transaction is not material to the organization's financial statements; as with all accounting standards, the guidance need not be applied to immaterial items. For example, the balance of trade receivables may not be material at the date of the statement of financial position. Or, if interest income on trade receivables is not a material component of the changes in net assets, the related accounting policies would not be material to the financial statements, and the organization would not be required to disclose them.

Examples of receivables that a nonprofit organization might have include the following:

- Receivables from program fees (e.g., from clients for counseling services or patrons for tickets to symphony performances).
- Receivables from the sale of program publications or materials (e.g., from sales of tapes, recording materials, or books).
- Tuition receivables (e.g., from students of a private school).
- Rent receivable from residents of a low-income housing project administered by the organization.
- Membership dues receivable.

Due to the nature of these receivables, they are usually short-term and noninterest bearing.

Promises to give are not included in the scope of FASB ASC 310-10-50 because they do not result from a lending or financing transaction. Similarly, it seems logical that receivables from grants that are considered contributions would not be included in the scope of the requirements. However, if a grant receivable results from an exchange transaction (i.e., not from a contribution) and is long-term, any related receivable would be included in the scope of the disclosure requirements in FASB ASC 310-10-50.

The disclosure requirements do not seem to apply to amounts due from nonprofit organizations that are related parties under an informal arrangement in which the two organizations make short-term advances to each other depending on the individual organization's working capital requirements. In that instance, the debtor and the creditor in the arrangement are in substance the same party, which is fundamentally different than the two-party arrangement that exists when there are receivables resulting from typical lending or financing transactions. In addition, related party disclosures would already be required for those informal receivables.

Receivables from Exchange Transactions, Credit Losses, and Doubtful Accounts. Accounting policies for trade receivables from exchange transactions, credit losses, doubtful accounts, and the carrying amount of receivables pledged as collateral are required to be disclosed. Additionally, GAAP requires disclosure of the amount of the valuation allowance for uncollectible receivables. Disclosure of material changes in the valuation allowance is also required. GAAP does not prescribe how organizations should account for recoveries of doubtful accounts. Instead, it allows organizations to credit either the valuation allowance or revenue and support for recoveries because the net effect of credit losses and recoveries is the same under either approach. As a practical matter, it seems logical for nonprofit organizations to credit recoveries to revenue and support.

The policies ordinarily can be disclosed through a relatively standard note in the summary of significant accounting policies, such as—

> Accounts Receivable
>
> Accounts receivable are stated at the amount management expects to collect from outstanding balances. Management provides for probable uncollectible amounts through a charge to bad debt expense and an adjustment to a valuation allowance based on its assessment of the current status of individual accounts. Balances that are still outstanding after management has used reasonable collection efforts are written off through a charge to the valuation allowance and a credit to accounts receivable. Changes in the valuation allowance have not been material to the financial statements.

Depending on the facts and circumstances, management may conclude that a valuation allowance is unnecessary, for example, because—

- Receivables are due within one year, and in accordance with FASB ASC 958-310-35-3 they are reported at net realizable value.
- Substantially all of the organization's credit sales are to a small number of clients, members, or patrons who have a history of paying promptly.

- Management considered subsequent collection results and wrote off all year-end balances that were not collected by the time the financial statements were available to be issued.

- The organization's client or member base is relatively stable; management closely monitors outstanding balances; collection losses have historically been immaterial; and management is not aware of client or member disputes or financial difficulties.

The following is an example of the accounting policy disclosure when management has concluded that a valuation allowance is unnecessary.

> Receivables from Patrons
>
> Receivables from patrons are reported at the amount management expects to collect on balances outstanding at year-end. Management closely monitors outstanding balances and writes off, as of year-end, all balances that have not been collected by the time the financial statements are available to be issued.

As another example—

> Trade Accounts Receivable
>
> Trade accounts receivable are stated at the amount management expects to collect from balances outstanding at year-end. Based on management's assessment of the credit history with clients having outstanding balances and current relationships with them, it has concluded that realization losses on balances outstanding at year-end will be immaterial.

Long-term Financing Receivables. The portfolio of receivables typically held by nonprofit organizations is from short-term financing of program services. Receivables that might be considered short-term financing receivables were listed earlier in this section. However, some organizations may have a portfolio of receivables from providing long-term financing. The disclosure requirements for long-term financing receivables are more extensive than those required for short-term receivables. The guidance defines *financing receivables* as financing arrangements that represent a contractual right to receive money and that are recorded as assets in the financial statements. Examples given in the guidance include trade accounts receivable, notes and loans receivable, and credit card receivables. Debt securities are not considered financing receivables. Examples of long-term financing receivables for nonprofit organizations could include:

- Assessments receivable (for example, from members of a country club to finance the construction of a new clubhouse).

- Notes or mortgages receivable (for example, mortgage loans to key employees, facilities loans, or loans to purchase professional musical equipment).

- Loans from the national organization to a local affiliate organization.

The disclosure requirements for long-term finance receivables are more extensive than those required for short-term receivables. Paragraph 12.16 of the Audit Guide states that when determining the extent of disclosures, financial statement preparers need to consider the relative significance of long-term financing receivables to the organization's operations and financial position, and the quantitative and qualitative risks that arise from the credit quality of those receivables. Accordingly, when such assessments are made, it seems likely that different approaches to meeting the disclosure requirements in GAAP can be taken. Paragraph 12.17 of the Audit Guide illustrates three alternative disclosure examples.

Nonprofit organization financial statement preparers may question whether the following types of receivables are within the scope of the disclosure requirements because they usually do not arise from a decision to extend credit:

- *Promises to give.* The implementation guidance at FASB ASC 310-10-55-15 specifically states that unconditional promises to give (contributions receivable) are not considered financing receivables.

- *Trade accounts receivable with maturities of one year or less (other than credit card receivables). Trade accounts receivable* are defined as non-credit card receivables that are recorded when goods or services are sold and that have a contractual maturity of one year or less. Thus, most trade receivables and short-term client receivables that arise from programs and services are exempt from the majority of disclosures.

- *Receivables measured at fair value or lower of cost or fair value.* The disclosure requirements do not affect disclosures about receivables measured at fair value or lower of cost or fair value.

- *Loans receivable.* Paragraph 12.16 of the Audit Guide states that financing receivables include the following:

  - Student loans issued by colleges and universities.
  - Housing association loans receivable.
  - Microfinance loans.
  - Certain program-related investments issued by foundations.
  - Notes receivable from officers and employees.

  Loans from the national organization to the local affiliate is another example not included in the Audit Guide.

- *Receivables that arise from programs and grants.* Receivables for program fees, services, grants that arise from exchange transactions, and contracts (such as cost-reimbursement arrangements) usually seem to meet the definition of a financing receivable.

The disclosure requirements for financing receivables include the following:

- Accounting policies (including any change in the policies and the rationale for the change) for placing receivables on nonaccrual status (that is, receivables for which the organization has suspended the accrual of interest), recording payments received on nonaccrual receivables, resuming interest accruals, determining past due or delinquency status, determining which loans management assesses for impairment and the factors it considers in determining that the loan is impaired, recognizing interest income on loans including impaired loans, recognizing cash received on impaired loans, and estimating the allowance for credit losses, by class of financing receivable.

- Total nonaccruing receivables and amounts over 90 days past due and still accruing interest. An analysis of the age of past due financing receivables as of the reporting date should be presented by class of financing receivable.

- A roll-forward of the allowance for credit losses (allowance for doubtful accounts) from the beginning to the end of the reporting period, by portfolio segment. (A portfolio segment is the level at which management determines the allowance for credit losses).

- The quantitative effect of any changes in accounting policies or methodology on the amount of the provision (bad debt expense) included in the rollforward.

- A description of the credit quality indicator(s) and information about them to provide the users of the financial statements an understanding of how and to what extent management monitors the credit quality of its financing receivables.

- The balance in the allowance for credit losses, disaggregated on the basis of the organization's impairment method (collectively evaluated for impairment or individually evaluated for impairment) and in total, along with the related recorded investment in financing receivables at the end of each period presented. (The recorded investment is the amount of the receivables including the accrued interest receivable, before adjustment by the allowance for credit losses.)

- For loans that are evaluated individually for impairment (instead of collectively) and for which the organization has determined that it is probable that it will not collect all the contractually required payments, the recorded investment in the impaired loans that do not have a related allowance for credit losses, the recorded investment in impaired loans for which there is a related allowance for credit losses, the total unpaid principal balance on the impaired loans, the average recorded investment in the impaired loans, and the related amount of interest income recognized for the time the loans were impaired during the period.

- Additional disclosures are required if the organization bought or sold receivables during the year.

HOW TO ADDRESS RISKS AND UNCERTAINTIES

In general terms, uncertainty stems from the inability to predict the future, and risks exist because uncertainty exists. FASB ASC 275 requires financial statements to:

- Disclose risks and uncertainties that could significantly affect the amounts reported in the financial statements in the near term or the near-term functioning of the organization.

- Communicate to financial statements users the inherent limitations in financial statements.

GAAP does not require disclosure of all risks and uncertainties, which would be an impossible task, but requires disclosure of certain risks and uncertainties that meet specified criteria. FASB ASC 275-10-50-1 requires disclosure in the following four areas:

- Nature of activities, including any activities that have not commenced in which the organization is currently engaged.

- Use of estimates when preparing the financial statements.

- Certain significant estimates.

- Current vulnerability as the result of certain concentrations.

The first two disclosures, nature of activities and use of estimates, are required for all financial statements. The second two are required only for estimates and concentrations that meet specified criteria.

Scope and Applicability

The disclosure requirements apply regardless of an entity's size, but they are not required in condensed or summarized interim financial statements. FASB ASC 275-10-15-4 explicitly excludes certain risks and uncertainties from the disclosure requirements, including those that might be associated with the following:

- Management or key personnel.

- Proposed changes in government regulations.

- Proposed changes in accounting principles.

- Deficiencies in an organization's internal control structure.

- Acts of God.

- War.

- Sudden catastrophes.

Nature of Activities

All financial statements should include a description of the major products or services the reporting entity sells or provides. For a nonprofit organization, that would include the principal services the organization performs and its sources of revenues. Also required is disclosure of the entity's principal markets, including the locations of those markets. If the entity operates in more than one business, disclosures must indicate the relative importance of each business and the basis for determining relative importance. Relative importance can be based on such things as assets or revenues and does not have to be quantified in the disclosure. It can be communicated by using terms such as "predominantly," "about equally," or "major." It seems likely that many nonprofit organizations will operate in only one "business" or program activity. However, GAAP does not address whether different programs of a nonprofit organization should be considered different businesses for disclosure purposes. If the different programs are considered different businesses, the nonprofit organization's financial statements may already provide information about the significance of different programs using expenses as a basis because of the requirement to report functional expense information for major classes of programs either in the financial statements or the notes to the financial statements.

FASB ASC 958-205-50-1 requires organizations to present a description of the nature of their activities, including a description of each of its major classes of programs, either in the financial statements (by use of column headings) or in the notes to financial statements. In addition, FASB ASC 275-10-50-2 requires organizations that have commenced planned principal operations to describe their principal markets, the sources of revenue for the organization's activities, and the relative importance of the organization's activities in each business if it operates in more than one business. If the organization has not yet commenced principal operations, FASB ASC 275-10-50-2A requires the organization to describe the risks and uncertainties related to the organization's current activities and an understanding of what those activities are being directed toward.

As discussed earlier in this lesson, FASB ASC 825-10 requires disclosure of concentrations of credit risk. If all or most of an organization's contributions are through unconditional promises to give, the disclosures for concentrations of credit risk may accomplish the disclosure of the organization's principal markets. Consequently, the disclosure requirements will often require only minor modification of existing disclosures. The following is an example of a disclosure of an organization's activities:

> The Organization provides job training and counseling to unemployed and underemployed individuals in the Dallas/Fort Worth Metroplex. The Organization is supported primarily through donor contributions, government grants, and the United Way.

Use of Estimates

GAAP requires financial statement disclosures to include an explanation that preparation of financial statements requires the use of management's estimates. The disclosure will usually be standardized (that is, boilerplate). The following are examples of disclosures regarding the use of estimates:

> The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Alternative Disclosure

> Management uses estimates and assumptions in preparing financial statements. Those estimates and assumptions affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities, and the reported revenues and expenses. Actual results could differ from those estimates.

See additional examples later in this section.

Certain Significant Estimates

GAAP requires additional disclosures for certain *significant* estimates. According to FASB ASC 275-10-50-8, disclosure regarding an estimate is required when known information available before the financial statements are available to be issued "indicates that both of the following criteria are met:

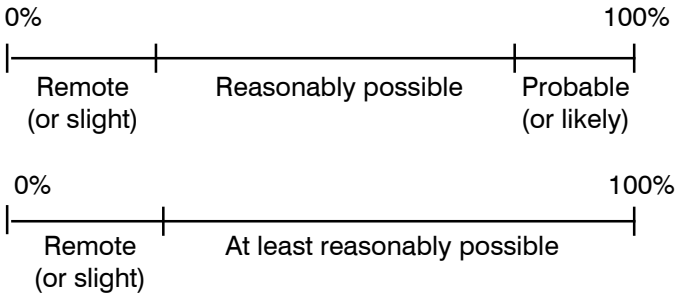
- It is at least reasonably possible that the estimate of *the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements* will change in the near term *due to one or more future confirming events*. . . [Emphasis added.]
- The effect of the change would be material to the financial statements."

Existing Condition. The *italicized* wording in the first criterion is intended to clarify that the condition that may cause the estimate to change in the near term must be *an existing condition*. This is consistent with the GAAP requirements for accounting for loss contingencies, and it helps to narrow the range of estimates that meet the criterion. If there is no existing condition, disclosure need not be considered.

Reasonably Possible. While the "existing condition" requirement helps to narrow the range of estimates that meet the criterion, the range is still very broad. That is primarily because of the use of the term "reasonably possible," which has the same meaning in FASB ASC 275 as it does in FASB ASC 450. FASB ASC 450-20-20 provides the following definitions:

- *Probable* The future event or events are likely to occur.
- *Reasonably possible* The chance of the future event or events occurring is more than remote but less than likely.
- *Remote* The chance of the future event or events occurring is slight.

Consequently, "reasonably possible" means anything more than remote but less than probable. FASB ASC 275-10-50-8 uses the phrase *at least* reasonably possible, which means anything more than remote, or slight. The ranges of probabilities can be depicted as follows:



Deciding where to apply the threshold within the range is very subjective. Is disclosure considered anytime the possibility of a change in estimate is not remote? How much less than likely must a situation be to avoid disclosure? Since there is no clear-cut answer, professional judgment should be used when deciding whether a change in an estimate is reasonably possible.

Near Term. *Near term* is defined in FASB ASC 275-10-20 as "a period of time not to exceed one year from the date of the financial statements."

Material. The second criterion for significant estimates is that the effect of the change would be material to the financial statements. FASB ASC 275-10-50-14 goes on to state:

> Whether an estimate meets the criteria for disclosure . . . does not depend on the amount that has been reported in the financial statements, but rather on the materiality of the effect that using a different estimate would have had on the financial statements. Simply because an estimate resulted in the recognition of a small financial statement amount, *or no amount*, does not mean that disclosure is not required . . . . [Emphasis added.]

Consequently, disclosure might be required even if no estimate is recognized in the financial statements (that is, the estimate is zero).

Estimates to Which this Disclosure Applies. The types of estimates that should be considered for disclosure are those used in the determination of the carrying amounts of assets or liabilities or in the disclosure of gain or loss contingencies. In other words, the disclosure requirements relate to estimates used to determine (a) recorded amounts and (b) disclosures of gain or loss contingencies. The disclosure requirements do not apply to estimates such as those used when disclosing the fair value of financial instruments in accordance with FASB ASC 825-10-50.

Also, disclosure should be *considered* for every estimate in the financial statements, but disclosure is not necessarily *required* for every estimate in the financial statements. Disclosure should generally be considered more closely when a condition, situation, or set of circumstances makes an estimate more susceptible to change than it ordinarily would be. Also, the more critical an estimate is to the financial statements, the more likely it is that disclosure is needed. As a practical matter, the disclosure can be used to provide an early warning to financial statement users that certain estimates, based on the best information available, are still somewhat soft and changes in them may affect future financial statements.

Recurring Estimates. Although not a definitive criterion, whether an estimate meets the criteria for disclosure can be influenced by whether it is a recurring or nonrecurring estimate. For recurring estimates, the organization often has enough history to develop an estimate that will vary only within a range of amounts that would not be material to the financial statements. Exceptions can, and do, occur however (for example, if a large customer, with a large accounts receivable due, announces just before issuance of the financial statements that it is considering filing for bankruptcy because of litigation). Also, even some recurring estimates may be so critical to the financial statements that the organization may choose to always include the disclosure.

Nonrecurring Estimates. The disclosure criteria are more likely to be met when a nonrecurring, or *new*, estimate is involved. Regardless of how much effort goes into new estimates, they often change, sometimes by an amount that is material to the financial statements. Examples include estimates of net realizable value of promises to give resulting from a first-time mass fund-raising appeal and pending litigation.

Known Information. The criteria for significant estimates are to be considered using "known information available before the financial statements . . . or are available to be issued." Therefore, if management is unaware of information that would cause a significant estimate to change, disclosure is not required. However, that does not mean that disclosure can be avoided by the failure of management to exercise due care to be informed about relevant trends, events, and uncertainties that would be expected to affect significant estimates.

As noted previously, the condition that may cause an estimate to change in the near term must have existed at the date of the financial statements. Consequently, the disclosure decision is based on information known prior to issuance of the financial statements about conditions that existed at the date of the financial statements. The requirement is essentially the same as that of FASB ASC 450-20-25-2, which refers to "information available before the financial statements . . . are available to be issued."

Examples of Estimates. Paragraph A-25 in Appendix A to Chapter 2 of the Audit Guide states that nonprofit organizations commonly use accounting estimates in the following areas:

- Measurement of noncash contributions other than marketable securities; especially measurement of unusual noncash assets.
- Estimation of the allowance for uncollectible promises to give.
- Calculation of present value estimates for unconditional promises to give and split-interest agreements.
- Choices of methods and factors used in allocating the costs of joint activities.
- Allocation of expenses to functional categories.
- Estimation of future cash flows related to assets that are possibly impaired.

Examples of accounting estimates that are less common for nonprofit organizations include:

- Inventory obsolescence.
- Environmental remediation liabilities.
- Estimates related to the acquisition or disposition of a business, merger with another nonprofit organization, or other significant asset acquisitions or disposals (i.e., estimated proceeds and expected losses).
- Obligations for pensions or postemployment benefits.
- Liabilities for unrelated business income taxes.
- Useful lives of intangible assets with finite lives.
- Liabilities resulting from audits of grants.

Example Disclosure. If an estimate meets the criteria for disclosure listed previously, the disclosure must:

- Describe the nature of the uncertainty, and
- Indicate that it is at least reasonably possible that a change in the estimate will occur in the near term (although GAAP does not require the words *reasonably possible* to be used).

The following is an example of a disclosure that meets those requirements:

> As a result of recent changes in the Organization's market for certain products, carrying amounts for those inventories have been reduced by approximately $60,000 due to quantities in excess of current requirements. Management believes that this reduces inventory to its lower of cost or net realizable value, and no additional loss will be incurred upon disposition of the excess quantities. While it is at least reasonably possible that the estimate will change materially in the near term, no estimate can be made of the range of additional loss that is at least reasonably possible.

However, including a disclosure about an inventory valuation allowance (or about any estimate) should not be considered an indication that the estimate is materially misstated. It is merely an indication that the chances of the estimate changing by a material amount in the near term is more than remote.

How Do Disclosures of Risks and Uncertainties Relate to Disclosures of Loss Contingencies? Throughout the preceding discussion of certain significant estimates, numerous references are made to FASB ASC 450. A point of confusion for many practitioners is how the requirements for disclosing certain significant estimates according to FASB ASC 275 relate to the requirements for disclosing loss contingencies under FASB ASC 450. The following paragraphs compare and contrast the requirements.

Both FASB ASC 275 and FASB ASC 450 require a description of the uncertainty. That is where the comparability of disclosure content stops. FASB ASC 450 also requires an estimate of possible loss or range of loss or a statement that such estimate cannot be made. FASB ASC 275, on the other hand, requires an indication that a change in the estimate that was used is at least reasonably possible to occur in the near term. Since the description is required in both cases, it is likely that the disclosures will be combined when situations meet the criteria of *both* FASB ASC 275 and FASB ASC 450. That can be accomplished by merely adding a sentence to the end of an FASB ASC 450 contingency note indicating that it is reasonably possible that any estimates used will change in the near term, as the following illustrates.

> The Organization is a defendant in a lawsuit involving one of its truck drivers. The driver allegedly failed to stop at a red light, colliding with a van, that ultimately resulted in the death of the van's driver. Although the Organization is vigorously defending its position and the trial has not begun, the Organization has made a tentative offer to the van driver's family of $250,000. The offer amount is the Organization's current estimate of the cost of resolving this case and has been accrued in the financial statements. Due to uncertainties in the litigation process, it is at least reasonably possible that the estimated cost of this case will change within the next year.

FASB ASC 275 only requires disclosure when the effect from a change in estimate is at least reasonably possible in the *near term*. FASB ASC 450 does not distinguish between near term and long term contingencies. Therefore, FASB ASC 450 contingencies that are not likely to result in a change in estimate within the next year would not need the incremental disclosures required by FASB ASC 275.

A number of estimates used in financial statements do not involve contingencies, such as those relating to long-term assets. In those cases, only the disclosure requirements of FASB ASC 275 need be considered.

The table at Exhibit 1-1 summarizes when the disclosure requirements of FASB ASC 450 and FASB ASC 275 should be considered.

Exhibit 1-1

When to Consider the Disclosure Requirements of FASB ASC 450 and FASB ASC 275

	Both FASB ASC 450 and FASB ASC 275 Apply	Only FASB ASC 450 Applies	Only FASB ASC 275 Applies
Loss Contingency Exists at the Statement of Financial Position Date— At least reasonably possible that the estimate will change *within the next year* by a material amount.	✓		
Not at least reasonably possible that the estimate will change within the next year by a material amount.		✓	
Gain Contingency	✓		
Financial Statement Estimate Not Involving a Contingency			✓

* * *

Current Vulnerability Due to Concentrations

FASB ASC 275-10-50 also requires disclosure of concentrations that meet certain criteria. The types of concentrations that must be *considered* for disclosure are as follows:

- Concentrations in the volume of business transacted with a particular client (customer), supplier, lender, grantor, or contributor.
- Concentrations in revenue from particular products, services, or fund-raising events.
- Concentrations in the available sources of supply of materials, labor, or services, or of licenses or other rights used in the organization's activities.
- Concentrations in the market or geographic area in which an organization conducts its operations.

Certain of the concentrations are already disclosed in some financial statements. One example is economic dependence on major grantors or contributors. Another example is disclosure of concentrations of credit risk. Although concentrations of financial instruments are specifically excluded from the concentration disclosure requirement in FASB ASC 275-10, disclosure of market or contributor concentrations may provide the necessary disclosure for credit risk concentrations required by FASB ASC 825-10.

What Is a Concentration? FASB ASC 275-10-50-16 does not specifically define "concentration." It states that:

> Vulnerability from concentrations arises because an entity is exposed to risk of loss greater than it would have had it mitigated its risk through diversification.

A concentration is of concern when it involves something that cannot be easily replaced. If, for example, an organization purchases most of its inventory from a single supplier, that is not a concentration unless the supplier cannot be easily replaced. Concentrations may not necessarily be identifiable solely on the basis of dollars. For example, if an organization purchases only a small amount of inventory from a supplier, but that inventory is critical to the organization's programs, a concentration exists if the supplier cannot be easily replaced.

Criteria for Disclosure. Disclosure of concentrations is required only if certain criteria are met. Those criteria are as follows, and they must *all* be met for disclosure to be required:

- The concentration exists at the date of the financial statements.
- The concentration makes the organization vulnerable to the risk of a near-term severe impact.
- It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

The criteria are similar in some ways and use some of the same wording as the criteria for disclosing certain significant estimates provided earlier in this section. For example, the concentration must be an *existing condition* and must be *at least reasonably possible*. Also, the criteria are to be considered using "information known to management before the financial statements are available to be issued." Those and other terms used in both sets of criteria are discussed in prior paragraphs.

Major Contributors, Customers, and Foreign Operations. For the following concentrations, it is *always* at least reasonably possible that events that could cause "severe impact" will occur in the near term:

- Concentrations in the volume of revenue received from a grantor or contributor.
- Concentrations in the volume of business transacted with a particular client or customer.
- Foreign operations.

As a result, disclosure is required if those concentrations exist at the date of the financial statements and their loss could cause a severe impact to the organization. GAAP, however, does not prohibit the disclosure from stating that the organization does not expect that the revenue from the grantor or contributor or the relationship with the client will be lost (or the foreign operations will be disrupted).

Severe Impact. The term *severe impact* when considering concentrations is defined in FASB ASC 275-10-20 as follows:

> A significant financially disruptive effect on the normal functioning of an entity. Severe impact is a higher threshold than material. Matters that are important enough to influence a user's decisions are deemed to be material, yet they may not be so significant as to disrupt the normal functioning of the entity . . . . The concept of severe impact, however, includes matters that are less than catastrophic.

Thus, severe impact is a significant financially disruptive effect on the normal functioning of the organization. It is more than just material, but less than catastrophic. An example of a catastrophic event is one that would result in the dissolution of the organization, such as the inability to obtain contributions or financing.

Group Concentrations. Even if an organization does not have concentrations with another entity or individual, the organization might still have group concentrations that require disclosure. Group concentrations exist if a number of counterparties or items that have similar economic characteristics collectively expose the reporting entity to a particular kind of risk. So, even if, for example, an organization does not have a single major contributor, it may have a disclosable concentration if a group of contributors has similar economic characteristics.

Example Disclosures. For concentrations meeting the criteria for disclosure, disclosures must include information that is adequate to inform financial statement users of the general nature of the risk associated with the concentration. Additional specific disclosures are required for concentrations of labor subject to collective bargaining agreements and for foreign operations. The following is an example of a disclosure that meets these requirements:

> Approximately 34% of the Organization's support was provided by contributions from one community foundation.

Summary of Disclosure Requirements

Exhibit 1-2 summarizes the disclosure requirements of for significant risks and uncertainties.

Practical Considerations for Disclosing Significant Risks and Uncertainties

The requirements for disclosing significant risks and uncertainties were discussed earlier in this section. The following paragraphs offer practical guidance for applying those requirements and the disclosures typically required for nonprofit organizations.

Nature of Activities. Using the following guidelines, a single description generally can address an organization's major products or services, principal markets, and lines of business:

a. *Major Products or Services.* Describe broad product and service groups. If the statement of activities presents expenses by major program, either repeat the major programs or use a broader description.

b. *Principal Markets.* General descriptions of industry and geographical concentrations normally give the reader enough information about principal markets, such as "obtains contributions primarily from employees of a major pharmaceutical company in Wilson County" or "provides child care in the metropolitan area."

c. *Lines of Business.* Lines of business are not the same as major products and services, and many nonprofit organizations have only one line. If there is more than one, disclose the relative importance of each line to the entity's financial results and describe how that determination was made. Often the most efficient approach for drafting the disclosure is to ask management how it views the importance of the lines. Typically, management will describe the lines' relative importance with words and phrases such as "about equal" and "mostly" and with rough percentages such as "60%/40%." Those same types of words may be used in the note disclosure.

Exhibit 1-2

Disclosing Significant Risks and Uncertainties

	Nature of Activities	Use of Estimates	Certain Significant Estimates	Concentrations
When to Disclose?	• Always.	• Always.	• It is at least reasonably possible that the estimate of the effect on the financial statements of an existing condition will change in the near term due to future confirming events. AND • The change in estimate would have a material effect on the financial statements.	• A concentration exists at the financial statement date. AND • The concentration increases the organization's vulnerability to the risk of a near-term severe impact. AND • It is reasonably possible that the events able to cause the severe impact could occur in the near term.
Threshold for Disclosing?	• N/A	• N/A	• Potential *material* effect on financial statements.	• Potential *severe* impact to the organization.
What to Disclose?	• Description of products or services (including each major class of programs). • Sources of revenues for the organization's services. • Relative importance of each business. • Basis used to determine relative importance of each business. • Principal markets and locations of the markets.	• Explanation that management estimates are used in preparing financial statements.	• Nature of uncertainty. • An indication that it is at least reasonably possible that a change in the estimate will occur in the near term.	• Description of the concentration. • Information about the general nature of the risk associated with the concentration. • Additional disclosures for concentrations of labor or foreign operations.

* * *

The nature of activities disclosure generally will be either in the first note, with the summary of significant accounting policies, or combined with a note on credit risk.

a. *Disclosed in the First Note.* The heading of the first note might be "Nature of Activities and (Summary of) Significant Accounting Policies," and the nature of activities disclosure might be the first disclosure in that note, with a heading such as "Nature of Activities." Placement in the first note often is preferable when the description is short or does not fit logically with other disclosures. The following is an example of such a disclosure:

> Lane Private School provides educational instruction to children in grades K-12 primarily from the southern area of Chicago.

b. *Disclosed with a Note on Credit Risk.* The note might be headed "Nature of Activities and Credit Risk." This is preferable when the nature of the organization's activities relate to its credit risk disclosure, as follows:

> The Organization's activities consist primarily of distributing grants to local arts organizations. Substantially all of the Organization's contributors are residents in the Little Rock area.

General Use of Estimates. The goal of disclosing the use of estimates is to alert readers that certain amounts reported in the financial statements are estimated. While the pervasiveness of estimates depends on the nature of operations, a brief discussion of the general use of estimates is usually the most efficient approach. The disclosure may initially generate some discussion about which amounts are estimated until users become accustomed to the disclosure. The following exceptions to disclosure of the general use of estimates may be helpful:

a. Estimates are not pervasive in the financial statements of some small, simple operations. In those situations, readers might want to know which amounts are estimated and that no material losses can result from them.

b. If the statements have no estimates, for example, because the assets consist of cash and investments in traded securities, the disclosure is irrelevant and the authors believe either of two alternatives is acceptable: (1) omit the disclosure or (2) if the entity is concerned that the reader may question why an estimates note is not included, draft the note to say that there are no estimates.

The disclosure probably is easiest for the reader to follow if it is either presented as an accounting policy or combined with the nature of activities description.

a. *Separate Policy Note.* The disclosure often will be disclosed as a separate policy within the "Summary of Significant Accounting Policies" note, using a subheading entitled "Use of Estimates." In that case, the following disclosures may be provided:

> Generally accepted accounting principles require management to estimate some amounts reported in the financial statements; actual amounts could differ.
>
> *or*
>
> Because of normal business uncertainties, management must estimate some information included in the financial statements, primarily the net amounts the Organization will realize from collecting unconditional promises to give.
>
> *or*
>
> Although the preparation of financial statements often requires estimating some information, estimates were not necessary to prepare the accompanying financial statements.

b. *Combined with the Nature of Activities Description.* If estimates are not pervasive, the use of estimates disclosure may be easily included with the nature of activities disclosure. Typically, this will be appropriate for small organizations with simple activities.

c. *Combined with the Basis of Accounting Disclosure.* Combining the use of estimates disclosure with the basis of accounting disclosure is helpful when a comprehensive basis of accounting other than GAAP is used. Usually, the note is the first or second policy note and is entitled "Basis of Accounting." An appropriate disclosure under such circumstances follows:

> The financial statements are prepared on the basis of accounting used for grant reporting, which is a comprehensive basis of accounting other than generally accepted accounting principles. It differs from generally accepted accounting principles primarily because accrued expenses generally are recognized only to the extent they will be paid within prescribed periods. Preparing financial statements on the Organization's grant basis requires estimating these and some other amounts. Actual results normally only vary within a small range.

Certain Significant Estimates. Since variances between estimated and actual amounts will be recorded in future financial statements, readers should be notified if there is a reasonable possibility that a variance from an estimate in the current statements will materially affect the following year's financial statements. Whether estimates need to be individually identified often depends on whether they are recurring:

a. *Recurring Estimates.* Usually, the entity has enough history to develop an estimate that will vary only within a range of amounts that would not be material to the financial statements. Exceptions may occur in special situations. An example is a valuation allowance for a large balance due from a contributor that announces it is considering Chapter 11 bankruptcy shortly before issuance of the organization's financial statements.

b. *New Estimates.* Regardless of how much effort goes into new estimates, they often change significantly and sometimes the change is material to the financial statements. Examples include the estimate of the fair value of promises to give noncash assets and pending litigation.

One approach to assessing the likelihood of a material change is to estimate a range and compare the maximum variance with financial statement materiality.

The disclosure does not need to use the specific terminology such as *near term* and *reasonable possibility*. Since the readers of the financial statements of many nonprofit organizations may not be familiar with such terminology, using alternate language may result in more easily understandable information. Depending on the nature of the estimate, the disclosure might either be presented as a policy note or as a separate note.

a. *Policy Note.* Including the disclosure for certain significant estimates with the policy note often is appropriate for new estimates that will become recurring estimates in future years, as the following illustrates:

> In 20X7, the Organization began operating a thrift shop with donated items as inventory. Since this is a new activity for the organization, management estimated the cost of donated inventory using the results of subsequent sales. Changes in the estimate will be reported in the statement of activities of the years in which they occur. As the Organization gains experience, it may find in 20X8 that its estimate in 20X7 was under- or overestimated by an amount that is material to the 20X8 financial statements.

b. *Separate Note.* Including the disclosure for certain significant estimates in a separate note may be helpful when disclosing the effects of a material change in estimate.

Current Vulnerability Due to Concentrations. Disclosing current vulnerability due to concentrations informs the reader about concentrations that exist at the statement of financial position date and expose the organization to the reasonable possibility of a severe impact within one year from the statement of financial position date.

This course interprets the term *severe impact* to mean a significant change in the way the organization conducts its activities or provides services. That depends on the facts and circumstances. Typically, organizations have contingency plans to compensate for the loss of a concentration. Cutting staff, consolidating operating facilities, and eliminating programs are common responses to such a loss. In addition to the related payments such as severance pay and lease termination settlements, delays in response to the loss lead to unabsorbed overhead and detain management from other responsibilities. Such contingency plans by management probably indicate the existence of concentrations that should be disclosed.

Revenue from Particular Customers, Grantors, or Contributors. A good way to disclose sources of revenue is based on whether management would change organization activities significantly in response to their loss. For example, if management would eliminate staff positions in response to the loss of a major contributor, the reader should be informed; otherwise, disclosure is not helpful. While disclosure depends on the facts and circumstances, the following guidelines may be helpful:

a. If the source comprises at least 30%–40% of total revenue, there is a rebuttable presumption that loss of the source would require a significant change in operations. For example, if 40% of revenues are from a large grant that finances separate, dedicated facilities, one might argue that closing the facilities would not be disruptive. However, it probably would require significant changes in operations, for example, to negotiate lease termination payments and severance arrangements with employees at the facility.

b. If the condition in Step a. does not exist, but loss of the source would have a material adverse effect on key operating statistics (such as causing violations of debt covenants or negative cash flows from operating activities), there is a rebuttable presumption that the loss would require a significant change in operations. For example, if a donor contributes 25% of an organization's revenues and the entity has only a marginal cash flow from operating activities, loss of the donor probably would cause management to significantly change operations. Even if the contributor funds a special program, eliminating the program usually is disruptive to normal operations. In addition, since potential donors and others might view the organization differently if it eliminated a program, such action often must be taken carefully.

c. If neither of the conditions in Steps a. and b. exists, there is a rebuttable presumption that loss of the source would not cause a significant change in operations.

As a practical matter, the management of most nonprofit organizations normally can readily assess whether the loss of a source would significantly disrupt their activities.

The goal of the disclosure is to inform the reader of risk associated with concentrations of revenue. The way that is accomplished is flexible and may be indicated as follows:

a. Naming the customer, grantor, or donor is unnecessary. For example, the disclosure could refer to contracts with a state agency.

b. If the source is disclosed in the statements, such as revenue from United Way, additional disclosure in the notes is unnecessary.

c. The requirement only applies to continuing relationships; it does not apply to organizations that have a small number of different customers, grantors, or donors each year. Disclosing that the organization has a constantly changing customer, grantor, or donor base gives sufficient notice to the reader of the associated risk. Nevertheless, additional disclosure may be helpful, such as when the organization has an unusually large contract or when the inability to complete a contract would require a significant change in activities (for example, because the backlog of contracts was developed considering how long the contract would take to complete).

d. The disclosure requirements do not apply to a contributor for a special fund-raising event, such as a capital campaign, but it does apply to a contributor to a recurring fund-raising event, such as the sponsor of a large annual banquet.

e. The disclosure can be provided in a variety of ways. Although general discussions normally are sufficiently informative, more detailed disclosures may be helpful.

f. Even though not required, mentioning contingency plans, such as the following, may help keep the reader from being unnecessarily alarmed:

> Approximately one-third of the revenue for each year is from a local foundation that funds most of the costs of the day care program. If that source of revenue were lost and other sources could not be found quickly enough, management would eliminate the program to minimize the damage to the agency's activities.

Revenue from Particular Products, Services, or Fund-raising Events. The goal of this disclosure is the same as the disclosure of customers and similar sources of revenues. However, accountants must also consider whether there is a reasonable possibility that the source will be lost. If so, consider the impact of the loss; if not, no further consideration is needed. The risk considerations may only be relevant when providing the source is not within management's control. For example, if a nonprofit organization holds a fund-raising event that requires special facilities (such as a stair climb in the tallest building in town) or special permission (such as floating rubber ducks down a river), the likelihood of not being able to use those facilities or obtain permission must be assessed. If there is a reasonable possibility of that, the impact must then be assessed. On the other hand, if there are no such special characteristics and holding the event is entirely within the organization's control, there is no risk to disclose.

Volume of Business with a Supplier or Lender. The reader should know if there is a reasonable possibility of the loss of a supplier or lender that would cause management to change activities significantly. Naming the supplier or lender is not required. Whether the organization is likely to lose the supplier or lender depends on whether the supplier or lender will stop doing business with the organization, not whether the organization will stop doing business with the supplier or lender, such as the following:

a. Sometimes local affiliates buy most of their products from their national affiliate, often because the national affiliate requires it. There is little likelihood of the national affiliate no longer selling to the local affiliate.

b. Other suppliers usually discontinue relationships only if the organization requires special treatment, for example, unusually favorable payment terms or especially timely delivery so the organization can maintain only minimal inventories.

c. Normally, the need to change lenders is reasonably possible only if the lender has indicated that it will not renew a line or refinance a balloon payment. The reasonable possibility of having to find new sources of large amounts of debt normally is something the reader should know. In that situation, disclosure is most helpful if combined with the debt disclosure, as follows:

> NOTE E—SHORT-TERM NOTE
>
> The short-term note is payable to a bank under a $350,000 line of credit that expires in September 20X7. Interest is payable monthly at prime plus 3%. The note is collateralized by the Organization's customer accounts, inventories, and property and equipment. The note is guaranteed by the Organization's board of directors and contains covenants that relate primarily to financial ratios. The bank has indicated that it will not renew the line when it expires, and management has begun negotiations with other banks to refinance the note.

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 nonprofit organizations has an unconditional receivable-payable contract?

    a. Feed Our Children has a direct financing lease.

    b. Urban Improvements holds a life insurance policy on its director.

    c. Environmental Clean-up Brigade has a mortgage loan with a prepayment right.

    d. The Grayson Group provides a guarantee on services to customers.

15. If an organization has a significant concentration of credit risk, it should disclose which of the following?

    a. Quantitative information about market risks associated with financial instruments.

    b. The minimum amount that the organization could lose due to this risk.

    c. The organization's policy for requiring collateral related to the credit risk.

    d. Information about the organization's warranty obligations and rights.

16. Which of the following disclosures is required when it is cost effective to estimate the fair value of financial instruments?

    a. Information about the organization's lease contracts, warranty obligations and rights, and unconditional purchase obligations.

    b. Information about equity investments in any consolidated subsidiaries.

    c. Pertinent information about the organization's financial instrument.

    d. The methods and significant assumptions the organization used to estimate fair value.

17. What disclosures are all organizations required to make about risks and uncertainties?

    a. A list of all risks and uncertainties that may affect the financial statements.

    b. The current vulnerabilities that affect the financial statements.

    c. The nature of the organization's activities.

    d. The use of specific values in the financial statements.

18. Which of the following accounting estimates is most common for a nonprofit organization?

    a. Inventory obsolescence.

    b. The allowance for uncollectible promises to give.

    c. Pension and postemployment benefit obligations.

    d. Liabilities from audits of the organization's grants.

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 nonprofit organizations has an unconditional receivable-payable contract? **(Page 65)**

    a. **Feed Our Children has a direct financing lease. [This answer is correct. An unconditional receivable-payable contract both (1) imposes on one entity an unqualified contractual obligation to deliver a specified amount of cash or other financial instrument to a second entity on demand or on or before a specified date and (2) conveys to that second entity an unqualified contractual right to receive a specified amount of cash or other financial instrument from the first entity on demand or on or before a specified date. Examples of this are leases that effectively transfer the benefits and risks of ownership of an asset from the lessor to the lessee at the inception of the lease, such as a capital lease or the direct financing lease held by Feed Our Children.]**

    b. Urban Improvements holds a life insurance policy on its director. [This answer is incorrect. Urban Improvements has a conditional receivable-payable contract in this scenario. This type of contract both (1) imposes on one entity a contractual obligation to deliver a specified amount of cash or other financial instrument to a second entity if a specified event beyond the control of either entity occurs and (2) conveys to that second entity a contractual right to receive a specified amount of cash or other financial instrument from the first entity if a specified event beyond the control over either entity occurs. All insurance policies are financial instruments under this category.]

    c. Environmental Clean-up Brigade has a mortgage loan with a prepayment right. [This answer is incorrect. Environmental Clean-up Brigade has a financial option contract. This type of contract (1) imposes on an entity (the option writer) a contractual obligation to exchange other financial instruments with a second entity (the option holder) on potentially unfavorable terms if an event within the control of the holder occurs and (2) conveys to the option holder a contractual right to exchange other financial instruments with the option writer on potentially favorable terms if an event within the control of the holder occurs. Common examples are a fixed-rate loan commitment and a mortgage loan with a prepayment right.]

    d. The Grayson Group provides a guarantee on services to customers. [This answer is incorrect. The Grayson Group is providing a financial guarantee, which is a different type of financial instrument. A financial guarantee or other conditional exchange contract both (1) imposes on one entity a contractual obligation to exchange other financial instruments with a second entity on potentially unfavorable terms if an event outside the control of either party to the contract occurs and (2) conveys to that second entity a contractual right to exchange other financial instruments with the first entity on potentially favorable terms if an event outside the control over either party to the contract occurs.]

15. If an organization has a significant concentration of credit risk, it should disclose which of the following? **(Page 69)**

    a. Quantitative information about market risks associated with financial instruments. [This answer is incorrect. FASB ASC 825-10-50-23 encourages but does not require disclosure of quantitative information about the market risks of financial instruments. Such optional disclosure should be consistent with the way the organization manages or adjusts market risks. However, in addition to being optional instead of required, this disclosure is related to a different area than concentrations of credit risk, so there is a better answer to this question.]

    b. The minimum amount that the organization could lose due to this risk. [This answer is incorrect. FASB ASC 825-10-50-21 requires specific disclosures about each significant concentration of credit risk. One of those requirements is to disclose the *maximum* amount of the accounting loss due to credit risk the entity would incur if parties to the financial instruments that make up the concentration failed completely to perform according to the terms of the contracts and the collateral or other security, if any, for the amount due proved to be of no value.]

c. The organization's policy for requiring collateral related to the credit risk. [This answer is correct. One of the required disclosures for significant concentrations of credit risk, as outlined in FASB ASC 825-10-50-21, is the entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security sponsoring those financial instruments.]

d. Information about the organization's warranty obligations and rights. [This answer is incorrect. FASB ASC 825-10-50-8 and 50-22 specifically exclude certain financial instruments that nonprofit organizations may hold from disclosure requirements for concentrations of credit risk. Included among those exclusions are certain insurance contracts and warranty obligations and rights.]

16. Which of the following disclosures is required when it is cost effective to estimate the fair value of financial instruments? **(Page 73)**

a. Information about the organization's lease contracts, warranty obligations and rights, and unconditional purchase obligations. [This answer is incorrect. These types of financial instruments are specifically excluded by FASB ASC 825-10-50-8 from the fair value disclosure requirements of FASB ASC 825-10.]

b. Information about equity investments in any consolidated subsidiaries. [This answer is incorrect. FASB ASC 825-10-50-8 specifically excludes certain financial instruments from the fair value disclosure requirements made by FASB ASC 825-10. One such exclusion is equity investments in consolidated subsidiaries. Another is fully benefit-responsive investment contracts, which are held by an employee benefit plan.]

c. Pertinent information about the organization's financial instrument. [This answer is incorrect. When it is *not* cost effective to disclose the fair value of a financial instrument, the pertinent information about the financial instrument (such as the carrying amount, effective interest rate, and maturity) and the reasons why estimating fair value is not cost effective should be disclosed. Other disclosures are required when the estimate is cost effective.]

d. The methods and significant assumptions the organization used to estimate fair value. [This answer is correct. When it is cost effective to estimate the fair value of financial instruments, FASB ASC 825-10-50-10 requires disclosure of, among other things, the methods and significant assumptions used to estimate the fair value of financial instruments. For fair value measurements that fall within Levels 2 or 3 of the fair value hierarchy, a description of the valuation technique and inputs used in the fair value measurement is required; also, any change in the valuation technique and the reason for the change should be disclosed.]

17. What disclosures are all organizations required to make about risks and uncertainties? **(Page 78)**

a. A list of all risks and uncertainties that may affect the financial statements. [This answer is incorrect. GAAP does *not* require disclosure of all risks and uncertainties, which would be an impossible task, but requires disclosure of certain risks and uncertainties that meet specified criteria.]

b. The current vulnerabilities that affect the financial statements. [This answer is incorrect. FASB ASC 275-10-50-1 requires disclosure of current vulnerability as the result of certain concentrations. This is required only for estimates and concentrations that meet certain criteria, so the disclosure may not affect all financial statements.]

c. The nature of the organization's activities. [This answer is correct. FASB ASC 275-10-50-1 requires disclosure in four areas, one of which is the nature of activities, including any activities that have not commenced in which the organization is currently engaged. The nature of activities disclosure is required for all financial statements under this authoritative guidance.]

d. The use of specific values in the financial statements. [This answer is incorrect. FASB ASC 275-10-50-1 requires disclosure of the use of estimates when preparing the financial statements, as that is more risky that using specific amounts. This disclosure of estimates is required for all financial statements.]

18. Which of the following accounting estimates is most common for a nonprofit organization? **(Page 81)**

    a. Inventory obsolescence. [This answer is incorrect. This is an example of an accounting estimate that is less common for nonprofit organizations; therefore, there is a better answer to this question.]

    b. The allowance for uncollectible promises to give. [This answer is correct. Paragraph A-25 in Appendix A to Chapter 2 of the Audit Guide states that nonprofit organizations commonly use accounting estimates in specific areas including measurement of noncash contributions other than marketable securities, estimation of the allowance for uncollectible promises to give, and the calculation of present value estimates for unconditional promises to give and split-interest agreements.]

    c. Pension and postemployment benefit obligations. [This answer is incorrect. Typically, this type of estimate is less frequently used by nonprofit organizations. One of the other answer choices illustrates an estimate that is more common for such organizations than this one.]

    d. Liabilities from audits of the organization's grants. [This answer is incorrect. Liabilities resulting from audits of grants are not considered common for nonprofit organizations; therefore, there is a preferable answer to this question.]

Lesson 2: Special Purpose Frameworks

INTRODUCTION

Lesson 1 presented guidance on preparing the notes to a nonprofit organization's financial statements in accordance with generally accepted accounting principles (GAAP), which is the basis of accounting normally used for financial statements of nonprofit organizations. GAAP financial statements, therefore, are the most meaningful and their presentation is encouraged. However, in some circumstances, it is more useful or cost-effective to prepare financial statements on a *special purpose framework*. This lesson provides general guidance on measurement and disclosure considerations when preparing financial statements on various special purpose frameworks. For detailed guidance on preparing special purpose financial statements, see *PPC's Guide to Cash, Tax, and Other Bases of Accounting*, which is available by calling (800) 431-9025 or visiting the Thomson Reuters Tax & Accounting website at **tax.thomsonreuters.com**.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine when a nonprofit organization might use a special purpose framework and what form the financial statements might take.
- Identify specific considerations that apply when nonprofit organizations use the pure cash basis, the modified cash basis, and the tax basis, as well as how to deal with accounting changes.

SPECIAL PURPOSE FRAMEWORKS AND RELATED AUTHORITATIVE LITERATURE

Bases of accounting other than GAAP (referred to in the authoritative literature as "special purpose frameworks") are a widely-used alternative to the numerous and sometimes complex accounting requirements prescribed by GAAP. Also contributing to the use of non-GAAP financial reporting is the availability of inexpensive accounting software, which allows individuals more familiar with tax laws than GAAP to maintain records and prepare financial statements with relative ease. Compared to the voluminous amount of GAAP basis guidance available, limited authoritative guidance exists for using special purpose frameworks.

The use of special purpose frameworks is discussed in the audit standards and the SSARS. AU-C 210, *Terms of Engagement*, requires the auditor to determine the acceptability of the financial reporting framework applied in the preparation of the financial statements. Ordinarily, that framework is provided by GAAP; but AU-C 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*, and the SSARS allow special purpose frameworks to be used. AU-C 800.07, AR-C 70.07, AR-C 80.05, and AR-C 90.05 describe the following special purpose frameworks:

- *Cash Basis.* A basis of accounting used by the reporting entity to record cash receipts and disbursements. It includes modifications of the cash basis having substantial support (for example, recording depreciation on fixed assets), commonly known as the modified cash basis.

- *Tax Basis.* A basis of accounting used by the reporting entity to file its tax return for the period covered by the financial statements. (The term *income tax basis* is also commonly used. While tax basis and income tax basis mean the same thing, it is a best practice for firms to select whichever term is preferred and use it consistently to avoid confusion.)

- *Regulatory Basis.* A basis of accounting used by the reporting entity to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction the entity is subject (for example, a basis of accounting that insurance companies use pursuant to the accounting practices prescribed or permitted by a state insurance commission).

- *Contractual Basis.* A basis of accounting used by the reporting entity to comply with an agreement between the entity and one or more third parties other than the practitioner.

- *Other Basis.* A basis of accounting used by the reporting entity that uses a definite set of logical and reasonable criteria that is applied to all material items within the financial statements.

According to AU-C 800.07, AR-C 70.07, AR-C 80.05, and AR-C 90.05, the cash, tax, regulatory, and other bases of accounting are also commonly referred to as *other comprehensive bases of accounting* (or OCBOAs). Additionally, the term *OCBOA* continues to commonly be used in practice. This course has predominantly switched to the use of *special purpose framework*. The occasional use of one term over the other has no particular significance.

AU-C 800 and the SSARS provide the primary guidance for disclosures in special purpose financial statements. When special purpose financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP, AU-C 800.17, AR-C 80.08, and AR-C 90.09 indicate the financial statements should include informative disclosures similar to those required by GAAP. In addition, the guidance indicates that additional disclosures, beyond those specifically required by the framework, related to matters that are not specifically identified on the face of the financial statements, or other disclosures, might be necessary for the financial statements to achieve fair presentation.

Auditing Standards, SSARS, and Special Purpose Framework Engagements

AU-C 800, AR-C 80, and AR-C 90 provide guidance for auditing, compiling, or reviewing special purpose financial statements. Some of the items that affect special purpose engagements include:

- *Terminology.* As mentioned above, throughout the auditing standards and SSARS, the use of the term *other comprehensive basis of accounting* has generally been replaced by the term *special purpose framework*, although use of the term OCBOA is still appropriate for the cash, tax, regulatory, and other bases of accounting.

- *Acceptability of the Reporting Framework.* AU-C 800.10 requires the auditor to determine whether the special purpose framework used to prepare the entity's financial statements is acceptable by obtaining an understanding of (a) the purpose for which the financial statements are prepared, (b) the intended users, and (c) the steps taken by management to determine that the framework is acceptable in the circumstances. AR-C 60.26 simply requires the accountant to determine whether the special purpose framework applied in preparing the financial statements is acceptable.

- *Preconditions for the Audit, Compilation, or Review.* AU-C 800.11, AR-C 80.08, and AR-C 90.09 require the auditor or accountant to (a) determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable and (b) obtain management's agreement that it acknowledges and understands its responsibility to include all informative disclosures that are appropriate for the special purpose framework used to prepare the financial statements. Management's acknowledgment and understanding should also cover any additional disclosures necessary to achieve fair presentation in the financial statements. The auditor or accountant should evaluate whether such disclosures are necessary.

- *Regulatory and Contractual Bases.* When the special purpose framework is the regulatory or contractual basis, certain performance, reporting, and/or presentation requirements exist under AU-C 800, AR-C 80, and AR-C 90. See *PPC's Guide to Cash, Tax, and Other Bases of Accounting* for further details.

- *Reporting.* Several requirements exist in the area of reporting that affect all types of special purpose frameworks pursuant to AU-C 800, AR-C 80, and AR-C 90. These requirements are discussed further later in this lesson.

Reporting Considerations. This lesson deals only with preparing special purpose financial statements, and, accordingly, it does not address reporting considerations for special purpose financial statements. More information on reporting considerations can be found in *PPC's Guide to Audits of Nonprofit Organizations, PPC's Guide to Auditor's Reports,* and *PPC's Guide to Compilation and Review Engagements.* [For order information, call (800) 431-9025 or visit **tax.thomsonreuters.com.**]

Coverage in This Course

The remainder of this course explores the implications of choosing the cash basis or tax basis of accounting. The regulatory basis, contractual basis, and other bases do not occur as frequently for nonprofit organizations and are not discussed in this course. Those bases are discussed in *PPC's Guide to Cash, Tax, and Other Bases of Accounting*.

USING A SPECIAL PURPOSE FRAMEWORK

The basis that a nonprofit organization uses to prepare its financial statements generally is determined by the needs of those who will use the financial statements.

Organizations reporting financial results to third parties ordinarily use GAAP for financial statements. The use of GAAP in such circumstances promotes comparability among financial statements and, because users become familiar with GAAP through experience with it, its general use increases user understanding.

There are, however, instances when a nonprofit organization may choose to present special purpose financial statements. Those situations typically occur as a result of one or more of the following:

a. There are no third-party users of the financial statements.

b. The organization's creditors do not require GAAP.

c. The cost of complying with GAAP would exceed the benefits.

d. The operations are heavily influenced by cash flows such as voluntary health and welfare organizations that receive contributions and then distribute substantially all of them to subrecipients.

Pure Cash Basis

Nonprofit organizations that use the pure cash basis of accounting typically have the following characteristics:

- Their operations are simple.
- Their accounting and finance functions are unsophisticated.
- There is only one major activity.
- Capital expenditures and long-term financing are not significant.

The following are examples of entities that sometimes use the pure cash basis of accounting:

- School activity funds.
- Fairs and other civic ventures.
- Political action committees and political campaigns.

Modified Cash Basis

Many nonprofit organizations use a modified cash basis of accounting. With that basis of accounting, certain transactions will be recorded on an accrual basis and other transactions on a cash basis. The most common modification results from reporting certain expenses on the accrual basis and revenues on the cash basis. However, there are many variations.

Nonprofit organizations that use the modified cash basis of accounting do not have to have a complex set of books. They can, if they choose, maintain their records on the cash basis and record certain assets and liabilities at the end of the month, either formally in the books or informally through worksheets.

Tax Basis

Typically, nonprofit organizations using the tax basis of accounting are seeking relief from the GAAP financial reporting requirements. The IRS does not require organizations to follow GAAP in all areas, such as when recording investments or contributions, for purposes of filing Form 990.

Financial Statements Included in Form 990. Some states allow charitable organizations to use IRS Form 990 (Return of Organizations Exempt from Income Tax) as a uniform annual report for reporting to both state and federal governments. Some of those states require Form 990 to be accompanied by an auditors' report on the financial statements included in the form. A nonprofit organization's use of the tax basis of accounting is discussed later in this lesson. *PPC's Guide to Auditor's Reports* provides guidance on the type of auditor's report to be issued on financial statements included in Form 990.

Using Special Purpose Frameworks for Monthly Financial Statements and GAAP for Annual Financial Statements

Another option that nonprofit organizations may want to consider is using a special purpose framework for preparing interim financial statements and GAAP for preparing the annual statements. Some organizations find that this is both efficient and cost effective. To reduce the costs of generating financial statements, many entities:

a. Use the cash or modified cash basis of accounting for monthly financial statements.

b. Omit all disclosures.

c. Generate annual GAAP financial statements with disclosures.

FORM OF THE FINANCIAL STATEMENTS

Statements Presented

Except for pure cash basis financial statements, special purpose financial statements typically present financial position and changes in net assets as measured under the special purpose framework.

Presentation Requirements. FASB ASC 958 provides the financial statement display provisions for nonprofit organizations preparing financial statements in accordance with GAAP. As discussed earlier in this lesson, AU-C 800 and the SSARS address the applicability of GAAP financial statement disclosures to special purpose financial statements. AU-C 800.17, AR-C 80.18, and AR-C 80.A31, AR-C 90.40, and AR-C 90.A83 indicate that special purpose financial statements with items requiring disclosure under GAAP either follow the GAAP disclosure requirements or provide information that communicates the substance of those requirements. Accordingly, an organization would be required to follow the presentation requirements of FASB ASC 958 or provide information that communicates the substance of those requirements.

Statement of Cash Flows. AU-C 800.A34 notes that special purpose financial statements may not include a statement of cash flows. In practice, some nonprofit organizations choose to present statements of cash flows in special purpose framework presentations even though not required. In such cases, the statement of cash flows should be treated and reported on as a basic financial statement, not as supplementary information. The statement should also follow the GAAP presentation requirements or communicate the substance of those requirements.

Functional Expense Reporting. Before the effective date of ASU 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities*, FASB ASC 958-205-45-6 requires voluntary health and welfare organizations to include in their GAAP financial statements a separate financial statement in a matrix format that presents expenses both by function and natural expense classification. FASB ASC 958-205-45-6 also

encourages, but does not require, other types of nonprofit organizations to present information by their natural expense classifications. FASB ASC 958-720-45-2 does, however, require all organizations to present information about expenses by their functional classifications in the statement of activities or the notes to the financial statements. Voluntary health and welfare organizations are not required to present a separate statement of functional expenses in special purpose financial statements. However, nonprofit organizations should communicate information about functional expenses in some manner in the financial statements. Accordingly, voluntary health and welfare organizations could present expenses on the statement of revenues, expenses, and other changes in net assets using natural expense classifications and disclose information about how those expenses were allocated among the various functions using percentages or estimates in the notes to the financial statements.

After the effective date of ASU 2016-14, all nonprofit organizations are required to present an analysis of expenses by their functional and natural expense classifications. The new guidance requires the information to be presented either on the face of the statement of activities, as a schedule in the notes to the financial statements, or in a separate financial statement. 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. An in-depth discussion of ASU 2016-is beyond the scope of this course, but more information is available in *PPC's Guide to Preparing Nonprofit Financial Statements.*

Other Financial Statements. Other financial statements may also be presented as desired by management or required by regulatory agencies.

Statement Titles

AU-C 800.15 and AU-C 800.A17, as well as AR-C 80.A28 and AR-C 90.A81), indicate the titles of special purpose financial statements would differ from those for similar statements prepared in accordance with GAAP so that there is no implication that the statements are presented in conformity with GAAP. Financial statement titles used in the compilation, review, or audit report should reflect the titles used within the body of the financial statements. The authoritative guidance does not specify required titles for special purpose financial statements; however, it does present examples. AR-C 80.A28 and AR-C 90.A81 also indicate that the description of the special purpose framework may be reflected in the financial statement titles and presents examples of suitable titles. Thus, accountants have flexibility in choosing appropriate financial statement titles.

Special purpose financial statements can be more understandable with the consistent use of uniform statement titles. The following suggestions may help:

- Using the title "Cash Basis" to refer to "Modified Cash Basis" financial statements (since the "modified cash basis" is frequently referred to as "cash basis" in practice), and

- Using consistent titles (e.g., "Statement of Assets, Liabilities, and Net Assets" in referring to the statement of financial position) for cash basis and tax basis financial statements, except for the addition of "cash basis" or "tax" to the end of each title.

That approach can facilitate review and promote consistency. Exhibit 2-1 compares this course's recommendations for special purpose financial statement titles to GAAP financial statement titles.

Exhibit 2-1

Comparison of GAAP and Special Purpose Financial Statement Titles before the Effective Date of ASU 2016-14[a], [b]

GAAP	Cash[c]	Tax
1. Statement of Financial Position	1. Statement of Assets, Liabilities, and Net Assets—Cash Basis	1. Statement of Assets, Liabilities, and Net Assets—Tax Basis
2. Statement of Activities	2. Statement of Revenues, Expenses, and Other Changes in Net Assets—Cash Basis	2. Statement of Revenues, Expenses, and Other Changes in Net Assets—Tax Basis
3. Statement of Functional Expenses	3. Statement of Functional Expenses—Cash Basis	3. Statement of Functional Expenses—Tax Basis
4. Statement of Unrestricted Revenues, Expenses, and Other Changes in Unrestricted Net Assets	4. Statement of Unrestricted Revenues, Expenses, and Other Changes in Unrestricted Net Assets—Cash Basis	4. Statement of Unrestricted Revenues, Expenses, and Other Changes in Unrestricted Net Assets—Tax Basis
5. Statement of Changes in Net Assets	5. Statement of Changes in Net Assets—Cash Basis	5. Statement of Changes in Net Assets—Tax Basis
6. Statement of Cash Flows	6. Statement of Cash Flows—Cash Basis[d]	6. Statement of Cash Flows—Tax Basis[d]

Notes:

[a] The statement titles are recommended by this course. They seem to be acceptable under AU-C 800 and the SSARS.

[b] This exhibit presents recommended financial statement titles applicable prior to the effective date of ASU 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities,* which is 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.

[c] The pure cash basis has a single asset and no liabilities. Accordingly, there is no need to present a statement of financial position. Instead, a single statement titled "Statement of Cash Receipts and Disbursements" is customarily presented.

[d] Although a statement of cash flows is not required for special purpose financial statements, if it is presented, it is a best practice to use the title "Statement of Cash Flows—Cash (or Tax) Basis" as indicated above.

* * *

Many accounting software packages preprogram statement titles, and they are usually accrual titles, such as statement of financial position or statement of activities. Such accrual titles should be modified to indicate the special purpose framework used.

Financial Statement Disclosures

AU-C 800 provides the following guidance about disclosures in financial statements prepared using a special purpose framework:

a. AU-C 800.15 requires special purpose financial statements to include a description of the special purpose framework, including a summary of significant accounting polices, and a description of the main differences from GAAP. (It is not necessary to quantify the differences.)

b. AU-C 800.17 requires that when special purpose financial statements include items that are the same as or similar to those in financial statements prepared under GAAP, the auditor should evaluate whether the special purpose financial statements include informative disclosures similar to those required by GAAP. Also, the auditor should evaluate whether additional disclosures, beyond those specifically required by the framework, that are related to matters not specifically identified on the face of the financial statements, or other disclosures, are necessary for the financial statements to achieve fair presentation.

c. AU-C 800.A19 explains that achieving fair presentation includes providing all informative disclosures appropriate for the applicable financial reporting framework, including matters that affect the use, understanding, and interpretation of the financial statements. AU-C 800.A34, Appendix B, "Fair Presentation and Adequate Disclosure," offers more guidance on determining the adequacy of disclosures prepared using a special purpose framework, including examples of qualitative disclosure information and some GAAP disclosure requirements that would not be relevant to specific special purpose frameworks.

d. Additionally, AU-C 800.A21 indicates that special purpose financial statements may present disclosures using qualitative information instead of the quantitative information that GAAP requires or, alternatively, provide information that communicates the substance of those requirements.

Guidance on disclosures in special purpose financial statements is found at AR-C 80.18, AR-C 80-A28–.A31, AR-C 90.40, and AR-C 90.A81–.A83. The SSARS indicate that for compiled or reviewed special purpose financial statements, those financial statements should include—

- A description of the special purpose framework, including a summary of significant accounting policies and a description of the main differences from GAAP. (It is not necessary to quantify the differences.)
- Disclosures similar to those required by GAAP when the financial statements include items that are the same as or similar to those included in GAAP-basis financial statements.
- Disclosures, in addition to those required by the special purpose framework, that may be necessary to achieve fair presentation.

The SSARS also include much of the disclosure information also found in AU-C 800. However, AU-C 800 still includes more guidance on this topic, primarily in the application and other explanatory material. Therefore, this lesson includes references to both the SSARS and auditing literature to provide information regarding disclosures in compilation and review engagements when applicable. As the level of service (financial statement preparation, compilation, review, or audit) should not affect what it means for financial statements to be fairly presented, this approach seems appropriate. Accordingly, this lesson is written with the perspective that the adequacy of disclosures in financial statements presented using a special purpose framework that have been prepared, compiled, or reviewed may be evaluated following the applicable guidance in the SSARS, supplemented by guidance in AU-C 800.

As previously discussed, AU-C 800.15, AR-C 80.08 and AR-C 90.09 require disclosure of the special purpose framework that is used and a description of how it differs from GAAP. It is a best practice to make this disclosure the first note in the summary of significant accounting policies and to caption it "Basis of Accounting." This disclosure seems to have two main objectives:

a. To put the readers on notice that the basis may be different from what they are used to seeing.

b. To disclose the *primary* differences between the basis of accounting used and GAAP.

Generally, the primary differences are those that individually have a material effect on the financial statements. Immaterial differences need not be mentioned. AU-C 800.15, AR-C 80.18, and AR-C 90.40 indicate that quantifying the effects of differences in the description of the basis is unnecessary. The intent of the disclosure is to warn the readers, not to reconcile the basis to GAAP.

Other matters should be disclosed if they would be required under GAAP and are relevant to the special purpose framework used. If cash, modified cash, or tax basis statements contain amounts for which GAAP would require disclosure, the statements should either provide the relevant disclosure that would be required for those amounts in a GAAP presentation or provide information that communicates the substance of that disclosure. For example, GAAP requires disclosure of depreciation expense; an entity using a special purpose framework that does not depreciate property and equipment, however, would deem the disclosure irrelevant and unnecessary. *PPC's Guide to Cash, Tax, and Other Bases of Accounting* discusses how to identify financial statement items for which GAAP would require disclosure, as well as how to assess the GAAP requirement's relevance to the special purpose framework.

GAAP requires organizations to disclose a variety of information that does not relate directly to amounts or transactions reported in the financial statements, such as related party transactions for which amounts are not recorded and subsequent events. The need for similar disclosures in special purpose financial statements can be evaluated by (a) identifying the other information that GAAP would require disclosing, (b) deciding whether the GAAP disclosure requirement is relevant to the basis of accounting, and (c) if the requirement is relevant, deciding whether to follow that requirement or to meet the objective of that requirement through other means.

Disclosure of Significant Risks and Uncertainties. FASB ASC 275-10-50 requires providing information about the nature of operations, the general use of estimates, certain significant estimates, and significant concentrations of risk. However, the applicability of the guidance related to significant risks and uncertainties and the need for related disclosures must be determined on a case-by-case basis, based on the facts and circumstances in each individual engagement.

- *Nature of Operations.* The disclosure provides key operation information to help the financial statement reader better understand the organization. This information seems to be relevant to all cash, modified cash, and tax basis presentations. Providing the necessary information typically takes little time and requires few changes in subsequent financial statements.

- *Use of Estimates.* Whether the information is relevant depends on the basis used. While the information is not relevant to the pure cash basis, it may be relevant to the modified cash or tax basis, such as when useful lives are estimated for depreciation calculations. Often preparation of special purpose financial statements may not require significant estimates.

- *Significant Concentrations of Risk.* The requirement is intended to notify financial statement readers of the reasonable possibility that the loss of a significant contributor, grant source, supplier, or other concentration will have a severe impact on the entity in the near term. The information seems to be relevant to all cash, modified cash, and tax basis presentations. As a practical matter, many special purpose financial statements may already disclose the nature of an organization's operations, as well as economic dependence (which, in many cases, will satisfy the requirements for disclosure of concentrations).

Going Concern Uncertainty and Special Purpose Frameworks. GAAP requires management to evaluate whether conditions and events indicate there is a substantial doubt about the entity's ability to continue as a going concern for a specified timeframe. However, special purpose frameworks are not GAAP, and such frameworks may not include an explicit requirement for management to evaluate the entity's ability to continue as a going concern for a reasonable period of time. An auditor's responsibility in this situation is addressed by SAS No. 132. Lack of a specific requirement for management to assess going concern under a special purpose framework is also discussed in the SSARS. According to AR-C 90.65, when the entity uses a financial reporting framework that does not specify a forward-looking time period for management to consider any going concern issue, then a reasonable period of time is one year from the date the financial statements were reviewed. This time period also seems appropriate for prepared or compiled 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.

19. Which of the following businesses would be more likely to use the pure cash basis of accounting?

    a. The Northern Organization has only one major activity and no long-term debt.

    b. The Southern Organization records most things on the cash basis, but a few expenses on the accrual basis.

    c. The Eastern Organization records contributions as necessary for filing Form 990.

    d. The Western Organization keeps is records specifically to comply with a material donor agreement.

20. What guidance does AU-C 800 provide about making financial statement disclosures when using a special purpose framework?

    a. A description of the special purpose framework is not needed because the frameworks are well known.

    b. Typically, special purpose financial statements will not have disclosures similar to GAAP.

    c. For fair presentation, the special purpose financial statements should include all information disclosures for that framework.

    d. Special purpose financial statements should primarily disclose quantitative information, not qualitative.

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. Which of the following businesses would be more likely to use the pure cash basis of accounting? **(Page 97)**

    a. The Northern Organization has only one major activity and no long-term debt. [This answer is correct. Nonprofit organizations that use the pure cash basis of accounting typically have the following characteristics: (1) their operations are simple, (2) their accounting and finance functions are unsophisticated, (3) there is only one major activity, and (4) capital expenditures and long-term financing are not significant.]

    b. The Southern Organization records most things on the cash basis, but a few expenses on the accrual basis. [This answer is incorrect. The modified cash basis would be the most appropriate for the Southern Organization. Under this basis of accounting, certain transactions are recorded on an accrual basis and other transactions on a cash basis. The most common modification results from reporting certain expenses on the accrual basis and revenues on the cash basis. However, there are many variations.]

    c. The Eastern Organization records contributions as necessary for filing Form 990. [This answer is incorrect. Typically, nonprofit organizations using the tax basis of accounting are seeking relief from the GAAP financial reporting requirements. The IRS does not require organizations to follow GAAP in all areas, such as when recording investments or contributions, for purposes of filing Form 990. Therefore, the Eastern Organization should use the tax basis of accounting.]

    d. The Western Organization keeps is records specifically to comply with a material donor agreement. [This answer is incorrect. Based on the information here, the Western Organization should use the contractual basis of accounting. This basis is used by the reporting entity to comply with an agreement between the entity and one or more third parties other than the practitioner. Western's donor agreement would fall under this classification.]

20. What guidance does AU-C 800 provide about making financial statement disclosures when using a special purpose framework? **(Page 101)**

    a. A description of the special purpose framework is not needed because the frameworks are well known. [This answer is incorrect. AU-C 800.15 requires special purpose financial statements to include a description of the special purpose framework, including a summary of significant accounting policies, and a description of the main differences from GAAP. However, it is not necessary to quantify the differences.]

    b. Typically, special purpose financial statements will not have disclosures similar to GAAP. [This answer is incorrect. AU-C 800.17 requires that when special purpose financial statements include items that are the same as or similar to those in financial statements prepared under GAAP, the auditor should evaluate whether the special purpose financial statements include informative disclosures similar to those required by GAAP.]

    c. For fair presentation, the special purpose financial statements should include all information disclosures for that framework. [This answer is correct. AU-C 800.A19 explains that achieving fair presentation includes providing all informative disclosures appropriate for the applicable financial reporting framework, including matters that affect the use, understanding, and interpretation of the financial statements.]

    d. Special purpose financial statements should primarily disclose quantitative information, not qualitative. [This answer is incorrect. AU-C 800.A21 indicates that special purpose financial statements may present disclosures using qualitative information instead of the quantitative information that GAAP requires or, alternatively, provide information that communicates the substance of those requirements.]

THE PURE CASH BASIS

A financial statement prepared under the pure cash basis of accounting only reflects transactions affecting cash and cash equivalents. Cash and cash equivalents are the only assets recognized, and there are no liabilities. Accordingly, the pure cash basis treats all receipts of cash as cash increases and all disbursements of cash as cash decreases. Thus, the purchase of an item such as a building is reflected as an expenditure under the pure cash basis and is not recorded as an asset, and the receipt of an item such as loan proceeds is reflected as a cash receipt and is not recorded as a liability.

Measurement

Cash and Cash Equivalents. The pure cash basis of accounting recognizes and measures all transactions by their effect on cash and cash equivalents (e.g., savings accounts, certificates of deposit, and money market accounts). For example, cash and cash equivalents may be increased by cash contributions, collection of receivables, borrowings, and proceeds from sales of assets. Examples of transactions that decrease cash and cash equivalents are the payment of expenses, purchases of equipment or investments, debt service payments, payment of tax withholdings, and the payment of unrelated business income tax. Also note that when presenting pure cash basis financial statements, a negative cash balance may be reflected with brackets and titled as cash overdraft.

Investments. Organizations that purchase investments do not capitalize them under the pure cash basis of accounting. Instead, the purchases are included in cash disbursements as cash is expended. Income from the investments is only recognized as cash is received. For example, while organizations would recognize cash received for dividend income, they would not recognize increases in unrealized gains or losses until the investments are sold and the cash is received.

Property and Equipment. Property and equipment are generally acquired in one of the following ways:

a. Internally generated cash.

b. Short-term or long-term financing.

c. Contribution.

Under the pure cash basis, property and equipment are not capitalized. Instead, they are included in cash disbursements based on cash outlays. Accordingly, cash acquisitions are included in cash disbursements in the year of acquisition, but financed acquisitions are included in disbursements as principal is reduced. Contributed property and equipment are not reflected in cash receipts or disbursements.

Since acquisitions are included in disbursements rather than capitalized, problems with determining which costs to capitalize are avoided. Accordingly, disbursements for cash and financed acquisitions reflect only the amount of cash the organization spends. GAAP regarding capitalization of leases and construction period interest does not apply to the pure cash basis. Therefore, interest and rent are included in disbursements only when paid.

Borrowings. Borrowings generally consist of two types:

a. Working capital loans.

b. Direct financing of assets.

Working capital loans provide the nonprofit organization with cash and, accordingly, are included in cash receipts when the loan proceeds are received. Loans that provide direct financing of assets are not included in cash receipts since cash is not provided directly to the nonprofit organization. (It is a best practice to disclose the terms of debt agreements, however.) Principal reductions of all loans, as well as the interest on the loans, are included in cash disbursements as payments are made.

Withholdings and Agency Transactions. Payroll disbursements are recorded as cash disbursements as paychecks are written. Payroll taxes and withholdings of taxes and other items from employees' paychecks are reflected in disbursements when the applicable payments are made. Collections of sales taxes are included in cash receipts, and remittances of those taxes to government agencies are included in cash disbursements.

Unrelated Business Income Taxes and Other Transactions. Unrelated business income taxes are charged to cash disbursements as entities make payments, and refunds are included in cash receipts when received. That same principle applies to all other revenues and expenses.

Form of Financial Statements

Types of Financial Statements. It is a best practice for an entity using the pure cash basis to present a single statement entitled "Statement of Cash Receipts and Disbursements." Other financial statements would be unnecessary for a pure cash basis presentation. A statement of financial position would be superfluous because the cash balance would represent all the items that would appear on a statement of financial position (assets and net assets). A statement of activities showing the changes in net assets would be unnecessary because the cash basis does not recognize net assets (except by analogy).

Does FASB ASC 958 Apply to the Pure Cash Basis? Although FASB ASC 958-205-05-6 requires a GAAP basis statement of financial position to classify and report net assets based on the existence or absence of donor-imposed restrictions and the statement of activities to disclose the changes in those classes, it does not require any distinction to be made in the statement of cash flows. (The statement of cash flows reports cash receipts and disbursements of nonprofit organizations in GAAP financial statements.) In addition, Paragraph 11.11 of the Audit Guide notes that donor-imposed restrictions typically apply to net assets rather to specific assets. Accordingly, donor-imposed restrictions generally do not apply to the cash balances reflected in a statement of cash receipts and disbursements. Therefore, it seems logical that the statement of cash receipts and disbursements need not reflect any distinction in classes of net assets. If the cash amounts reflected in the statement of cash receipts and disbursements include donor-imposed restricted amounts, the pure cash basis statements should provide information about restrictions on cash and significant changes in donor-imposed restricted cash amounts.

If the organization chooses to apply the provisions of FASB ASC 958 to the statement of cash receipts and disbursements, one approach is to distinguish between the net asset classes by reflecting the changes in cash balances subject to donor-imposed restrictions and those balances that are not subject to donor restrictions. Some organizations may find that approach provides useful information to the users of the financial statement.

Captions. The following captions can be used in the statement of cash receipts and disbursements:

- Cash Receipts.
- Cash Disbursements.
- Increase (Decrease) in Cash.
- Beginning Cash.
- Ending Cash.

Although the title and format of pure cash basis financial statements differ from those prepared in accordance with GAAP, the *accounts* described within the captions in those statements, e.g., rent, may be the same as those described in GAAP statements. The following illustrates that format:

THE MOON VALLEY BOTANICAL GARDENS
STATEMENTS OF CASH RECEIPTS AND DISBURSEMENTS
Years Ended June 30, 20X7 and 20X6

	20X7	20X6
CASH RECEIPTS		
Membership dues	$ 170,000	$ 150,000
Interest	2,000	1,000
Donations	6,000	4,000
Other	2,000	5,000
	180,000	160,000
CASH DISBURSEMENTS		
Administrative and miscellaneous	3,000	2,000
Lawns and grounds upkeep	5,000	3,000
Maintenance	8,000	5,000
Management fee	26,000	23,000
Snow and ice removal	3,000	2,000
Garden magazine—newsletter	10,000	9,000
Trash removal	3,000	2,000
Utilities		
Electricity	6,000	5,000
Gas	50,000	48,000
Sewer	9,000	8,000
Water	7,000	5,000
	130,000	112,000
INCREASE IN CASH	50,000	48,000
BEGINNING CASH	53,000	5,000
ENDING CASH	$ 103,000	$ 53,000

Disclosure

A note should be included with financial statements prepared on the pure cash basis that states the basis of accounting and describes how it differs from GAAP. The following would provide appropriate disclosure of the basis used for a statement of cash receipts and disbursements:

> The accompanying financial statement has been prepared on the cash receipts and disbursements basis of accounting, which is a basis of accounting other than accounting principles generally accepted in the United States of America. Under that basis, the only asset recognized is cash, and no liabilities are recognized. All transactions are recognized as either cash receipts or disbursements, and noncash transactions are not recognized in the financial statement. The cash basis differs from accounting principles generally accepted in the United States of America primarily because the effects of outstanding dues at the date of the financial statement are not included in the financial statement.

Note disclosures may also be necessary when a nonprofit organization presents a single statement of cash receipts and disbursements, although no authoritative pronouncement specifically addresses which matters

should be disclosed when only a single statement is presented. The following advice is based on various sources of guidance:

a. AU-C 800.A19 explains that the financial statements, including related notes, need to include all informative disclosures appropriate for the applicable financial reporting framework, including matters that affect their use, understanding, and interpretation for such statements to represent a fair presentation. In determining disclosures that may be necessary, accountants might consider the viewpoint of a business person with a basic knowledge of accounting and determine whether disclosures have been made that would affect that type of reader's use, understanding, and conclusions about the statement. In addition, as discussed earlier in this lesson, AU-C 800.17 and the SSARS require the auditor to evaluate whether additional disclosures related to matters not identified on the face of the financial statements, or other disclosures, may be needed for the financial statements to achieve fair presentation. AU-C 800.A22 provides the following examples of disclosures that may be relevant (most of the disclosures also seem to be appropriate for a statement of cash receipts and disbursements):

   - Significant uncertainties.
   - Related party transactions.
   - Subsequent events.
   - Restrictions on assets.

b. AU-C 805.A9, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement*, indicates that when certain single financial statements are presented (such as a statement of financial position or a statement of activities), each would include related notes. It is a good idea to follow that same principle when a single statement of cash receipts and disbursements is presented. However, since the only asset recognized is cash and net assets are recognized only to the extent cash is recognized, the number of disclosures is limited.

c. FASB ASC 235-10-50-1 requires disclosure of accounting policies pertinent to a stand-alone basic financial statement. Because assets, liabilities, and noncash transactions are not recognized under the pure cash basis of accounting, common significant accounting policy disclosures such as inventory pricing, depreciation methods, and amortization of intangibles are not relevant. If cash equivalents are reflected on the statement of cash receipts and disbursements, however, the entity's policy for determining which items are treated as cash equivalents should be disclosed.

THE MODIFIED CASH BASIS

The modified cash basis of accounting is described at AU-C 800.07 and by the SSARS at AR-C 70.07, AR-C 80.05, and AR-C 90.05 as the pure cash basis incorporating "modifications having substantial support." The appropriate modifications and the extent of those modifications are not clearly defined in the authoritative literature; however, the AICPA practice aid, *Accounting and Financial Reporting Guidelines for Cash- and Tax-Basis Financial Statements* (the AICPA Practice Aid), provides nonauthoritative guidance about cash basis modifications. According to the AICPA Practice Aid, modifications to the cash basis of accounting involve using logical and consistent modifications to transactions derived from cash receipts or disbursements. The AICPA Practice Aid also indicates that inconsistent use of a modified cash basis framework would normally result in financial statements that are misleading.

This course is another source of nonauthoritative guidance about modifications to the cash basis of accounting. Many of the conclusions made in both this course and the AICPA Practice Aid on this topic are in agreement. However, there are a few differences between the two sources. Throughout the remainder of this section, both the similarities and differences between the two are highlighted. Where differences exist, the accountant needs to use his or her professional judgment to determine the appropriate course of action for a particular organization's situation.

Based on the guidance at AU-C 800.07, AR-C 70.07, AR-C 80.05, and AR-C 90.05, the preparer starts with the pure cash basis and modifies certain elements and considers whether the modifications make sense. However, it seems

that there should be a limit on the extent of modifications. If the modifications are so extensive that the modified *cash basis* statements are equivalent to financial statements on the accrual basis, the statements should be considered GAAP basis. The modified cash basis, thus, spans the range between the pure cash basis and GAAP. However, requiring the modifications to be consistent and logical, and precluding modifications that are too comprehensive, narrows the range.

A common tendency is to assume that a financial statement that excludes promises to give or accounts payable is not presented on the accrual basis. However, if the omission of accrual entries does not have a material effect on financial position, changes in net assets, and cash flows, the statements should be referred to as accrual basis statements.

Modifications of the cash basis have evolved through common usage and practice. The following examples of modifications seem likely to be recognized in practice as having substantial support:

- Property and equipment purchased and financed as assets.
- Accumulated depreciation.
- Material amounts of inventory purchased and financed as assets.
- Liabilities arising from the receipt of borrowed cash.
- Employee FICA and withholding taxes not deposited with the IRS.
- Accrued federal income taxes on unrelated business income (or excise taxes for private foundations).

Some accountants prefer identifying modified cash basis financial statements as "modified cash basis"; others use the term "cash basis."

Measurement

Revenues. Under the pure cash basis, revenues are recognized when collected and costs are charged when paid. A decision to modify the pure cash basis to record revenues on the accrual basis, but to continue to record purchases and other costs on the pure cash basis, would not be logical and, thus, would be inappropriate.

Inventory. If inventory is recorded in financial statements prepared on the modified cash basis, it should be recorded based on the method appropriate for the organization under GAAP. Inventory should probably not be carried in excess of net realizable value (except for inventory valued using LIFO or the retail inventory method) as that would not be consistent with GAAP. Accordingly, if cost is in excess of net realizable value, the inventory should be written down.

Unconditional Promises to Give. A modification of the pure cash basis to record unconditional promises to give converts contribution revenues to the accrual basis. That result seems to be inconsistent with the cash orientation portrayed by the modified cash basis. Nevertheless, if the organization believes the facts and circumstances support such a modification, promises to give that will be collected in more than one year generally should be recorded at their fair value. While accountants differ as to whether the promise to give should subsequently be reduced to reflect probable realization losses, this course generally recommends such adjustments. However, if the organization believes the facts and circumstances support electing to record unconditional promises to give but not recognizing such losses, the description of the differences from GAAP in the basis of accounting note should disclose that losses are recognized when realized rather than when they are probable. In addition, disclosure of the loss that is likely on realization of the promise to give may be necessary to keep the statements from being misleading.

Marketable Securities. Organizations may modify the pure cash basis to capitalize payments to acquire marketable securities. However, if significant amounts of securities are donated, only recognizing purchased securities results in a portfolio value that is artificially low. Some accountants believe that donated securities should also be recorded because, presumably, the intent behind presenting securities as assets is to report information to financial

statement users about the organization's investments. Excluding contributed securities from that presentation would be inconsistent with that intent. Other accountants believe recognizing an increase in net assets from donated securities is inconsistent with the cash orientation of operations that is portrayed by the modified cash basis. While either approach is acceptable, if the organization only capitalizes purchased securities, it is a best practice to disclose the amount of securities donated during the period and the total held at year end, if practicable. The AICPA Practice Aid indicates that a common cash basis modification is to record the cash purchase of investments in marketable securities as assets.

If the cash basis has been modified to record securities, accountants differ as to whether the securities should subsequently be measured at fair value. Not subsequently measuring securities at fair value only seems to be appropriate in limited circumstances where the statement of activities consists almost entirely of cash receipts and disbursements. However, the AICPA Practice Aid disagrees and indicates that subsequent write ups or write downs to fair value to recognize unrealized gains and losses should not be recorded in the modified cash basis financial statements, and the assets should remain on the statement of financial position at cost, unless or until, the investments become worthless or sold.

Property and Equipment. Under the pure cash basis, additions to property and equipment are not capitalized. A common modification is the capitalization of property and equipment acquired. If the organization decides to record such acquisitions, it is a best practice to do so for all property and equipment acquired (although it may still be appropriate to charge small items to expense as acquired).

Property and equipment may be acquired through internally generated cash, external financing, or a combination of internal and external financing. Although not required, if such additions are to be capitalized, it is a best practice to capitalize all of them, including items acquired through contribution. The considerations for whether to record material amounts of donated property and equipment are the same as those discussed above for donated marketable securities. Therefore, while either recording or not recording donated amounts is acceptable, if the organization only capitalizes purchased property and equipment, it is a best practice to disclose the amount of property and equipment donated during the period, if practicable. Additionally, disclosing the total amount of donated property and equipment on hand at year end would be a best practice.

The total of the costs directly attributable to acquiring the asset is generally the amount to be capitalized. That amount includes not only invoice cost, but also related costs such as sales tax (if any), freight, installation, and fees.

The AICPA Practice Aid indicates that under the cash basis of accounting, property and equipment purchases would be recorded in the financial statements as cash disbursements in the period that the transaction occurred, but assets would not be capitalized, nor depreciation recorded. However, the AICPA Practice Aid further indicates that recording the cash purchase of property and equipment as an asset is a common modification to the cash basis of accounting, and once such a modification is made, the organization should adopt and consistently apply a depreciation or amortization policy that has substantial support in the accounting literature and is logical. Additionally, such a policy needs to include recording any financing arrangements that are part of the cash transaction. The AICPA Practice Aid, however, suggests recording and depreciating donated capital assets would not be logical because such an event does not arise from a cash transaction.

Accountants differ as to whether material amounts other than the direct costs discussed above should be capitalized. While some believe the modification to capitalize property and equipment should result in reporting the amount that would be reported under GAAP, others believe a step approach may provide information useful to the primary financial statement users. The modifications that result in reporting property and equipment at the same amount that GAAP normally would report seem to portray the entity's activities. For example:

- Capitalizing overhead shows that some of the organization's efforts were devoted to construction of a long-term asset rather than normal activities.
- Capitalizing interest removes from operations interest costs incurred solely because of the construction activities.

Nevertheless, the facts and circumstances may support a modification to record property and equipment at an amount that differs from GAAP.

Depreciation. If property and equipment are capitalized, an additional modification may be made to depreciate the assets. However, the election of one modification does not necessarily require the election of related modifications. That is, a decision to modify the pure cash basis of accounting to capitalize property and equipment does not necessarily require the recognition of depreciation. If assets are depreciated, the cost of the assets should be charged over their estimated economically useful lives using a depreciation method allowable under GAAP, as opposed to an IRS method. Under the modified cash basis, it seems likely that capitalized assets should not be depreciated using the Modified Accelerated Cost Recovery System (MACRS) allowed for federal income tax purposes unless such use results in an immaterial difference from the amounts that would be calculated based on estimated economically useful lives.

Other Assets. It also may be appropriate to record other amounts as assets, depending on whether the method of asset recognition is consistent with GAAP and whether it is logical. Preparers should also keep in mind that recognition of certain assets may also require recognition of other financial statement items to be logical.

Liabilities. The pure cash basis may be modified to recognize liabilities. In recognizing liabilities and determining the amounts at which they should be carried, the preparer should consider whether the approach is consistent with GAAP and logical, and whether other items should be recognized as well. The AICPA Practice Aid specifies (a) liabilities resulting from short-term cash borrowings and (b) long-term notes or other debt arising from cash transactions or events are appropriate modifications to the cash basis of accounting.

Unrelated Business Income Taxes. Under the pure cash basis, income taxes on unrelated business income are charged to expense (disbursements) when cash is expended. It is a best practice for unrelated business income taxes to be accrued based on the amount of taxes reflected on the tax return.

Net Assets. This course recommends that financial statements prepared on the modified cash basis present net assets rather than fund balances. The statement of assets, liabilities, and net assets may reflect only total net assets, however, rather than amounts for total net assets and each of the classes of net assets as required by GAAP. Additional disclosures related to donor-imposed restrictions on net assets should be provided in the notes to the financial statements.

Consolidation or Combination. Modified cash basis financial statements may be consolidated or combined similarly to those prepared in conformity with GAAP. If consolidated or combined financial statements are prepared for organizations using the modified cash basis, the following best practices should be considered:

a. All combined or consolidated entities should be on the modified cash basis and should use substantially the same modifications to the pure cash basis; e.g., it would ordinarily be inappropriate to combine one organization that accrues receivables with other organizations that do not.

b. All intra-entity balances and transactions should be eliminated.

c. The consolidation or combination policy should be disclosed.

Form of Financial Statements

Titles of Financial Statements. This course's recommendations for titles of modified cash basis financial statements were presented earlier in this lesson.

Does FASB ASC 958 Apply to the Modified Cash Basis? FASB ASC 958-205-05-6 requires GAAP basis statements of financial position to disclose the classes of net assets and statements of activities to disclose the changes in those classes of net assets. AU-C 800, AR-C 80, and AR-C 90 note that GAAP presentation requirements should be followed in modified cash basis financial statements, or their substance should be communicated in some other manner. Accordingly, modified cash basis financial statements should either disclose the classes of net assets and present the changes in those classes of net assets or provide other information communicating the substance of those requirements. For example, the substance of the GAAP requirements could be communicated in the notes to the financial statements rather than in the financial statements themselves. The statement of assets, liabilities, and net assets could present total net assets, and the statement of revenues, expenses and changes in net assets could present the total change in net assets rather than the change in each class of net assets. The notes to the financial statements could then provide additional information about significant donor-imposed restrictions

related to net assets and changes in those amounts. In addition, the notes could use actual amounts, estimates, or percentages to communicate information about significant donor-imposed restrictions and changes in those amounts.

Captions. The other account captions used in special purpose financial statements generally should be the same as those used in GAAP financial statements. A classified statement of financial position is not required; however, it is a best practice for assets and liabilities to be sequenced in the order of their liquidity if a classified statement is not prepared.

Statement of Cash Flows. As discussed earlier in this lesson, a statement of cash flows is not required in modified cash basis financial statements. However, if that statement is presented, a good title would be "Statement of Cash Flows—Cash Basis." A discussion of the statement of cash flows is beyond the scope of this lesson, but more information and recommendations for such a statement can be found in *PPC's Guide to Nonprofit Financial Statements.*

Disclosures

Basis of Accounting. As previously discussed, special purpose financial statements should state the basis used and describe material differences from GAAP. To illustrate such a disclosure for the modified cash basis, assume a country club acquired its facilities and equipment through bank loans and has no other noncurrent assets or liabilities. Assume also that it accrues retirement plan contributions and that all other accrued liabilities would be immaterial. If the modifications of the pure cash basis consisted of capitalizing and depreciating its facilities and equipment and recognizing its obligations for bank loans and retirement plan contributions, the following disclosure would be appropriate:

> The accompanying financial statements have been prepared on the modified cash basis of accounting, which is a basis of accounting other than accounting principles generally accepted in the United States of America. Under the modified cash basis of accounting, certain revenues and related assets are recognized when received rather than when earned, and certain expenses are recognized when paid rather than when the obligation is incurred. Consequently, the Country Club has not recognized dues receivable from members, accounts payable to vendors, or their related effects on the change in net assets in the accompanying financial statements.

Because the modified cash basis covers a wide range of possibilities, accountants will need to use judgment in deciding which items to disclose as material differences. Quantification is not necessary. The basis of accounting notes will need to focus on how the modified cash basis used differs from GAAP rather than addressing the significant modifications made to the pure cash basis. As discussed below, the summary of significant accounting policies normally will disclose significant modifications to the cash basis.

Significant Accounting Policies. The significant accounting policies disclosed for modified cash basis financial statements will generally consist of customary GAAP policy disclosures related to the modifications.

THE TAX BASIS

According to AU-C 800.07, AR-C 80.05, and AR-C 90.05, the tax basis is the basis of accounting an entity uses to file its tax return for the period covered by the financial statements.

The guidance in this section applies to situations in which *financial statements* are prepared based on information reported in Form 990. Nonprofit organizations must file an annual information return on Form 990 (Return of Organization Exempt From Income Tax) with the following exceptions:

- Organizations otherwise required to file Form 990 may file Form 990-EZ (Form 990-EZ is a condensed version of Form 990), rather than Form 990, if their gross receipts during the year are less than $200,000 and their total assets at year end are less than $500,000.
- Organizations with gross receipts that are normally $50,000 or less, and certain religious and governmental organizations, are not required to file Form 990 or Form 990-EZ. An organization exempt from filing an

annual return under the gross receipts test must file an annual notice with the IRS by using Form 990-N [Electronic Notice (e-Postcard) for Tax-Exempt Organizations Not Required to File Form 990 or 990-EZ]. In addition, some of these smaller organizations voluntarily file Form 990 or Form 990-EZ.

- Private foundations file Form 990-PF [Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation], rather than Form 990 or Form 990-EZ. (Certain private foundations may find it appropriate to use an excise tax basis if the users of the financial statements are concerned primarily with net investment income and the amount of excise taxes the organization will have to pay.)

It is a best practice for nonprofit organizations to base their tax basis financial statements on the requirements of the form they expect to file. Furthermore, it does not seem appropriate for nonprofit organizations that are not required to file a return with the IRS to prepare tax basis financial statements since the organizations do not "use" or "expect to use" the basis of accounting to file a tax return. For example, the tax basis is not appropriate for certain religious organizations not required to file the Form 990 or Form 990-EZ or for smaller organizations that file only the Form 990-N.

Measurement

Accounting Methods. An organization may prepare Form 990 using the cash, accrual, or other (i.e., hybrid) method. Generally, the method used depends on the accounting method regularly used to keep the organization's books and records. Thus, an organization that keeps its general ledger on the cash basis might use that method for Form 990 rather than the accrual method unless cash to accrual adjustments are few and information needed for the adjustments can be easily gathered. Organizations also should consider the following factors when determining which method to use:

- Organizations that file Form 990-T (Exempt Organization Business Income Tax Return) in addition to Form 990 might choose to file Form 990 on the accrual basis since they must report certain income and expenses on the accrual basis for Form 990-T.

- Some state and local governmental units accept the Form 990 in place of their financial report forms. Organizations that use Form 990 to satisfy state reporting requirements should consider whether the state requires the accrual method to be used to report all amounts. In addition, some states require organizations to report certain transactions, such as contributions, grants, and functional expenses, in accordance with the guidance in the Audit Guide and FASB ASC 958.

Regardless of the method selected, it generally should be applied consistently from year to year.

Pledges Receivable (Promises to Give). Pledges receivable for tax reporting purposes may be different from amounts measured under GAAP. (Although FASB ASC 958-310-20 refers to those receivables as promises to give, the Form 990 continues to refer to them as pledges receivable.) The following areas could result in differences:

- Nonprofit organizations are permitted, but not required, to adopt FASB ASC 958 for tax reporting purposes. Accordingly, tax basis financial statements can report pledges receivable at the gross amount the organization expects to receive. Long-term pledges receivable do not have to be measured at fair value as would generally be required under GAAP. (The timing and uncertainties associated with future contributions expected to be received are considered when fair value is measured under GAAP. For example, if a present value technique is used for fair value measurement, the gross amount of the contribution is discounted to the present value of the future cash inflows.)

- Even if organizations follow GAAP for tax reporting purposes, they are not allowed to reflect the free use of materials, equipment, or facilities as revenues. Consequently, nonprofit organizations should not recognize pledges receivable for those types of transactions in tax basis financial statements. GAAP requires nonprofit organizations to recognize unconditional promises to give for the free use of materials, equipment, or facilities in the financial statements.

- If organizations use the cash method for tax reporting purposes, they would not reflect pledges receivable in the financial statements.

Investments. Organizations are permitted, but not required, to follow FASB ASC 958, for tax reporting purposes. Accordingly, the IRS allows organizations to carry securities held for investment at either cost or fair value. If the securities are carried at cost, the cost should not be adjusted subsequently for changes in fair value.

Organizations that follow GAAP for tax reporting purposes should adjust the carrying value of marketable securities with readily determinable fair values (whether bought or received as a donation) to fair value. It is a best practice for unrealized gains or losses resulting from carrying investments at fair value to be reflected in tax basis statements of revenues, expenses, and other changes in net assets in the same manner in which they are reported on Form 990. Form 990 requires the change in the carrying value of marketable securities to be reflected in Part XI, "Reconciliation of Net Assets," and Schedule D, "Supplemental Financial Statements," Part XI, which reconcile the change in net assets from the beginning of the year to the end of the year per the Form 990, and revenue per audited financial statements with revenue per the Form 990, respectively. Accordingly, it seems logical that the unrealized gains/losses can be included in the statement of activities in a section for other changes in net assets or fund balances rather than in the excess or deficit of revenues over expenses for the year.

Contributions. Since the IRS does not require organizations to follow FASB ASC 958 in recording and reporting contributions for tax reporting purposes, the following differences may occur:

- Organizations that do not follow GAAP are not required to measure contributions resulting from pledges receivable that will be collected in future years at their fair value.
- Organizations that do not follow GAAP may report fund balances for tax reporting purposes and report contributions as increases in the appropriate fund balances rather than recording them as increases in the appropriate class of net assets.
- It seems logical that organizations that do not follow GAAP should report any contributions with use that is donor restricted to future years as deferred revenue in the statement of assets, liabilities, and net assets.

Organizations that follow FASB ASC 958 for tax reporting purposes must record contributions as an increase in the appropriate class of net assets, depending on the existence or absence of donor-imposed restrictions.

Even if organizations choose to follow GAAP for tax reporting purposes, the IRS requires different treatment for certain transactions. For example, organizations are not allowed to include donated services or the free use of materials, equipment, or facilities in contribution revenue for tax reporting purposes. (Organizations that receive contributions of the actual materials, equipment, or facilities rather than their free use, however, should record the donations in tax basis financial statements at their fair value in the period received.) It is a best practice for the notes to tax basis financial statements to disclose the nature of donated services and contributions of the free use of materials, equipment, and facilities that have not been reflected in the financial statements.

Contributions for Federated Fund-raising Organizations. The instructions to Form 990 require a federated fund-raising organization (such as the local United Way) to include in revenue all of the contributions it receives in conjunction with its fund-raising efforts. That requirement applies even if a portion or all of the contributions are designated by donors for a particular organization or organizations. In addition to being reflected as revenues, those amounts should be reflected as grants and allocations expense to the designated organizations. That treatment differs from the GAAP requirements included in FASB ASC 958-605-25. As a general rule, FASB ASC 958-605-25-24 notes that an organization that accepts assets from a donor and agrees to use those assets on behalf of a specified beneficiary or disburse those assets, the return on investment of those assets, or both to that beneficiary, has not received a contribution. Accordingly, GAAP requires that organization to recognize a liability to the specified beneficiary when it recognizes the assets received from the donor. The amount should be measured at the fair value of the assets received. (FASB ASC 958-605-25 also contains three exceptions to that general rule.)

Form of Financial Statements

Titles of Financial Statements. This course's recommendations for titles of tax basis financial statements were presented earlier in this lesson.

Does FASB ASC 958 Apply to the Tax Basis? As previously discussed, the IRS does not require nonprofit organizations to follow FASB ASC 958 for tax reporting purposes. Tax basis financial statements should either follow GAAP presentation requirements or communicate their substance in some other manner. Consequently, tax

basis financial statements should either disclose the classes of net assets and the changes in those classes of net assets as required by GAAP or provide other information that communicates the substance of those requirements.

The intent of the requirements of FASB ASC 958 seems to be communicating information about significant donor-imposed restrictions on the organization's equity and changes in those donor-restricted amounts; the substance of those requirements can be met even if the organization reports information about fund balances. The substance of those requirements can be communicated in the notes to the financial statements rather than in the financial statements themselves. For example, the statement of assets, liabilities, and net assets could present total net assets and the statement of revenues, expenses, and other changes in net assets could present the total change in net assets rather than the change in each class of net assets. (Similarly, if organizations do not follow the financial statement presentation requirements included in FASB ASC 958, the statement of assets, liabilities, and fund balances could present total fund balances and the statement of revenues, expenses, and other changes in fund balances could present the total change in fund balances rather than the change in each fund balance.) Additional information about any significant donor restrictions on net assets or fund balances and information about significant changes in those amounts could be provided in the notes to the financial statements using actual amounts, estimated amounts, or percentages.

Captions. The other account captions used in special purpose financial statements generally should be the same as those used in GAAP financial statements. A classified statement of financial position is not required; however, it is a best practice to sequence assets and liabilities in the order of their liquidity if a classified statement is not prepared.

Statement of Cash Flows. As discussed earlier in this lesson, a statement of cash flows is not required in tax basis financial statements. However, if that statement is presented, a good title would be "Statement of Cash Flows—Tax Basis." A discussion of the statement of cash flows is beyond the scope of this lesson, but more information and recommendations for such a statement can be found in *PPC's Guide to Nonprofit Financial Statements.*

Disclosures

Basis of Accounting. As previously discussed, special purpose financial statements should state the basis used and describe material differences from GAAP. This course suggests that the disclosure need only address the substance of the differences between the bases, thus avoiding a detailed discussion of the GAAP treatment of an item. The following is an example disclosure that could be used when tax basis financial statements reflect fund balances and changes in fund balances rather than net assets and changes in net assets:

> The accompanying financial statements have been prepared on the tax basis of accounting, which is a basis of accounting other than accounting principles generally accepted in the United States of America. Accordingly, the Organization has not classified the difference between its assets and liabilities based on the existence or absence of donor-imposed restrictions. In addition, the Organization has not reported the changes in each of those classes of net assets in the accompanying financial statements.

The organization should adapt the disclosure to reflect the organization's actual reporting considerations.

Significant Accounting Policies. Special purpose financial statements should disclose the significant accounting policies used to prepare them. Significant accounting policies include those for which there is a selection from existing acceptable alternatives, principles, and methods peculiar to the industry in which the entity operates, and unusual or innovative applications of the special purpose framework. For example, a nonprofit organization might disclose information about the following alternatives that exist for tax reporting purposes:

- Organizations may choose not to record contributions and pledges receivable (promises to give) in accordance with FASB ASC 958. If the organization chooses not to follow GAAP, its policy could be disclosed as follows:

> Contributions
>
> The Organization records contributions and grants when they are received. Funds restricted by donors, grantors, or other outside parties for specific operating purposes

or plant acquisitions are recognized as revenue in the appropriate fund upon the Organization's compliance with the specific restrictions. Amounts received but not yet recognized are recorded as deferred restricted support in the accompanying statement of assets, liabilities, and fund balances.

- Organizations may choose not to follow the financial statement presentation requirements in FASB ASC 958 for tax reporting purposes. The following is an example policy disclosure for an organization that does not comply with GAAP:

  Financial Statement Presentation

  The accounts of the Organization are maintained in accordance with the principles of fund accounting. Under fund accounting, resources for various purposes are classified for accounting and reporting purposes into funds established according to their nature and purpose. Separate accounts are maintained for each fund; however, in the accompanying financial statements, funds that have similar characteristics have been combined into fund groups.

DEALING WITH ACCOUNTING CHANGES

FASB ASC 250-10 provides the guidance under GAAP for measurement and disclosure of accounting changes. GAAP uses the broad term *accounting change* to include a change in an accounting principle, a change in an accounting estimate, or a change in the reporting entity. The correction of an error is not an accounting change.

Nonprofit organizations sometimes change accounting principles within a special purpose framework, change from one special purpose framework to another, or change from GAAP to a special purpose framework. This section discusses reporting those changes in special purpose financial statements.

Changes in Accounting Principle within a Special Purpose Framework

FASB ASC 250-10-45-5 generally requires voluntary accounting changes to be applied retrospectively through an adjustment of net assets, as of the beginning of the period of the first financial statement presented. On the other hand, a change in accounting estimate such as a change in depreciation method that effects a change in accounting estimate, needs to be applied prospectively. GAAP does not permit reporting the cumulative effect of a voluntary accounting change in the change in net assets in the year of change.

GAAP measurement guidance should generally be applied to reporting accounting changes in financial statements prepared on the modified cash basis. It seems logical that changes in accounting principles in financial statements prepared on the tax basis would be governed by how the organization reported the change in its Form 990.

Changes from GAAP to a Special Purpose Framework or from One Special Purpose Framework to Another

GAAP does not seem to provide analogous guidance for reporting a change from generally accepted accounting principles to a special purpose framework, such as a change from generally accepted accounting principles to the modified cash basis, or for reporting a change from one special purpose framework to another, such as a change from the modified cash basis to the tax basis. Those changes generally occur because of one of the following:

- In prior years, GAAP approximated the modified cash basis; however, a new transaction has caused a material difference between GAAP and the special purpose framework. For example, the Organization receives a substantial promise to give that GAAP requires to be recognized.

- Prior requirements for GAAP statements have been eliminated. For example, the Organization has paid off of a loan with covenants that required GAAP statements, and compliance with GAAP is costly.

The central measurement issue is how to apply the change in basis. If there were no material differences between the old and new bases in prior statements, adoption of a new basis would not require restatement. However, if there were material differences, it is a best practice to restate prior financial statements to the new basis.

If the basis used in the prior year approximates the results that would have been obtained using the current year's basis, previously issued financial statements may be presented in comparison with the current statements. It is a best practice, however, to use titles that are appropriate for the current basis of accounting.

To illustrate, assume that in the current year the organization changes from accounting principles generally accepted in the United States of America to the modified cash basis of accounting. However, use of the modified cash basis in the prior year would not have materially changed the financial statements, and accordingly they are presented in comparison with the current-year financial statements without restatement. The following note would provide appropriate disclosure of the change if no material changes to the prior year's financial statements were necessary:

> NOTE B—CHANGE IN BASIS OF ACCOUNTING
>
> In previous years, the Organization prepared its financial statements using accounting principles generally accepted in the United States of America, which were substantially the same as the modified cash basis of accounting. In 20X7, the Organization elected to treat the new promises to give described in Note A differently from the accounting treatment that would be required by accounting principles generally accepted in the United States of America. It has adopted the modified cash basis of accounting for financial statement reporting. Since there were no substantive differences between accounting principles generally accepted in the United States of America and the modified cash basis in 20X6, no restatement of the previously issued financial statements was necessary to convert them to the modified cash basis.

The following basis of accounting note would be appropriate in the preceding situation:

> Basis of Accounting
>
> The accompanying financial statements have been prepared on the modified cash basis of accounting, which is a basis of accounting other than accounting principles generally accepted in the United States of America. In 20X7, that basis differs from accounting principles generally accepted in the United States of America primarily because the Organization records contribution revenue when received as described in Note X instead of recognizing unconditional promises to give in the period the promise is received. In previous years, the Organization had no unconditional promises to give. In 20X6, there were no substantive differences between the modified cash basis and accounting principles generally accepted in the United States of America.

In the preceding situation, Note X might describe the contributions as follows:

> Contributions
>
> The Organization records contributions and grants when they are received. Funds restricted by donors, grantors, or other outside parties for specific operating purposes or plant acquisitions are recognized as revenue upon the Organization's compliance with the specific restrictions. Amounts received but not yet recognized are recorded as deferred restricted support in the accompanying statement of assets, liabilities, and net assets.

If the prior year's financial statements would have been materially different using the new basis of accounting, it is a best practice not to present the current year in comparison with previously issued financial statements. To present them side-by-side would imply comparability when there is none.

The organization, therefore, would have two alternatives:

- Restate the prior year's financial statements using the new basis of accounting.
- Issue single year financial statements with the opening balance of net assets restated.

Changes in bases of accounting generally are not discussed in the authoritative literature, although FASB ASC 250-10 provides related guidance in the requirements for correcting an accounting error in previously issued GAAP

basis financial statements. FASB ASC 250-10-45-22 through 45-24 describe the process of restating the prior period financial statements so that the effect of the error correction is not reflected in revenues or expenses of the current period. Accordingly, another option to show the effects of changes in the bases of accounting in special purpose financial statements is as adjustments of beginning net assets rather than included in the change in net assets for the current period. Practice generally has adopted that approach, while some accountants show the effects of the change in the statement of revenues, expenses, and other changes in net assets, and others show a new beginning net assets balance and disclose the effects of the change in the notes to the financial statements.

The following disclosure would be appropriate if there is a change in the basis of accounting used in the current year and the prior year financial results would have been materially different using the current special purpose framework:

> NOTE B—CHANGE IN BASIS OF ACCOUNTING
>
> In previous years, the Organization prepared its financial statements using accounting principles generally accepted in the United States of America. In 20X7, the Organization adopted the modified cash basis of accounting as the basis for its financial statements. Under that new basis of accounting, the Organization records contributions when they are received. The accompanying 20X6 financial statements have been restated to conform with the new basis of accounting. As a result of the differences described in Note A between the modified cash basis and accounting principles generally accepted in the United States of America, net assets at the beginning of 20X6 are approximately $50,000 less, the increase in net assets for 20X6 is approximately $10,000 less, and net assets at the end of 20X6 are approximately $60,000 less than the amounts previously reported.

SELF-STUDY QUIZ

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

21. An organization using the pure cash basis of accounting would do which of the following?

    a. Use brackets for negative cash balances.

    b. Capitalize its investments.

    c. Include direct financing loans in cash receipts.

    d. Payroll taxes are reflected in disbursements when paychecks are written.

22. If a nonprofit organization uses the modified cash basis, what should it do when presenting consolidated or combined financial statements?

    a. Convert from the modified cash basis to the pure cash basis.

    b. Make sure that all relevant statements are either on the modified or pure cash basis.

    c. Include sufficient detail about intra-entity transactions and balances.

    d. Disclose the organization's consolidation or combination policy.

23. Which of the following statements best describes an aspect of using the tax basis of accounting?

    a. Organizations should base their tax basis statements on the requirements of Form 990.

    b. It is inappropriate for an organization to use the tax basis if it will not file a tax return.

    c. An organization will not be able to fill out a tax return if it does not use the tax basis.

    d. Organizations that have investments must carry and report them at fair value.

24. No More Hunger is a nonprofit organization that uses GAAP. During the current fiscal period, it changes to using the modified cash basis. There are material changes in the organization's financial statements. How should it proceed?

    a. It should restate prior financial statements.

    b. It should leave its financial statement titles the same.

    c. It should present comparative financial statements.

    d. It should include changes in changes in net asset for the period.

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. An organization using the pure cash basis of accounting would do which of the following? **(Page 105)**

    a. Use brackets for negative cash balances. [This answer is correct. The pure cash basis of accounting recognizes and measures all transactions by their effect on cash and cash equivalents. When presenting pure cash basis financial statements, a negative cash balance may be reflected with brackets and titled as cash overdraft.]

    b. Capitalize its investments. [This answer is incorrect. Organizations using this basis that purchase investments do *not* capitalize them. Instead, the purchases are included in cash disbursements as cash is expended. Income from the investments is only recognized as cash is received.]

    c. Include direct financing loans in cash receipts. [This answer is incorrect. Loans that provide direct financing are *not* included in cash receipts since cash is not provided directly to the nonprofit organization.]

    d. Payroll taxes are reflected in disbursements when paychecks are written. [This answer is incorrect. Payroll disbursements are recorded as cash disbursements as paychecks are written. Payroll taxes and withholdings of taxes and other items from employees' paychecks are reflected in disbursements when the applicable payments are made.]

22. If a nonprofit organization uses the modified cash basis, what should it do when presenting consolidated or combined financial statements? **(Page 111)**

    a. Convert from the modified cash basis to the pure cash basis. [This answer is incorrect. There is no prohibition to using the modified cash basis in combined financial statements. Such a conversion would not be necessary.]

    b. Make sure that all relevant statements are either on the modified or pure cash basis. [This answer is incorrect. All combined or consolidated entities should be on the modified cash basis and should use substantially the same modifications to the pure cash basis (e.g., it would ordinarily be inappropriate to combine one organization that accrues receivables with other organizations that do not).]

    c. Include sufficient detail about intra-entity transactions and balances. [This answer is incorrect. When consolidating or combining such financial statements, all intra-entity balances and transactions should be *eliminated*.]

    d. Disclose the organization's consolidation or combination policy. [This answer is correct. Modified cash basis financial statements may be consolidated or combined similarly to those prepared in conformity with GAAP. This course provides recommendations for doing so, including that it is a best practice for the consolidation or combination policy to be disclosed.]

23. Which of the following statements best describes an aspect of using the tax basis of accounting? **(Page 113)**

    a. Organizations should base their tax basis statements on the requirements of Form 990. [This answer is incorrect. It is a best practice for nonprofit organizations to base their tax basis financial statements on the requirements of the form they expect to file. Therefore, if the organization does not expect to file Form 990, it should not use that as its basis.]

    b. It is inappropriate for an organization to use the tax basis if it will not file a tax return. [This answer is correct. Based on the guidance in this course, it does not seem appropriate for nonprofit organizations that are not required to file a return with the IRS to prepare tax basis financial statements since the organizations do not "use" or "expect to use" the tax basis of accounting to file a tax return. For example, the tax basis is not appropriate for certain religious organizations not required to file the Form 990 or Form 990-EZ or for smaller organizations that file only the Form 990-N.]

c. An organization will not be able to fill out a tax return if it does not use the tax basis. [This answer is incorrect. An organization may prepare Form 990 using the cash, accrual, or other (i.e., hybrid) method. Generally, the method used depends on the accounting method regularly used to keep the organization's books and records.]

d. Organizations that have investments must carry and report them at fair value. [This answer is incorrect. Organizations are permitted, but not required, to follow FASB ASC 958 for tax reporting purposes. Accordingly, the IRS allows organizations to carry securities held for investment at either cost or fair value. If the securities are carried at cost, the cost should not be adjusted subsequently for changes in fair value.]

24. No More Hunger is a nonprofit organization that uses GAAP. During the current fiscal period, it changes to using the modified cash basis. There are material changes in the organization's financial statements. How should it proceed? **(Page 116)**

a. It should restate prior financial statements. [This answer is correct. The central measurement issue is how to apply the change in basis. If there were no material differences between the old and new bases in prior statements, adoption of a new basis would not require restatement. However, if there were material differences (as in this scenario), it is a best practice to restate prior financial statements to the new basis.]

b. It should leave its financial statement titles the same. [This answer is incorrect. If the basis used in the prior year approximates the results that would have been obtained using the current year's basis, previously issued financial statements may be presented in comparison with the current statements. It is a best practice, however, to use titles that are appropriate for the current basis of accounting. Therefore, even if No More Hunger can present comparative statements, it should not use the same titles. If it did not present comparative statements, it still would not use the same titles.]

c. It should present comparative financial statements. [This answer is incorrect. If the prior year's financial statements would have been materially different using the new basis of accounting, it is a best practice not to present the current year in comparison with previously issued financial statements. To present them side-by-side would imply comparability when there is none. Therefore, since No More Hunger had material differences after changing bases, it is probably better for this organization not to present comparative statements.]

d. It should include changes in changes in net asset for the period. [This answer is incorrect. FASB ASC 250-10-45-22 through 45-24 describe the process of restating prior period financial statements so that the effect of the error correction is not reflected in revenues or expenses of the current period. Accordingly, another option to show the effects of changes in the bases of accounting in special purpose financial statements is as adjustments of beginning net assets rather than included in the change in net assets for the current period. Practice generally has adopted that approach. Therefore, it would be better for No More Hunger to adjust beginning net assets instead.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Preparing Nonprofit Financial Statements
Course 1—Financial Statement Notes and Special Purpose Frameworks (NFSTG181)

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.tr.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 $95 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 ($95 for email or fax; $105 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
     NFSTG181 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 ($95 for answer sheets sent by email or fax; $105 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 $271 (a 5% discount on all three courses). If you complete four courses, the price for

grading all four is $342 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $404 (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 **May 31, 2019**. 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 Preparing Nonprofit Financial Statements—Course 1—Financial Statement Notes and Special Purpose Frameworks (NFSTG181)

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. Disclosures related to which of the following should be determined as to whether they are still helpful instead of included every year?

   a. The statement of activities.

   b. The statement of cash flows.

   c. The statement of financial position.

   d. The statement of functional expenses.

2. When are disclosures necessary?

   a. When they are required by authoritative guidance.

   b. When they are needed for clarity.

   c. When they were used in the previous year's financial statements.

   d. When required by authoritative guidance or needed for clarity.

3. Which of the following organizations needs to describe multiple accounting policies in its disclosure about depreciation?

   a. No More Hunger used one method for depreciation in the past, and switched to its current method three years ago.

   b. Helping Hands has two deprecation methods, one of which accounts for most of the effect of depreciation on the financial statements.

   c. Preserve Our Landmarks uses two depreciation methods, both of which have a significant effect on the financial statements.

   d. Donation Distribution uses a deprecation method that is different from the one normally used by similar organizations in this area.

4. Nonprofit organizations have flexibility in what area when disclosing subsequent events?

   a. Such a disclosure is only needed if such events exist that affect the financial statements.

   b. Such a disclosure is only needed if the financial statements are prepared using a special purpose framework.

   c. Such a disclosure can be included as part of the summary of significant accounting policies or in a separate note.

   d. Such a disclosure can be omitted if the subsequent event occurs after the date the financial statements were issued.

5. A nonprofit organization with an endowment fund that is donor restricted and/or board designated, must disclose which of the following prior to the adoption of ASU 2016-14?

   a. The total amount of donor-restricted and board-designated funds.

   b. A list of the laws that affect its net asset classification for donor-restricted funds.

   c. A reconciliation of the fund's beginning and ending balances that does not include reclassifications.

   d. A description of policies the organization uses to make appropriations for expenditures from the fund.

6. Doing which of the following (prior to the adoption of ASU 2016-14) will help an organization develop appropriate major classes of property and equipment that adhere to FASB ASC 360-10-50-1 guidelines?

   a. Grouping accounts by amount.

   b. Providing detailed information on all equipment.

   c. Presenting immaterial amounts in an "Other" column.

   d. Disclosing the estimated useful lives of items of property and equipment.

7. Which of the following would be disclosed on the statement of financial position instead of in the notes to the financial statements prior to the adoption of ASU 2016-14?

   a. Basic information about capitalized collections.

   b. Capitalizing a collection prospectively.

   c. Electing not to capitalize a collection.

   d. Information about capitalized works of art not considered a collection.

8. The Mercer Organization has two notes payable, but they are immaterial to the organization's financial statements. Mercer combines the two notes for its financial statements and discloses the current total of installments and a range of current discount rates. Mercer is adhering to the professional guidance in place prior to the adoption of ASU 2016-14. Which of the following will be of more use to a reader of Mercer's financial statements based on this type of disclosure?

   a. The range of installments.

   b. The total of installments.

   c. Comparative amounts.

   d. Interest costs.

9. If a nonprofit organization is not in compliance with donor restrictions, it is considered which of the following prior to the adoption of ASU 2016-14?

   a. An asset.

   b. An expense.

   c. A contingent liability.

   d. A long-term debt.

10. If a nonprofit organization transfers assets to another organization and has itself designated as the beneficiary, which of the following pieces of information must be disclosed prior to the adoption of ASU 2016-14?

    a. Confirmation that the organization did not grant variance power to the recipient organization.

    b. The way that the recipient organization will distribute the assets to the original organization.

    c. Whether the organization's investments in its other unrestricted operations column are greater than any deficit.

    d. Total amounts that the organization has raised for organizations other than itself.

11. Prior to the adoption of ASU 2016-14, which of the following disclosures is required in relation to a nonprofit organization's fund-raising expenses?

    a. Costs of such activities divided by either function or object classification.

    b. The method used to determine the ratio of fund-raising expenses to funds raised.

    c. A summary of the terms of any related split-interest agreement.

    d. Justification for why natural classification was used instead of functional classification.

12. Financial statement disclosures that are not related to a specific financial statement caption (or multiple captions) are called what?

    a. Common disclosures.

    b. Frequent disclosures.

    c. General disclosures.

    d. Other disclosures.

13. The Oakmont Group is a nonprofit organization. Julia is an officer of Oakmont. Tom is Julia's cousin, but not affiliated with Oakmont himself. Harken is a nonprofit organization to which Oakmont makes regular donations, but Harken does not contribute anything financially to Oakmont. The Wilson Partnership provides a large enough amount of revenue to Oakmont that it would be considered to have a concentration. Oakmont Charter is a local affiliate of the Oakmont Group, but it does not meet the GAAP guidelines for an affiliate. All of these entity's/individuals would be considered related parties with respect to the Oakmont Group **except**:

    a. Harken.

    b. The Wilson Partnership.

    c. Oakmont Charter.

    d. Tom.

14. A long-term lease that has fixed payments over the course of multiple years is an example of what?

    a. An accounting change.

    b. A commitment.

    c. A contingency.

    d. A subsequent event.

15. Why might a nonprofit organization request a *cy pres* ruling?

    a. To eliminate the need for disclosing contingencies that are only reasonably possible (not probable) in the financial statements.

    b. To receive immunity when restricted donor resources were used by the organization for other purposes.

    c. To provide positive assurance that an organization has complied with all applicable donor restrictions.

    d. To change donor restrictions on contributions for which it has no foreseeable future use.

16. Which of the following disclosures would be necessary if a nonprofit organization issues guarantees?

    a. The name and contact information of users who hold such guarantees.

    b. The minimum amount of potential future payments that could be required.

    c. The carrying amount of any liability for the organization's obligations under the guarantee.

    d. Whether it is probable, reasonably possible, or unlikely that the organization will have to make payments under the guarantee.

17. Which of the following disclosures is required for an accrued environmental remediation liability?

    a. The nature and the amount of the accrual for the remediation.

    b. The estimated time frame for making remediation disbursements.

    c. The estimated time frame under which the recognized recoveries will be realized.

    d. A description of how environmental laws and regulations affect activities.

18. The required fair value disclosures in FASB ASC 820-10-50 generally do which of the following?

    a. Differentiate disclosures required by this standard from those required in other accounting standards.

    b. Provide information about subjectivity related to fair value measurements.

    c. Provide information about assets and liabilities that are measured at fair value upon recognition.

    d. Provide information about fair value in leases and lease classification.

19. Which of the following disclosures would only be necessary for a fair value measurement made with unobservable inputs in the fair value hierarchy?

    a. The fair value measurements as of the organization's reporting date.

    b. The policy used to determine when transfers between levels in the hierarchy are recognized.

    c. Quantitative information about the unobservable inputs created for the disclosure.

    d. A reconciliation of the beginning and ending balances of major asset and liability classes in the category.

20. What type of subsequent event provides more information about conditions existing at the date of the statement of financial position?

    a. Recognized (Type I).

    b. Nonrecognized (Type II).

    c. Observable (Level 1).

    d. Unobservable (Level 3).

21. Which of the following is an example of a disclosure issue that is not likely to occur every year?

    a. An accounting change, such as a change in accounting estimates.

    b. A related entity, such as another nonprofit the organization controls.

    c. Electing the fair value option to account for a specific financial asset.

    d. Terms related to the organization's long-term debt.

22. When might a nonprofit organization need to make disclosures about prior-period adjustments?

    a. It decides to retire specific long-lived assets.

    b. It needs to correct an error in prior statements.

    c. It has a change in reporting entity.

    d. It makes a change to an accounting principle.

23. What are the three major categories of financial instruments?

    a. Cash, cash equivalents, and evidence of an ownership interest in an entity.

    b. Cash, evidence of an ownership interest in an entity, and contracts that require an exchange of cash or other financial instruments.

    c. Cash, contracts that require an exchange of cash or other financial instruments, deferred compensation and pension plan agreements.

    d. Cash and cash equivalents, deferred stock and pension plan agreements, and operating leases.

24. What is the term for the possibility that an organization could suffer a loss due to another party's failure to perform as outlined in a contract?

    a. Credit risk.

    b. Market risk.

    c. Uncertainties.

    d. Vulnerability due to concentrations.

25. Which of the following considerations apply when making the fair value disclosures outlined in FASB ASC 825-10-50-10?

    a. A supplementary table is required, whether or not the information is disclosure in multiple notes.

    b. The disclosures should be made so that it is clear whether the amounts reported are assets or liabilities.

    c. The fair values of nonderivative financial instruments should be netted against that of derivative instruments.

    d. The disclosures must be combined with those required by other standards, such as FASB ASC 825-10-50.

26. Which of the following receivables would typically be included in a nonprofit organization's disclosures as required under FASB ASC 310-10-50?

    a. Promises to give.

    b. Trade accounts with maturities of a year or less.

    c. Receivables measured at fair value or the lower of cost or fair value.

    d. Receivables arising from grants and programs.

27. Which of the following statements best describes the disclosure requirements for risks and uncertainties?

    a. Small organizations that meet a specific threshold are exempt.

    b. Disclosures are necessary in condensed and summarized financial statements.

    c. A description of major products or services and its principal markets should be included.

    d. The disclosure about management's estimates should be uniquely tailored to that fiscal year.

28. Under what circumstances does GAAP require disclosures for significant estimates?

    a. It is possible that the condition could occur after the financial statement date.

    b. If it occurred, the change would be material to the financial statements.

    c. The future event could occur within five years of the financial statement date.

    d. The future event is possible, but the likelihood is remote.

29. Which of the following nonprofit organizations has correctly addressed an issue related to its disclosure of significant estimates?

    a. The Gold Organization makes more disclosures for new estimates than recurring estimates.

    b. The Silver Organization makes disclosures for all estimates in its financial statements.

    c. The Bronze Organization discloses estimates used to determine the fair values of financial instruments.

    d. The Pearl Organization's management stays away from trends in the industry so it will not have to disclose known information.

30. Which of the following guidelines will help an organization disclose the nature of its activities?

    a. Product and service groups should be categorized and described in detail.

    b. Geographical and industrial concentrations should be generalized.

    c. Lines of business should have equal rank regardless of importance.

    d. Information about activities must be included in a separate note.

31. What is a good way to determine whether the revenue from a particular customer, grantor, or contributor should be disclosed?

    a. Whether its loss is material to the financial statements.

    b. Whether the loss will be made up by revenue or contributions from other sources.

    c. Whether the loss was related to the violation of donor restrictions.

    d. Whether management would change organizational activities in response to its loss.

32. Under what circumstances might a nonprofit organization decide to use a special purpose framework for its financial statements?

    a. Third parties use its financial statements.

    b. Its creditors require the use of GAAP.

    c. The cost of complying with GAAP is high.

    d. Its operations are heavily influenced by cash flows.

33. Kindness Matters is a nonprofit organization that operates using the modified cash basis. What is an appropriate title for its statement of financial position before the effective date of ASU 2016-14?

    a. Statement of Financial Position.

    b. Statement of Assets, Liabilities, and Net Assets—Cash Basis.

    c. Statement of Assets, Liabilities, and Net Assets—Modified Cash Basis.

    d. Statement of Revenues, Expenses, and Other Changes in Net Assets—Cash Basis.

34. Which of the following should be done when disclosing an organization's special purpose framework and how it differs from GAAP?

    a. Alert readers that the basis may differ from what they typically see.

    b. Outline all the differences, big and small, between the framework and GAAP.

    c. Quantify the material differences between the framework and GAAP.

    d. Limit disclosures to information that relates specifically to amounts reported in the statements.

35. What is the only type of financial statement needed for a pure cash presentation?

    a. A statement of cash flows.

    b. A balance sheet.

    c. A statement of financial position.

    d. A statement of cash receipts and disbursements.

36. Though it generally uses the cash basis, the Monarch Organization accounts for property and equipment purchases as assets. What basis of accounting is Monarch using?

    a. The contractual basis.

    b. The modified cash basis.

    c. The tax basis.

    d. The accrual basis.

37. Does the requirement to disclose classes of net assets in FASB ASC 958-205-05-6 apply to financial statements prepared using the modified cash basis?

    a. Yes, nonprofit organizations using this basis are required to disclose the classes of net assets.

    b. Yes, the organization must either follow those requirements or communicate them in another manner.

    c. No, but the organization can choose to follow those requirements if it wants to or it is cost effective.

    d. No, nonprofit organizations do not have to follow these requirements and usually do not because they are cost prohibitive.

38. Which of the following is a difference that may occur when an organization uses the tax basis to record and report its contributions instead of GAAP?

    a. It will have to measure contributions from future pledges receivable at fair value.

    b. It can report contributions as increases in the appropriate fund balances.

    c. It should report donated services as contribution revenue for tax purposes.

    d. It is required to adopt FASB ASC 958 for tax reporting purposes.

39. Changing from GAAP to a special purpose framework is considered what?

    a. An accounting change.

    b. A change in accounting estimate.

    c. A change in accounting principle.

    d. An error correction.

40. The Ombudsman Group is a nonprofit organization that uses the modified cash basis of accounting. During its fiscal year, the organization has a change in accounting principle. How should it deal with that change in its special purpose financial statements?

    a. By treating it the same as on its Form 990.

    b. By using GAAP measurement guidance.

    c. By applying it only to the period in question.

    d. By applying it prospectively.

GLOSSARY

Accounting changes: Changes in accounting estimates, the reporting entity, and accounting principle.

Accounting policies: The specific accounting principles and methods of applying those principles that have been adopted for preparing the financial statements.

Available to be issued: Financial statements are *available to be issued* when they are complete in a form and format that complies with GAAP and all approvals necessary for their issuance have been obtained.

Cash basis: This is a *special purpose framework* in which the reporting entity records cash receipts and disbursements. It includes modifications of the cash basis having substantial support, commonly known as the modified cash basis.

Commitments: Contractual obligations for a future expenditure.

Contingencies: Existing conditions that may create a legal obligation in the future but arise from past transactions or events.

Contractual basis: A *special purpose framework* used by the reporting entity to comply with an agreement between the entity and one or more third parties other than the practitioner.

Fair value option: Assets and liabilities measured at fair value under this option should be reported separately from the carrying amounts of similar assets and liabilities measured using another measurement attribute by either (1) presenting the aggregate of fair value and non-fair-value amounts in the same line-item in the statement of financial position and parenthetically disclosing the amount measured at fair value included in the aggregate amount, or (2) presenting two separate line items to display the fair value and non-fair-value carrying amounts.

Financial guarantee: This and other conditional exchange contracts both (1) impose on one entity a contractual obligation to exchange other financial instruments with a second entity on potentially unfavorable terms if an event outside the control of either party to the contract occurs and (2) conveys to that second entity a contractual right to exchange other financial instruments with the first entity on potentially favorable terms if an event outside the control of either party to the contract occurs.

Financial statement notes: This integral part of the financial statements is used to present material disclosures that are required by generally accepted accounting principles that are not otherwise presented on the face of the financial statements.

Financial receivables: Financing arrangements that represent a contractual right to receive money and that are recorded as assets in the financial statements.

General disclosures: Disclosures in the financial statements that concern matters unrelated to a financial statement caption (such as contingencies) or related to several captions (such as related parties).

Issued: Financial statements are considered *issued* when they are widely distributed to shareholders and other financial statement users for general use and reliance in a form and format that complies with GAAP.

Near term: A period of time not to exceed one year from the date of the financial statements.

Nonpublic entity: An entity that (1) does not trade its debt or equity securities in a public market; (2) is not a conduit bond or obligor for conduit debt securities traded in a public market; (3) does not file with a regulatory agency when selling its debt or equity securities in a public market; and (4) is not controlled by an entity that trades its debt or equity securities in a public market, is a conduit bond obligor for conduit debt securities traded in a public market, or that files with a regulatory agency when selling its securities in public markets.

Nonrecognized (type II) subsequent events: Events that provide evidence about conditions that *did not* exist at the date of the statement of financial position; they arose after that date but before the financial statements are available to be issued.

Other basis: A *special purpose framework* used by a reporting entity that uses a definite set of logical and reasonable criteria that is applied to all material items within the financial statements, such as the AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities.

Pension benefits: Periodic (usually monthly) payments made pursuant to the terms of the pension plan to a person who has retired from employment or to that person's beneficiary.

Pension plans: These include (1) written plans, as well as plans whose existence may be implied from a well-defined, although unwritten, organization policy; (2) unfunded plans, as well as insured plans and trust fund plans; (3) defined benefit and defined contribution plans; and (4) deferred compensation contracts with individual employees if the contracts taken together are equivalent to a pension plan. Such plans exclude (1) death and disability payments under a separate arrangement and (2) payments of retirement benefits to selected employees in amounts determined on a case-by-case basis or after retirement.

Probable: The future event or events are likely to occur.

Postemployment benefits: Benefits paid after employment but before retirement to former or inactive employees, their beneficiaries, and their covered dependents, including (1) salary continuation, (2) supplemental unemployment benefits, (3) severance benefits, (4) disability-related benefits, (5) job training and counseling, and (6) continuation of health care benefits and life insurance coverage.

Reasonably possible: The change of the future event or events occurring is more than remote but less than likely.

Recognized (type I) subsequent events: Those that provide additional evidence about conditions that existed as of the date of the statement of financial position, including the estimates inherent in preparing the financial statements.

Regulatory basis: A *special purpose framework* used by the reporting entity to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction the entity is subject.

Remote: The chance of the future event or events occurring is slight.

Severe impact: A significant financially disruptive effect on an entity's normal functioning. It is a higher threshold than material; however, it does include matters that are less than catastrophic.

Special purpose framework: What was previously called an "other comprehensive basis of accounting" or an "OCBOA." These are bases of accounting other than generally accepted accounting principles (GAAP). Under some circumstances, use of such frameworks can be more useful or cost-effective than GAAP.

Tax basis: A *special purpose framework* that the reporting entity uses to file its tax return for the period covered by the financial statements.

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COMPANION TO PPC'S GUIDE TO PREPARING NONPROFIT FINANCIAL STATEMENTS

COURSE 2

FORM, STYLE, AND THE STATEMENTS OF FUNCTIONAL EXPENSES AND CASH FLOWS (NFSTG182)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course discusses general form and style considerations as they relate to preparing financial statements for a nonprofit organization. In addition, authoritative literature and form and presentation considerations are covered for the statement of functional expenses and the statement of cash flows

PUBLICATION/REVISION DATE: May 2018

RECOMMENDED FOR: Users of *PPC's Guide to Preparing Nonprofit Financial Statements*

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 **May 31, 2019**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Form and Style Considerations

Completion of this lesson will enable you to:
- Identify general form and style considerations as they relate to preparing financial statements for nonprofit organizations.

Lesson 2—The Statement of Functional Expenses

Completion of this lesson will enable you to:
- Recognize the authoritative guidance and form and presentation considerations as they relate to preparing a nonprofit's statement of functional expenses.

Lesson 3—The Statement of Cash Flows

Completion of this lesson will enable you to:
- Recognize the authoritative guidance and form and style considerations as they relate to preparing a nonprofit's statement of cash flows.

- Identify cash flows from operating activities and how they are presented.
- Identify cash flows from investing activities, financing activities, and noncash investing and financing activities and how they are presented.

TO COMPLETE THIS LEARNING PROCESS:

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

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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: Form and Style Considerations

INTRODUCTION

This lesson discusses matters of form and style as they relate to preparing financial statements for a nonprofit organization. In practice, there is a wide variety of approaches to those considerations. Authoritative literature provides limited guidance.

Typically, the style of preparers evolves over time by addressing questions as they arise. As a result, inconsistencies may develop and, since the policies may not be written, training new staff can be frustrating and time-consuming.

This lesson is intended to serve as a convenient reference for questions concerning general style and form that arise during the preparation of financial statements for a nonprofit organization. The policies presented in this lesson:

a. Are easily understood and remembered.

b. Are logical and consistent.

c. Are comprehensive.

d. Result in a pleasing style.

Adopting detailed format policies has the following advantages:

- It frees up the time previously needed to resolve format questions. Since that frequently involves individuals with a higher salary or billing rate, cost savings and added efficiency may result.

- It provides a reference for new administrative personnel, thus reducing the amount of training time (including supervisory time).

- It promotes more efficient use of talents by enabling the individuals drafting and reviewing the financial statements to concentrate on presentation and leaving the detailed format considerations to the administrative personnel.

The content in this lesson may be adopted "as is" or easily adapted to serve as a firm or organization's style manual. Format preferences may often be changed by habit. For example, preparers frequently find that after they adopt new format policies, financial reports prepared in accordance with former policies quickly look peculiar to them. Accordingly, preparers may find it efficient to adopt content in this lesson as it is, even if it requires changes in some of their present policies. Subsequent changes to those policies should be unnecessary.

Throughout this lesson, the wording used implies that the policies have been adopted by the preparer. However, all of the policies are general best practices, and the use of the word "should" is not intended to imply that other policies are incorrect or inferior.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify general form and style considerations as they relate to preparing financial statements for nonprofit organizations.

FINANCIAL REPORTS

The term "financial report" is used throughout this course to refer to the entire package that typically incorporates the presentation of financial statements. For nonprofit organizations, that package generally includes many, if not all, of the following:

- Title (or cover) page.
- Table of contents.
- Accountant's or auditor's report.
- Basic financial statements and notes.
- Supplementary or other information.

Style considerations concerning each of the major components of a typical financial report are discussed in the following sections.

TITLE PAGE (COVER PAGE)

General

A title page is recommended for all financial statement presentations. The title page should contain the name of the organization, the title of the financial statements, and the date or period covered, as follows:

ABC ORGANIZATION

FINANCIAL STATEMENTS

Year Ended December 31, 20X7

Note that all lines are centered and that a line is skipped between each line of the title. The name of the organization and the term "FINANCIAL STATEMENTS" are capitalized, whereas only the first letter of each word in the date or period covered by the financial statements is capitalized.

If the preparer uses a front cover that has a window, the first page after the cover should provide the preceding information positioned to appear through the cover's window. If the preparer uses a solid cover, the information should either be typed or printed on the cover and located above the center of the page, since this is the section that first draws the reader's attention.

The cover information should appear only once. Accordingly, if the preparer uses covers without windows, the information should be typed or printed on the cover and the next page should be the table of contents.

Name of the Organization

The name of the organization should be presented as listed in its charter, certificate of incorporation, or other appropriate legal document. If it is not obvious from the name of the organization that it is a nonprofit entity, some accountants disclose that parenthetically on the title page and in the accountant's or auditor's report. While that policy is acceptable, the critical disclosure is in the accounting policies note. Additional disclosure on the title page or in the accountant's or auditor's report is optional. Examples of appropriate presentations of the name of the organization on the title page are as follows:

UNITED WAY OF METROPOLIS

DENTON BREEDERS ASSOCIATION, INC. (a nonprofit corporation)

CHILD GUIDANCE CLINIC OF ADAMS COUNTY

MISSION MINISTRIES

GREENWOOD SCHOOL, INC. (a nonprofit corporation)

MIKE JONES FOUNDATION

Title of Financial Statements

If the presentation includes more than one type of financial statement (for example, statement of financial position, statement of activities, and statement of cash flows), the term "FINANCIAL STATEMENTS" is the most practical method of communicating to the reader what is included in the presentation. For example:

FINANCIAL STATEMENTS

When only one type of statement is presented, it is more appropriate to use the exact title of the statement as follows:

STATEMENT OF FINANCIAL POSITION

If more than one period is presented, most accountants believe the title should be plural as follows:

STATEMENTS OF FINANCIAL POSITION

STATEMENTS OF ACTIVITIES

Other accountants believe singular is appropriate regardless of the number of periods presented (i.e., there is only one statement, regardless of the number of periods presented).

When supplementary or other information is included, the title should be modified as follows:

FINANCIAL STATEMENTS AND SUPPLEMENTARY (OR OTHER FINANCIAL) INFORMATION

Some practitioners add a description of the service performed to the title of the financial statements on the title page as follows:

ABC ORGANIZATION

COMPILED FINANCIAL STATEMENTS

Year Ended December 31, 20X7

This course does not follow that practice because it complicates the production process, especially when comparative statements with different levels of service are presented or when supplementary information is included and accountants are expressing a level of assurance on the supplementary information that differs from the assurance expressed on the financial statements. The one exception to that policy is when comparative statements include one period audited and one period unaudited.

Different Levels of Service—Comparative Financial Statements

When audited financial statements are presented in comparative form with unaudited financial statements, the title page may indicate the level of service as follows:

ABC ORGANIZATION

FINANCIAL STATEMENTS

Years Ended December 31, 20X7 (Audited)
and 20X6 (Unaudited)

or

Years Ended December 31, 20X7 (Unaudited)
and 20X6 (Audited)

Consolidated or Combined Financial Statements

When consolidated or combined financial statements are presented, the title on the cover page should include the word "consolidated" or "combined." For example:

CONSOLIDATED FINANCIAL STATEMENTS

COMBINED STATEMENT OF FINANCIAL POSITION

CONSOLIDATED STATEMENT OF ACTIVITIES

Date or Period Covered

When both a statement of financial position and a statement of activities are presented, the title page should only reflect the period covered by the statement (or statements) of activities as the following illustrates:

Years Ended December 31, 20X7 and 20X6

Three Months Ended March 31, 20X7 and 20X6

Six Months Ended June 30, 20X7

One Month and Six Months Ended June 30, 20X7

The last day of the month should be used even if that date falls on a Sunday or holiday, except in circumstances such as the following:

- Initial Financial Statements for a new organization:

  From January 23, 20X7 (Date of Inception), to March 31, 20X7

- Final Financial Statements for a terminating organization:

  From January 1, 20X7, to September 17, 20X7 (Date of Termination)

When only statements of financial position are presented, the date of the statements would appear on the title page as follows:

December 31, 20X7 and 20X6

Annual Reports and Loan Proposals

Occasionally, the term "Financial Statements" does not adequately represent the contents of the package and, thus, should not be used on the cover or title page. When financial statements are bound with nonfinancial data (prepared either by the accountant or the nonprofit organization), a title such as "Annual Report" may be more appropriate.

As an example, an annual report that includes audited comparative financial statements for 20X7 and 20X6 and supplementary financial information could include a cover or title page as follows:

ABC ORGANIZATION

ANNUAL REPORT

Year Ended December 31, 20X7

Notice that the period covered is 20X7 (the annual report period), although the report includes financial statements of several periods. Alternatively, the title and report period could be combined by using "20X7 Annual Report."

When pro forma (or prospective) financial statements and historical financial statements are bound together for a loan proposal, the cover or title page might appear as follows:

GREENWOOD SCHOOL, INC.

LOAN PROPOSAL

November 17, 20X7

Generally, the date that the loan proposal was completed would be used on the title page because both historical and prospective financial statements covering different periods may be presented.

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When to Use It

If the financial report consists of a single financial statement, the accompanying notes, and an accountant's report, a table of contents is generally not useful to the reader and, therefore, should not be presented. However, longer financial reports, especially those that include supplementary information, should include a table of contents.

Heading

The heading should only use the term "TABLE OF CONTENTS." The title page has properly introduced the contents page and, thus, presentation of a complete heading is not necessary. In addition, production of the table of contents is simpler when the heading is limited. Note that in this course, headings are blocked on the left margin and are in "all caps."

Other Format Policies

The column heading "Page No." is used to identify the page references. Best practices suggest listing only the first page on which an item appears rather than all pages covered by the item.

Items listed should be grouped into the following major sections:

a. ACCOUNTANT'S (OR AUDITOR'S) REPORT

b. FINANCIAL STATEMENTS

c. SUPPLEMENTARY INFORMATION

Each word of the major sections should be typed in all capital letters (for example, FINANCIAL STATEMENTS). The titles of financial statements and supplementary schedules should appear exactly as shown on the page headings of the statements. They should be typed with the first letter of each word capitalized under the appropriate major section. Skip lines *between* and *within* each major section. The title of each financial statement should be indented two spaces from the left margin.

Illustrations of the Table of Contents

The following illustrates how to apply the preceding policies when a single accountant's review report covers both the financial statements and the other financial information of another nonprofit organization:

TABLE OF CONTENTS

	Page No.
INDEPENDENT ACCOUNTANT'S REVIEW REPORT	1
FINANCIAL STATEMENTS	
Statements of Financial Position	2
Statements of Activities	3
Statements of Cash Flows	4
Notes to Financial Statements	5
SUPPLEMENTARY INFORMATION	
Schedules of General and Administrative Expenses	9

If separate accountant's review reports are presented for the financial statements and the supplementary information, the following would be an appropriate presentation for a voluntary health and welfare organization:

TABLE OF CONTENTS

	Page No.
INDEPENDENT ACCOUNTANT'S REVIEW REPORT ON FINANCIAL STATEMENTS	1
FINANCIAL STATEMENTS	
Statements of Financial Position	2
Statements of Activities	3
Statements of Functional Expenses	4
Statements of Cash Flows	5
Notes to Financial Statements	6
INDEPENDENT ACCOUNTANT'S REVIEW REPORT ON SUPPLEMENTARY INFORMATION	10
SUPPLEMENTARY INFORMATION	
Schedules of Other Income	11

PRESENTATION OF THE ACCOUNTANT'S REPORT

General

The appropriate wording of the accountant's or auditor's report is beyond the scope of this course. *PPC's Guide to Compilation and Review Engagements* provides reporting guidance and illustrative accountant's reports for compilation and review engagements. *PPC's Guide to Auditor's Reports* and *PPC's Guide to Audits of Nonprofit Organizations* provide reporting guidance and illustrative auditor's reports for audit engagements.

SSARS No. 21.SSARS No. 21, *Statements on Standards for Accounting and Review Services: Clarification and Recodification*, superseded all existing SSARS, other than SSARS No. 14. The reporting-related changes in SSARS No. 21 included the following:

- Practitioners no longer have the option to perform management-use-only compilation engagements in which no report is issued.
- A new level of service, the financial statement preparation service, was introduced, which allows practitioners, if they are engaged to do so, to prepare financial statements that may be given to third parties and not report on those financial statements.
- Compilation and review report language was changed, and inclusion of the city and state in which the practitioner practices is required.

AR-C 70 allows the accountant to prepare financial statements without issuing an accountant's report. To avoid any inappropriate reliance on the accountant's work, AR-C 70.14 requires each page of the financial statements to include a statement indicating no assurance has been provided on the financial statements. Best practices indicate that this will most commonly be done with the use of a legend with wording such as, "No assurance is provided on these financial statements."

SSARS No. 23. In October 2016, the ARSC issued SSARS No. 23, *Omnibus Statement on Standards for Accounting and Review Services—2016*. The reporting-related changes in SSARS No. 23 became effective upon issuance and include the following:

- Harmonizes the guidance for compilation engagements in AR-C 80 with respect to the requirement that the accountant's compilation report include the signature of the accountant or the accountant's firm with the comparable requirement for review engagements in AR-C 90.
- Clarifies that the accountant is required to disclose known departures from the applicable financial reporting framework in the accountant's compilation report and that when the accountant becomes aware of a material departure and the financial statements are not revised, the accountant is required to consider whether modification of the report is adequate to disclose the departure.
- Revises the accountant's reporting responsibilities when supplementary information accompanies reviewed financial statements and the accountant's review report on those financial statements.

This course incorporates the guidance, as applicable, in SSARS No. 23. *PPC's Guide to Compilation and Review Engagements* provides extensive guidance on the SSARS. In addition, guidance on the financial statement preparation service is included in *PPC's Guide to SSARS Preparation Engagements*.

Nonprofit Organization Accountants

Lack of independence precludes nonprofit organization accountants from including an audit report or a review report with financial statements they prepare for their employer; but, can they issue a compilation report (provided their lack of independence is disclosed)? The answer depends on whether the CPA is *a member in public practice or a member in business* as defined by the AICPA's Professional Code of Conduct. (ET 0.400). *Public practice* is defined as the performance of professional services by a member or a member's firm for a client, and the definition

of *client* specifically excludes a member's employer. In addition, the definition of a *member in business* includes a member who is employed by, is under contract to, or volunteers for a nonprofit organization. Thus, an accountant employed by a nonprofit organization is not a member in public practice in his or her employee role, the SSARS do not apply, and the member may not issue a compilation report.

There may be less common situations in which the determination of whether a CPA is a *member in business* or in *public practice* is not as clear. For application guidance in these situations, see *PPC's Guide to SSARS Preparation Engagements* if the CPA is engaged to prepare financial statements (AR-C 70) or *PPC's Guide to Compilation and Review Engagements* if the CPA is engaged to compile financial statements (AR-C 80). These situations will be rare, and thus nonprofit organization accountants will generally not issue an accountant's report.

The AICPA's *Code of Professional Conduct* has requirements in Section 2 that relate specifically to *members in business.* This section covers various topics, including requirements on integrity and objectivity, ethical behavior, compliance with standards and accounting principles, as well as acts discreditable. ET 2.130.030 requires a member to maintain integrity and objectivity and that the member be candid and not knowingly misrepresent facts or fail to disclose material facts to the employer's external accountant. ET 2.130.020 discusses differences of opinion between a member and his or her supervisor or another member of the organization and the steps a member must take if he or she has a disagreement relating to preparing financial statements or recording transactions. ET 2.130.010 discusses examples of knowingly misrepresenting facts, which violate the integrity and objectivity rule.

Letterhead

There is no requirement that the accountants' report be printed on the firm's letterhead. Consequently, the report can be presented on plain letterhead. However, best practices indicate that it is generally preferable for the accountants' report to be presented on the firm's letterhead. The use of firm letterhead adds a professionalism to the financial statements. Practitioners may use software packages that generate the appropriate accountant's report, which may be difficult to print on firm letterhead. In those situations, accountants may enhance the professional appearance of the product by binding the software-generated statements and report in report covers containing the firm name and logo. Alternatively, the practitioner may take the system-generated report and photocopy it onto the firm's letterhead if it is difficult to have the system print the report directly onto the firm's letterhead.

Report Heading

A report on audited or reviewed financial statements is required to have a title that includes the word *independent*, according to AU-C 700.23 and AR-C 90.39, respectively. AR-C 80 does not require a title for compilation reports; however, accountants may choose to include one. If the accountant gives the report a title, it should only include the word independent when applicable.

Address

Generally, the accountant's or auditor's report should be addressed to the Board of Directors or Trustees. Reports are not intended as letters. Accordingly, addresses that include street names and zip codes generally are not appropriate. Many firms also omit the city and state from the address of the report, especially when the report is addressed to directors who are widely dispersed. Illustrations of appropriate addresses follow:

To the Board of Directors
ABC Organization
Philadelphia, Pennsylvania

To the Board of Trustees
ABC Organization

The Board of Directors and Trustees
ABC Organization
Chicago, Illinois

Signature

Compilation, review, and audit reports must be signed. It is common practice to omit complimentary closings, such as "Sincerely" or "Very truly yours," and to sign the report with the firm's signature rather than an individual signature unless the accountant is a sole practitioner. Those practices add formality to the accountant's report. However, certain state boards require the individual signature of a shareholder if the firm is a professional corporation. Likewise, certain regulatory agencies require the signature of the individual engagement partner.

The signature should appear on a line approximately midway between the end of the report and the date. Because the addressee of the accountant's report is blocked at the left margin, begin the signature on the left margin to provide a balanced appearance. If firm letterhead is used, there is no need to also type the firm name below the signature.

Date of Report

The date of the report affects the responsibility assumed by the accountant or auditor. Selection of the appropriate date is discussed in *PPC's Guide to Compilation and Review Engagements* and *PPC's Guide to Auditor's Reports*. The format of the date is straightforward unless dual dating is necessary. The date should appear beginning at the left margin to provide a consistent block format. Examples of date formats are as follows:

March 3, 20X7

March 3, 20X7 (except as to Note D, which is as of April 20, 20X7)

Reference to Office Location

AU-700.40 requires the auditor's reports to name the city and state where the auditor practices. AR-C 80.17 and AR-C 90.39 both indicate that compilation and review reports should include the city and state in which the accountant practices. For audit reports printed on firm letterhead that indicates the city and state, best practices indicate that information would not have to be repeated after the signature. This practice is consistent with the nonauthoritative guidance at Q&A 9100.07 of the Questions and Answers. For compilation and review reports, AR-C 80.A26 and AR-C 90.A77 indicate that the city and state may be indicated on the letterhead. If the office location is not included in the letterhead, it should appear at the left margin on the line immediately above the date, illustrated as follows:

Fort Worth, Texas
March 31, 20X1

If the firm has more than one office, it should indicate in the report the office responsible for the engagement. The office location should appear at the left margin on the line immediately above the date. Some multioffice local firms have a centralized review function and are located close enough geographically to use personnel interchangeably. In those cases, the office location used should be the office where the engagement partner or stockholder resides. Note also that certain regulatory agencies require the accountant's report to indicate the address of the firm even if the firm has only one office.

BASIC FINANCIAL STATEMENTS

What Are They?

The basic financial statements generally included in the typical financial report of a nonprofit organization are as follows:

- A statement of financial position.
- A statement of activities.

- Before the effective date of ASU 2016-14, a statement of functional expenses (required for voluntary health and welfare organizations only).

- A statement of cash flows.

The typical presentation also includes descriptions of accounting policies and notes to financial statements. This section discusses some style considerations common to all statements.

Heading Financial Statements

Each financial statement should use a heading that includes the legal name of the organization, the title of the specific statement, and the date or period covered.

ABC ORGANIZATION
STATEMENT OF FINANCIAL POSITION
March 31, 20X7

ABC ORGANIZATION
STATEMENTS OF ACTIVITIES
Years Ended December 31, 20X7 and 20X6

Format such as the placement of the heading and capitalization should be consistent with the style used for other parts of the financial report. The examples above use a block style beginning at the left margin with the name of the organization and the statement title in "all caps" and the date or period covered in "initial caps."

The spacing between the last line of the financial statement heading and the first line of the column headings, e.g., 20X7, or the first caption in single-period financial statements, e.g., ASSETS, will vary with the length of the statement.

Different Levels of Service

When issuing comparative financial statements, the level of service provided for the periods presented may differ. Unaudited financial statements presented in comparative form with audited financial statements must be clearly marked to show their status, which may be done parenthetically either in the statement headings or column headings. Some accountants follow a similar policy when the financial statements for all periods are unaudited but the level of service differs. The following illustrates disclosing the level of service in the financial statement headings when one period has been compiled and another has been reviewed.

ABC ORGANIZATION
STATEMENTS OF FINANCIAL POSITION
December 31, 20X7 (Reviewed)
and 20X6 (Compiled)

If one period is *audited* and the other is *unaudited*, disclosure in the heading would be as follows:

ABC ORGANIZATION
STATEMENTS OF FINANCIAL POSITION
December 31, 20X7 (Audited)
and 20X6 (Unaudited)

Summarized Comparative Information

Nonprofit organizations sometimes choose to present only summarized comparative information that does not include the minimum information required by GAAP. For example, a voluntary health and welfare organization may present a statement of functional expenses that provides prior year expense amounts in total, rather than separated into program and supporting services. If comparative information is not sufficient to constitute a presentation in

accordance with GAAP, organizations should use financial statement titles or column headings that appropriately describe the summarized prior year information, such as the following:

> ABC ORGANIZATION
> STATEMENT OF FUNCTIONAL EXPENSES
> Year Ended 20X7 with Comparative Totals for the Year Ended 20X6
>
> or
>
> ABC ORGANIZATION
> STATEMENT OF FUNCTIONAL EXPENSES
> Year Ended 20X7 with Summarized Financial Information for the Year Ended 20X6

Referencing Notes

Generally accepted accounting principles do not require the financial statements to be referenced to the notes. However, it is common practice to do so, and it is recommended that each of the financial statements be referenced to the notes, either by reference to specific items in the financial statements (a practice followed by many firms in the interest of clarity), or by a *general* reference to the notes (usually shown at the bottom of the page). However, GAAP requires the caption for "Collections" to have a reference to a note to the financial statements that describes the collections. In all other instances, the use of a general reference reduces production time and eliminates the likelihood of referencing errors. Examples of general references to the notes follow:

> See accompanying notes.
>
> See notes to financial statements.
>
> The accompanying notes are an integral part of these financial statements.
>
> See notes to combined financial statements.

If only one financial statement is presented, the reference might refer to the statement by name rather than use of a general reference to the "financial statement." For example, when only a statement of financial position is presented, the reference could appear as follows:

> See notes to statement of financial position.

Also, if an individual financial statement extends beyond a single page, only the last page should include a reference to the notes.

While any of the preceding references are acceptable, using "See accompanying notes" is recommended because it may be used unmodified for almost any combination of financial statements. Start the reference at the left margin and capitalize and punctuate the reference as a sentence.

When a note that is presented directly on the face of a financial statement also applies to other financial statements, a reference such as "See Note A on the statement of financial position" should be made on those statements.

When *selected information* instead of all notes is presented in compiled financial statements, the financial statements should contain a reference to the selected information and the accountant's report, such as the following:

> See accompanying selected information and accountant's report.

Referencing the Accountant's or Auditor's Report

Audit literature does not require a reference to the auditor's report on each page of the financial statements. AR-C 80.A24 and AR-C 90.A66 indicate that references to the accountant's report in compiled and reviewed financial statements are optional, but they minimize the possibility of a user placing unintended reliance on the financial statements where the accountant's report gets separated from the financial statements.

If the accountant chooses to include a reference to the notes as discussed in paragraphs above, the reference can be expanded to include both the notes and the accountant's report. Although not required, this is a common practice and recommended that accountants include a reference, such as the following, when the financial statements include notes:

> See accompanying notes and accountant's compilation report.

Column Headings

Because the statement headings include the date or period covered, column headings are not necessary in single-period financial statements.

ABC ORGANIZATION
STATEMENT OF ACTIVITIES
Year Ended December 31, 20X7

REVENUES, GAINS, AND OTHER SUPPORT	$ 176,000

When comparative statements are presented, the column headings should be identified by year, as illustrated by the following:

	20X7	20X6
ASSETS		
Cash	$ 32,000	$ 28,000

When the periods presented cover a different number of months, for example, three months and six months ended June 30, 20X7, using the year as the column heading will not properly distinguish the two periods. The following heading is suggested in such circumstances:

ABC ORGANIZATION
STATEMENTS OF ACTIVITIES
Three Months and Six Months
Ended June 30, 20X7

	Three Months	Six Months
TOTAL EXPENSES	$ 1,057,235	$ 2,327,624

If one period covered is audited and the other is unaudited, some practitioners indicate which column of data in the financial statements is unaudited, such as in the following example:

ABC ORGANIZATION
STATEMENTS OF FINANCIAL POSITION
December 31, 20X7 and 20X6

	20X7	20X6 (Unaudited)
ASSETS		
Cash	$ 75,000	$ 53,000
Unconditional promises to give	220,000	195,000

Each column heading should be centered over the column and underlined with the underline extending the width of the column. Generally, however, it is preferable for the columns to be approximately the same width. Under that policy, if headings are unusually long, they should be presented on two or more lines. When comparative financial statements are presented, the columns for each year should be the same width, i.e., the underline should be the same length in each column. A line should be skipped between the last line of the column headings and the first caption of the statement.

NOTES TO FINANCIAL STATEMENTS

General

Notes are an integral part of financial statements. They should be used to present material disclosures required by generally accepted accounting principles that are not otherwise presented on the face of the statements. Notes for comparative financial statements generally should cover all periods presented to the extent they remain relevant.

As an integral part of the financial statements, the notes are the responsibility of the nonprofit organization although the practitioner may assist with, or totally prepare, the statements and notes. The wording of the notes should follow that principle, and such words as "we," "us," "client," and "our" should not be used, so as to avoid any implication of reference to the CPA. Terms such as "the Organization," "the Entity," or "Management," are more appropriate ways of referring to the client.

Format

Generally, notes are accumulated and presented as a separate page or pages after the basic financial statements. Arrange the notes in the same order as the amounts in the statements to which they relate. Each note should bear a descriptive caption that corresponds to a financial statement caption. In using that approach, the following additional guidelines are recommended:

- If a note addresses items in more than one statement, its placement would be determined by the first statement that would ordinarily be encountered. For example, a note providing disclosure of assets and liabilities under capital leases and rent expense under operating leases would be placed with asset notes.
- Commitments and contingencies liabilities notes would be placed between liabilities and equity notes.
- A subsequent events note would be the last note.

When there are only a few notes, it may be appropriate to present the notes at the bottom of the first financial statement to which they refer. If the note also applies to other statements, a reference to the note (such as "See Note A on the statement of financial position") should be made at the bottom of those statements.

Title

When the notes are presented on separate pages rather than on the face of the statements, the first page of the notes should be appropriately titled as follows:

ABC ORGANIZATION
NOTES TO FINANCIAL STATEMENTS

The format and capitalization policy of the note heading should be consistent with that used for heading the financial statements.

Use the caption "NOTES TO FINANCIAL STATEMENTS" with no date because notes relate to the accompanying statements, each of which is dated. However, in practice, some firms present the statement of financial position date in the caption.

When a single statement is presented and notes are presented on separate pages, the title should include the name of the statement rather than the general term "financial statements." For example:

ABC ORGANIZATION
NOTES TO STATEMENTS OF FINANCIAL POSITION

Financial Statements That Omit Substantially All Disclosures. Financial statements that omit substantially all disclosures may be compiled by the accountant provided the accountant's report discloses the omission, and the omission is not, to his or her knowledge, undertaken to mislead those who might reasonably be expected to use the financial statements. AR 80.27 states the accountant's report must disclose the omission in a separate paragraph.

When the organization wishes to include disclosures about only a few matters in the form of notes to the compiled financial statements, such disclosures should be labeled as follows:

ABC ORGANIZATION
SELECTED INFORMATION—Substantially All Disclosures Required by
Accounting Principles Generally Accepted in the United States of America Are Not Included

However, AR-C 80.28 states that when an entity includes substantially all disclosures, but omits one or more disclosures required by the applicable financial reporting framework, the financial statement disclosures should *not* be labeled as illustrated in the preceding paragraph. Instead, accountants should consider the omission as a departure from the applicable financial reporting framework in the accountant's report, and the nature and effects of the departure, if known, should be disclosed.

The guidance for accountants discussed in the preceding paragraph when the entity presents financial statements that omit substantially all disclosures is applicable only to compilation engagements. Since the omission of material disclosures is a departure from the applicable financial reporting framework, in a review engagement the accountant's review report would have to be modified to include the omitted disclosures, including the effects on the financial statements, if known. Because of these reporting requirements, an accountant ordinarily would not accept an engagement to review financial statements that omit substantially all disclosures.

Heading Individual Note Captions

Start the note caption at the left margin and use the following style for headings of individual notes within the "Notes to Financial Statements" section. For example:

NOTE C—PROPERTY AND EQUIPMENT

Use letters of the alphabet to identify notes rather than numbers because they seem to soften what otherwise may appear to be an overwhelming sea of numbers. Also, the entire note caption is capitalized, which sets off the title from the text of the notes and simplifies location of specific notes.

Summary of Significant Accounting Policies

The summary of significant accounting policies is generally presented as the first note to the financial statements. GAAP requires the summary in all but unaudited interim financial statements when the entity has not changed its accounting policies since the end of the preceding year.

The caption recommended is:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

This caption appears to be the most commonly used in practice.

Generally, the summary of significant accounting policies note is divided into subsections for each specific policy or financial statement caption discussed. The format used in this course includes first letter (initial) capitalization and underlining of subcaptions.

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Activities

Estimates

Promises to Give

Property and Equipment

Referencing Accounting Standards in the Notes. FASB ASC 105-10-05-5 states that Accounting Standards Updates (ASUs), which are issued by the FASB to update the FASB Accounting Standards Codification (ASC) with new or amended guidance, are not considered authoritative in their own right. Since individual ASUs are not authoritative, best practices suggest that they generally should not be cited in disclosures to financial statements. Thus, the illustrative notes in this course follow this guideline. However, in practice some financial statement preparers refer to individual ASUs when discussing changes in accounting and disclosure requirements. Practice can be expected to evolve in this area.

SUPPLEMENTARY OR OTHER INFORMATION

General

The financial statements of a nonprofit organization often include detailed schedules, summaries, comparisons, or statistical information that is not part of the basic financial statements. That information, which is not required for a fair presentation in accordance with GAAP, is often very useful to financial statement users.

Presentation

The supplementary information schedules should be presented after the basic financial statements and notes and should ordinarily be preceded by a title page that separates the information from the basic financial statements. The title page need not repeat the organization's name and date. Use the heading "SUPPLEMENTARY INFORMATION" typed in all capital letters on a line above the center of the page.

If a separate accountant's (auditor's) report on the supplementary information is to be presented, it should follow the title page. Some practitioners feel that the title page is unnecessary as a divider when a separate accountant's report is presented. Using a title page provides a clearer break between the basic financial statements and supplementary information.

The order of presentation of supplementary schedules may vary widely but should follow some logical pattern. One such method is to present the schedules in the order in which the subject appears in the basic financial statements.

Schedule Headings

Schedule headings should include the nonprofit organization's name, the title of the schedule, and the date or period covered. The style of the headings should be consistent with the style used in heading the basic financial statements. However, the descriptive titles should clearly distinguish the schedules from the basic financial statements. The schedules should *not* be referred to as "statements" to avoid confusing them with the basic financial statements.

ABC ORGANIZATION
SCHEDULES OF JOINT COSTS
Years Ended December 31, 20X7 and 20X6

ABC ORGANIZATION
SCHEDULES OF MARKETABLE SECURITIES
December 31, 20X7 and 20X6

If schedules are comparative, the title should be plural. If a schedule for one year is presented, the title normally should be singular. However, if more than one schedule is presented on the same page, the heading "SCHEDULES" may be used.

Numbering Schedules

Some accountants prefer to number each schedule to simplify cross-referencing from the basic financial statements. Best practices suggest that the basic financial statements should not include references to supplementary schedules.

Numbering schedules may, however, facilitate identification of the other financial information in the accountant's or auditor's report. If numerous supplementary schedules are presented, numbering the schedules may enhance their usefulness. A heading for a numbered schedule is illustrated below:

ABC ORGANIZATION
SCHEDULE 1—ANALYSES OF INDIRECT COSTS
Years Ended December 31, 20X7 and 20X6

Reference to the Report

While the SSARS have no requirement for a reference to the accountant's report, some accountants believe that each supplementary schedule should include a reference to the accountant's report. AR-C 80.A43 and AR-C 90.A134 both state that the accountant may choose to include a reference to the accountant's report on each page of the supplementary information to avoid any inadvertent reliance on the supplementary information if the accountant's report were to become detached. For example, some accountants may choose to include the reference when reviewed financial statements are accompanied by supplementary schedules, which are not subjected to the accountant's review procedures as the level of service provided on the supplementary schedules is lower than that provided on the basic financial statements. An appropriate reference when the accountant's report on the supplementary information is part of the report on the basic financial statements would be:

See accountant's compilation report or See independent accountant's review report.

If a separate report on the supplementary information is presented, the reference would be:

See independent accountant's report on supplementary information.

Audit literature does not require a reference to the auditor's report to be printed on each page of the supplementary information. Thus, the auditor is not required to use such a reference when supplementary information is presented with audited financial statements.

OTHER MATTERS OF FORM AND STYLE

Continuation Pages

Continuation pages generally include a heading. For example, if a statement of activities takes two pages, each page would have an appropriate heading. It is not necessary, however, to use the word "continued," to subtotal numbers, or to otherwise cross-reference financial statements or notes that take more than one page. For example, notes to financial statements that take several pages would be presented as follows:

Example 1-1: Multipage notes to financial statements.

(First page of notes)

ABC ORGANIZATION
NOTES TO FINANCIAL STATEMENTS

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Activities

Estimates

Promises to Give

NOTE B—EQUIPMENT AND LEASEHOLD IMPROVEMENTS

NOTE C—DEBT

The Organization's long-term debt consists of the following:

Note payable in quarterly installments of $25,000, plus interest at prime plus 1%	$ 125,000

(Second page of notes)

ABC ORGANIZATION
NOTES TO FINANCIAL STATEMENTS

Installment notes payable in installments that include interest at rates ranging from 10½% to 15%	$ 100,000
Obligation under capital leases	150,000
	$ 375,000

While it is desirable for all pages to end at the same place, this often is not feasible. For example, a note may include a table that can be started toward the bottom of the page but would extend to the next page. The preparer may, therefore, have to make a trade-off between even margins and making the statements easier to understand. Accordingly, the preparer may want to consider starting the table at the top of the next page even though there is a large space at the end of the preceding page. A table within a note could also be divided at a logical point such as at a subtotal.

Dollar Signs

A dollar sign should appear before the first number in a column, before each double underlined number, and before the first number appearing in a column after a double underlined number. The dollar sign should appear at the left tab setting. The number of spaces between the dollar sign and the number will vary with the size of the number but should be no fewer than one space. The following illustrates application of the preceding policies in a supplementary schedule of expenses:

	20X7	20X6
PROGRAM SERVICES		
Instruction	$ 100,000	$ —
Auxiliary activities	75,000	70,000
Summer school	15,000	10,000
	$ 190,000	$ 80,000
SUPPORTING SERVICES		
Management and general	$ 125,000	$ 100,000
Fund-raising	75,000	70,000
Membership development	—	120,000
	$ 200,000	$ 290,000

If the column has no total, a dollar sign should be placed beside the first number only, as follows:

20X7	$ 100,000
20X8	100,000
20X9	105,200
20Y0	123,000
20Y1	126,900

Underlining and Spacing

Within statements, schedules, and notes, key totals and subtotals are presented. Underlining helps the reader follow the flow of the numbers and highlights key totals. The underline should run the full width of the column. The suggested underlining policy is described in the following paragraphs.

Each time a subtotal is drawn, the last number preceding the subtotal should be single underscored. The subtotal should follow immediately below the single underscore unless the subtotal carries a caption, for example, "TOTAL CURRENT ASSETS," in which case a line should be skipped between the single underscore and the captioned subtotal. The subtotal is followed immediately by the next number unless the subtotal is the last number of a major caption or is a captioned subtotal. Then, a line should be skipped between the subtotal and the next number.

Each time a subtotal is presented, the number above the subtotal should be single underlined. The subtotal would be followed by a line skip when it is captioned or it is the last number of the major caption. When it is a major caption subtotal, it is both preceded and followed by a line skip. For example, a subtotal of inventory would be immediately followed by prepaid expenses with no line skip before or after, while a line would be skipped after a subtotal of net property and equipment, and a line would be skipped before and after the total current assets subtotal.

Each time a grand total is presented, it should be double underlined. The lines above and below the grand total should be skipped, and the number above the grand total should be single underlined.

The preceding underlining and spacing policies are illustrated in the partial statements of financial position that follow:

GREENHAVEN, INC. (a nonprofit organization)
STATEMENTS OF FINANCIAL POSITION
December 31, 20X7 and 20X6

	20X7	20X6
CURRENT ASSETS		
Cash	$ 55,608	$ 60,274
Unrestricted unconditional promises to give	265,000	245,000
Accounts receivable, less allowances of $41,900 in 20X7 and $32,900 in 20X6	143,303	104,691
Inventories	146,149	514,698
Prepaid expenses	24,065	23,039
TOTAL CURRENT ASSETS	634,125	947,702
PROPERTY AND EQUIPMENT		
Land and land improvements	69,075	69,075
Buildings	1,120,641	1,061,714
Machinery and equipment	820,018	746,599
Construction in process	36,162	14,431
	2,045,896	1,891,819
Accumulated depreciation	(484,447)	(333,742)
	1,561,449	1,558,077
TOTAL ASSETS	$ 2,195,574	$ 2,505,779

Typically, the following numbers in the basic financial statements will be double underlined:

Statement of Financial Position

1. Total of all assets.
2. Total of all liabilities and net assets.

Statement of Activities

1. Net assets at the end of the period.

Statement of Functional Expenses

1. Total expenses.

Statement of Cash Flows

1. Cash and cash equivalents at the end of the period.

In the notes to the financial statements, the total of any tables presented should be double underlined. As an example, FASB ASC 840-20-50-2 requires disclosure of total minimum lease payments required under operating leases. The total should be double underlined, as follows:

> The following is a summary of future minimum lease payments required under the Organization's operating leases:
>
20X8	$ 83,500
20X9	69,200
20Y0	53,300
20Y1	40,500
20Y2	34,600
Later years	206,600
	$ 487,700

Tables without a total would not require double underlining. As an example, FASB ASC 470-10-50-1 requires disclosure of principal reduction required on long-term debt during the next five years; however, a total generally is not presented. As a result, no double underlining would appear in the table, as illustrated below.

> The following is a summary of principal installments due on the Organization's long-term debt during the next five years:
>
20X8	$ 100,000
20X9	100,000
20Y0	105,200
20Y1	123,000
20Y2	126,900

Any presentation of tables within the notes to the financial statements should be centered under the note to which it pertains.

Some schedules presented as other financial information show the components of financial statement items. The total, therefore, equals the financial statement element and should, accordingly, be double underlined. For

example, the total of the components of management and general expenses (corresponding to the statement of activities line item) would be double underlined, as follows:

	20X7	20X6
Advertising	$ 100,000	$ 90,000
Depreciation	75,000	70,000
Rent	50,000	40,000
Repairs and maintenance	25,000	20,000
	$ 250,000	$ 220,000

Zeros in a Column

If the number to be presented for a line item is zero, the preparer has three options:

a. Present a zero.

b. Use a dash or hyphen to represent zero.

c. Leave the space blank.

A dash is preferred because it acknowledges that a number was expected and has not been overlooked. Also, a page with numerous dashes does not appear as cluttered (or as negative) as a page full of zeros (-0-). The formatting of dashes should be consistent.

Use of Brackets

Readers of financial statements should understand the basic mathematical exercises involved in financial statements. As an example, they should understand that total expenses are usually subtracted from total revenues to arrive at the increase or decrease in net assets. Accordingly, brackets should not be used each time one number or subtotal is subtracted from another. However, it is generally appropriate to use brackets to represent negative numbers when a line, column, or subtotaled grouping includes both positive and negative numbers.

In classified statements of financial position, accumulated depreciation, the current portions of long-term debt, and net asset deficits are often bracketed as negative numbers in subtotaled groupings of otherwise positive numbers. In statements of activities, statements of functional expenses, and statements of cash flows, the use of brackets is less predictable. When using brackets, there is no need to precede the caption with the word "less" since the brackets notify the reader to subtract the number (for example, "accumulated depreciation" rather than "less accumulated depreciation").

Lines Having Both a Positive and a Negative Number

A line item may show a positive number for one year and a negative number for the other. When appropriate, the description of the line item should be revised to identify the positive and negative numbers [for example, "Increase (decrease) in net assets"]. If a reader would expect a particular description, the caption should consist of that description followed by a bracketed description of what the negative number represents. This rule applies even if the negative number appears in the current year. The following example illustrates how to apply the preceding policy when the current year has a decrease in unrestricted net assets, but the preceding year has an increase in unrestricted net assets (before the adoption of ASU 2016-14).

	20X7	20X6
UNRESTRICTED REVENUES, GAINS, AND OTHER SUPPORT	$ 43,000	$ 37,550
EXPENSES		
Program A	18,250	9,175
Program B	13,795	3,775
Program C	24,100	18,005
	56,145	30,955
INCREASE (DECREASE) IN UNRESTRICTED NET ASSETS	(13,145)	6,595
UNRESTRICTED NET ASSETS AT BEGINNING OF YEAR	11,027	4,432
UNRESTRICTED NET ASSETS (DEFICIT) AT END OF YEAR	$ (2,118)	$ 11,027

Increase and decrease captions should customarily begin with "Increase." In the caption, brackets should appear around increase or decrease as applicable. The following illustrates how to apply that policy:

	20X7	20X6
CASH FLOWS FROM OPERATING ACTIVITIES		
Change in net assets	$ (10,000)	$ 25,000
Adjustments to reconcile change in net assets to net cash provided by operating activities		
Depreciation	15,000	15,000
(Increase) decrease in accounts receivable	10,000	(20,000)
Increase (decrease) in accounts payable	17,000	(12,000)
NET CASH PROVIDED BY OPERATING ACTIVITIES	32,000	8,000

If a number is negative in both years, brackets should appear around both numbers but not in the caption. The following example illustrates this policy.

	20X7	20X6
DECREASE IN NET ASSETS	(2,800)	(1,000)
NET ASSETS AT BEGINNING OF YEAR	4,000	5,000
NET ASSETS AT END OF YEAR	$ 1,200	$ 4,000

The following example illustrates application of the preceding policy when a similar item also has both an increase and a decrease:

	20X7	20X6
CASH FLOWS FROM OPERATING ACTIVITIES		
Change in net assets	$ 10,000	$ 15,000
Adjustments to reconcile change in net assets to net cash provided (used) by operating activities		
Depreciation	5,000	5,000
(Increase) decrease in accounts receivable	(12,000)	7,000
Increase in prepaid expenses	(5,000)	(2,000)
NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES	(2,000)	25,000

Rounding

Numbers in financial statements and schedules should ordinarily be in whole dollars. Presentation of cents takes additional space without providing the reader with any useful information.

For some presentations, it may be appropriate to round higher than the nearest dollar. A common example is forecasted information for which the use of dollars implies a much greater precision than actually exists. In addition, some nonprofit organizations may find that the primary users prefer historical presentations that have been rounded to the nearest hundred dollars because they are easier for users to evaluate and discuss.

When numbers have been rounded higher than the nearest dollar, adding the parenthetical phrase "(Rounded to the Nearest Hundred Dollars)" as the last line in the page heading is appropriate, as shown in the following illustration:

> ABC ORGANIZATION
> STATEMENTS OF FINANCIAL POSITION
> December 31, 20X7 and 20X6
> (Rounded to the Nearest Hundred Dollars)

When numbers are rounded to the nearest dollar or higher, the individual rounded amounts should, nevertheless, equal the amounts of totals and subtotals. For example, rounded increase in net assets added to rounded beginning net assets should equal rounded ending net assets. Similarly, rounded components of an expense account should add to the total.

Whether the financial statements are rounded is a matter of style, it is good practice to round amounts that represent estimates such as the allowance for doubtful accounts and unrelated business income tax provisions when computed before the tax return is prepared.

It is appropriate to round amounts presented in the notes to the financial statements. When an amount has been rounded in the notes, best practices recommend preceding it with the word "approximately" to notify the reader. As an example, a note disclosing donated services not recorded in the financial statements might read:

> Although no amounts have been reflected in the financial statements for donated services, management estimates the fair value of the services to be approximately $63,000 and $43,000 for the years ended June 30, 20X7 and 20X6, respectively.

Notes designed to balance to amounts presented in the statements should, of course, follow the same rounding policy as used for the amount in the statement.

Use of Percentages

Presentations of percentages often provide useful information. The percentages normally should show no more than tenths and generally should be in whole numbers. Percentages that show hundredths clutter the presentation and normally will be rounded by readers in their evaluation.

The adoption of a consistent policy for presenting percentages in narrative presentations, such as debt disclosures, results in a better appearance. Since most debt agreements express uneven percentages using fractions, all such percentages included in narrative presentations should be presented using fractions. The following illustrates the preceding policy:

> The note is secured by equipment and bears interest at a rate that fluctuates between a minimum of 10% and a maximum of prime plus 1/4%.

Page Numbers

Whenever a table of contents is used, the financial statements should, of course, have page numbers. Every page in the financial report should have a number, except for the table of contents and the page introducing the other financial information. The pages should be numbered consecutively, and the page number should be centered two or three lines from the bottom of the page. Page numbers are not necessary when a table of contents is not used.

SELF-STUDY QUIZ

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

1. If it is not obvious from the name of the organization that it is a nonprofit entity, some accountants will make optional disclosures to make the users of the financial reports aware of that fact. Where in the financial report is the disclosure required that the organization is a nonprofit entity?

   a. Accountant's or auditor's report.

   b. Basic financial statements and notes.

   c. Title (or cover) page.

   d. Table of contents.

2. When nonfinancial data is bound and presented with the nonprofit financial statements, what would be an appropriate title for the financial report?

   a. Supplementary information.

   b. Pro forma financial statements.

   c. Annual report.

   d. Consolidated financial statements.

3. Can an accountant prepare an audit report for his or her nonprofit organization employer?

   a. Yes, if the CPA is in the practice of public accountancy.

   b. Yes, if the CPA is a member in business.

   c. No, a CPA cannot issue an audit report for his or her employer.

4. Sarah, a CPA with the accounting firm of Tidwell and James, is preparing the auditor's report that will be included in the financial report for The Verla Vance Foundation. Which of the following is true?

   a. The auditor's report must be printed on the foundation's letterhead.

   b. The title of the auditor's report must include the word *independent.*

   c. The auditor's report is generally not signed.

   d. The date of the auditor's report is always the date of the Statement of Financial Position.

5. Carter, an accountant with the firm of Stanley & Parker CPAs, prepares the financial statements for The Tulbert Organization, a nonprofit entity. The notes are being presented on separate pages after the basic financial statements. How should the notes be titled?

   a. No title is necessary.

   b. The notes should be titled NOTES TO FINANCIAL STATEMENTS.

   c. The notes should be titled THE TULBERT ORGANIZATION with NOTES TO FINANCIAL STATEMENTS on the following line.

   d. The notes should be titled THE TULBERT ORGANIZATION with NOTES TO STATEMENTS OF FINANCIAL POSITION on the following line.

6. Which of the following is correct regarding supplementary information presented in the financial statements of a nonprofit organization?

   a. The supplementary information should be separated from the basic financial statements.

   b. A separate accountant's or auditor's report should not be presented on supplementary information.

   c. Information included in the supplementary information of the financial statements is required by GAAP.

   d. For supplementary information, the headings of schedules must include the word "statement."

7. As a matter of general form and style, which of the following is **not** an appropriate way to present a zero in one of the basic financial statements?

   a. Leave the space blank.

   b. Use the word "zero."

   c. Presenting a zero.

   d. Use a dash or hyphen.

8. Which of the following is generally a form and style best practice?

   a. Numbers in financial statements should be rounded to the second decimal space.

   b. All pages in the financial report should be numbered.

   c. Percentages in narratives should be in whole numbers.

   d. Generally, brackets around numbers indicate a negative number.

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. If it is not obvious from the name of the organization that it is a nonprofit entity, some accountants will make optional disclosures to make the users of the financial reports aware of that fact. Where in the financial report is the disclosure required that the organization is a nonprofit entity? **(Page 144)**

   a. Accountant's or auditor's report. [This answer is incorrect. Although some accountants parenthetically disclose that the entity is a nonprofit on the accountant's or auditor's report, that disclosure is optional.]

   b. Basic financial statements and notes. [This answer is correct. Per best practices, the critical disclosure is in the accounting policies note. Therefore, the basic financial statements and notes would be the best answer choice.]

   c. Title (or cover) page. [This answer is incorrect. Although some accountants disclose that parenthetically on the title page, disclosure that the entity is a nonprofit on the title page of the financial report is optional.]

   d. Table of contents. [This answer is incorrect. The accountant or auditor would not disclose that in the table of contents.]

2. When nonfinancial data is bound and presented with the nonprofit financial statements, what would be an appropriate title for the financial report? **(Page 147)**

   a. Supplementary information. [This answer is incorrect. The financial report may include a sections titled "Supplementary Information;" however, that would not be an appropriate title for the entire report.]

   b. Pro forma financial statements. [This answer is incorrect. When pro forma (or prospective) financial statements and historical financial statements are bound together for a loan proposal, an appropriate title may be "Loan Proposal."]

   c. Annual report. [This answer is correct. When financial statements are bound with nonfinancial data (prepared either by the accountant or the nonprofit organization), a title such as "Annual Report" may be more appropriate.]

   d. Consolidated financial statements. [This answer is incorrect. "Consolidate Financial Statements" would be appropriate only when consolidate financial statements are presented, not when nonfinancial data is presented with the nonprofit financial statements.]

3. Can an accountant prepare an audit report for his or her nonprofit organization employer? **(Page 149)**

   a. Yes, if the CPA is in the practice of public accountancy. [This answer is incorrect. Public practice is defined as the performance of professional services by a member for a client. The definition of client excludes a member's employer. Therefore the CPA cannot be a member in public practice.]

   b. Yes, if the CPA is a member in business. [This answer is incorrect. A member of business definition includes a member who is employed by a nonprofit organization. Thus the CPA employed by the nonprofit is not a member in public practice and SSARS do not apply. In addition, the CPA may not issue a compilation report.]

   c. No, a CPA cannot issue an audit report for his or her employer. [This answer is correct. Because of the lack of independence, nonprofit organization accountants cannot issue an audit report or review report with financial statements they prepare for their employer. However, they may be able to issue a compilation report.]

4. Sarah, a CPA with the accounting firm of Tidwell and James, is preparing the auditor's report that will be included in the financial report for The Verla Vance Foundation. Which of the following is true? **(Page 150)**

   a. The auditor's report must be printed on the foundation's letterhead. [This answer is incorrect. The report may be presented on the CPA firm's letterhead or on plain letterhead, not the foundation's letterhead. The use of firm letterhead rather than plain letterhead adds a more professional appearance to the financial statements.]

   b. The title of the auditor's report must include the word *independent.* [This answer is correct. A report on audited or reviewed financial statements is required to have a title that includes the word *independent,* according to AU-C 700.23 and AR-C 90.39, respectively.]

   c. The auditor's report is generally not signed. [This answer is incorrect. Compilation, review, and audit reports must be signed.]

   d. The date of the auditor's report is always the date of the Statement of Financial Position. [This answer is incorrect. The date of the report affects the responsibility assumed by the accountant or auditor. For an audit, the date should not be earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion. Therefore, the date must be later than the date of the Statement of Financial Position.]

5. Carter, an accountant with the firm of Stanley & Parker CPAs, prepares the financial statements for The Tulbert Organization, a nonprofit entity. The notes are being presented on separate pages after the basic financial statements. How should the notes be titled? **(Page 155)**

   a. No title is necessary. [This answer is incorrect. When there are only a few notes, it may be appropriate to present the notes at the bottom of the first financial statement to which they refer. A title would not be necessary. However, in this scenario, the notes are presented on separate pages rather than on the face of the statements. Therefore, a title is needed.]

   b. The notes should be titled NOTES TO FINANCIAL STATEMENTS. [This answer is incorrect. The title should include the name of the organization.]

   c. The notes should be titled THE TULBERT ORGANIZATION with NOTES TO FINANCIAL STATEMENTS on the following line. [This answer is correct. When the notes are presented on separate pages, the first page of the notes should be titled THE TULBERT ORGANIZATION with NOTES TO FINANCIAL STATEMENTS on the following line. The format and capitalization policy should be consistent with that used for heading the financial statements.]

   d. The notes should be titled THE TULBERT ORGANIZATION with NOTES TO STATEMENTS OF FINANCIAL POSITION on the following line. [This answer is incorrect. When a single statement is presented and notes are presented on separate pages, the title should include the name of the statement rather than the general term "financial statements." However, more than one statement is being presented in this scenario.]

6. Which of the following is correct regarding supplementary information presented in the financial statements of a nonprofit organization? **(Page 157)**

   a. The supplementary information should be separated from the basic financial statements. [This answer is correct. The supplementary information schedules should be presented after the basic financial statements and notes and should ordinarily be preceded by a title page that separates the information from the basic financial statements.]

   b. A separate accountant's or auditor's report should not be presented on supplementary information. [This answer is incorrect. A separate accountant's (auditor's) report on supplementary information can be presented when appropriate.]

c. Information included in the supplementary information of the financial statements is required by GAAP. [This answer is incorrect. The information included in the supplementary information section is not information required for a fair presentation in accordance with GAAP. However, it is often very useful to financial statement users.]

d. For supplementary information, the headings of schedules must include the word "statement." [This answer is incorrect. The heading "schedule" may be used. The schedules should not be referred to as "statements" to avoid confusing them with the basic financial statements.]

7. As a matter of general form and style, which of the following is **not** an appropriate way to present a zero in one of the basic financial statements? **(Page 162)**

a. Leave the space blank. [This answer is incorrect. Leaving the space blank is one of the generally approved choices.]

b. Use the word "zero." [This answer is correct. Typing "zero" in a numeral field would not be the best presentation.]

c. Presenting a zero. [This answer is incorrect. Typing a number zero is commonly used.]

d. Use a dash or hyphen. [This answer is incorrect. Using a dash or hyphen is a commonly used and is be preferable because it acknowledges that a number was expected and has not been overlooked.]

8. Which of the following is generally a form and style best practice? **(Page 162)**

a. Numbers in financial statements should be rounded to the second decimal space. [This answer is incorrect. Numbers in financial statements should ordinarily be in whole dollars.]

b. All pages in the financial report should be numbered. [This answer is incorrect. Whenever a table of contents is used, the financial statements should have page numbers. Page numbers are not necessary when a table of contents is not used.]

c. Percentages in narratives should be in whole numbers. [This answer is incorrect. Generally, percentages should show no more than tenths and generally should be in whole numbers. However, when the financial report presents items with many uneven percentages, percentages included in narrative presentations should be presented using fractions.]

d. Generally, brackets around numbers indicate a negative number. [This answer is correct. It is generally appropriate to use brackets to represent negative numbers when a line, column, or subtotaled grouping includes both positive and negative numbers.]

Lesson 2: The Statement of Functional Expenses

INTRODUCTION

Before the effective date of ASU 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities,* FASB ASC 958-720-45-2 requires all organizations to present information about expenses (but not losses) by their functional classification in either the statement of activities or the notes to the financial statements to assist users in assessing the organization's service efforts. *Functional classification* is a method of grouping expenses according to the purpose for which they were incurred. The primary functional classifications are program services and supporting activities. FASB ASC 958-205-05-5 also requires voluntary health and welfare organizations to present a statement of functional expenses, which shows information about natural and functional expense classifications in a matrix format, as a basic financial statement. FASB ASC 958-720-45-16 encourages, but does not require, other types of nonprofit organizations to present information about their natural expense classifications as well.

Although voluntary health and welfare organizations are the only nonprofit organizations required to present a statement of functional expenses as a basic financial statement, large donors to other nonprofit organizations often request the type of information contained in a functional expense statement. In addition, the Audit Guide, Paragraphs 3.42–.43, encourages nonprofit organizations supported by the general public to present a statement of functional expenses either as a basic financial statement or in the notes to the financial statements. The Audit Guide indicates that nonprofit organizations receiving contributions of 20 to 30 percent or more of total revenue and support may be presumed to be supported by the general public. Therefore, it is recommended that nonprofit organizations that are not required to present a statement of functional expenses consider including a schedule of functional expenses as a supplementary schedule to the financial statements. Alternatively, such organizations may voluntarily present the statement as part of the basic financial statements. In either case, the information required to prepare that schedule or statement should be readily available since all nonprofit organizations are required to provide information about expenses reported by their functional classification. Therefore, any allocation of expenses, such as salaries or occupancy, to various program and supporting services reflected on a schedule or statement of functional expenses would have already been completed. As a best practice, the schedule of functional expenses should be prepared in the same matrix format as the statement of functional expenses required for voluntary health and welfare organizations.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize the authoritative guidance and form and presentation considerations as they relate to preparing a nonprofit's statement of functional expenses.

Statement or Schedule of Functional Expenses

A statement or schedule of functional expenses shows how the natural expense classifications are allocated to significant program and supporting services. It is a detailed analysis of the expense portion of the statement of activities in a matrix format. Natural expense classifications include such items as salaries, rent, electricity, interest expense, depreciation, professional fees, and insurance. The level of detail (i.e., the number of natural expense classifications into which total expenses are broken down) may vary depending on the nature and complexity of the organization's activities. Generally, the level of detail should provide the reader an understanding of the nature of the expenses incurred in carrying out the programs and activities of the organization.

FASB ASC 958 distinguishes between expenses and losses. All expenses are required to be included in a statement of functional expenses, while losses are not. Expenses result from a nonprofit organization's ongoing major or central activities; losses result from peripheral or incidental transactions and from events and circumstances largely beyond the control of the organization. For example, unrealized losses on investments or a loss from a fire would not be included in a statement or schedule of functional expenses. Neither would expenditures related to an occasional fund-raising activity that is considered a peripheral transaction if its receipts and related expenditures are reported net in the statement of activities. Another example is the change in the value of split-interest agreements. Certain events

can cause a nonprofit organization to record a debit to the statement of activities relating to split-interest agreements. This change in the value of split-interest agreements is not considered an expense; it has more of the characteristics of a loss. Therefore, the change in the value of split-interest agreements is not required to be included on the statement of functional expenses. However, expenses related to a senior citizens' center cafeteria that is considered an ongoing or central activity would be included in a statement or schedule of functional expenses.

If a statement or schedule of functional expenses is presented, it should report *all* expenses, regardless of where they are classified on the statement of activities. In the senior citizen's center cafeteria example, the cost of sales of the cafeteria may be reported in the revenue section of the statement of activities as a direct deduction from the related revenues. In that case, the individual components of cost of sales (e.g., salaries and food) would be reflected in the statement or schedule of functional expenses by their natural expense classifications. Cost of sales would generally be reported as a separate function; that is, as either a separate program service or supporting service, depending on the major activities of the organization. Also, any nonoperating expenses broken out on a statement of activities with an intermediate measure of operations should be included in the statement or schedule of functional expenses.

FORM AND PRESENTATION CONSIDERATIONS

Title and Heading

In current practice, the most widely used title is "statement of functional expenses" for voluntary health and welfare organizations that are required to include the statement as one of the required financial statements. FASB ASC 958-205-05-5 also refers to the statement by that same title. If the organization is not required to present the statement as a basic financial statement and elects to provide the information in a supplementary schedule, the most widely used title is "schedule of functional expenses." Because those titles are the ones most widely used in practice, they are the titles used throughout this course.

Specialized Titles. Some situations require a specialized title. For example, a statement presented on a comprehensive basis of accounting other than GAAP must have a different title to distinguish it from a GAAP presentation. Sample titles that can be used if the statement is presented on a comprehensive basis of accounting other than GAAP include "statement of functional expenses—cash basis" or "statement of functional expenses—tax basis."

Heading. In addition to the statement title, the heading of the statement of functional expenses should include the legal name of the organization and the period or periods as of which the statement is presented. For example, a one-year presentation might be headed as follows:

> ABC Organization
> Statement of Functional Expenses
> Year Ended December 31, 20X7, with
> Comparative Totals for 20X6

If the information is presented as a supplementary schedule, a two-year presentation might be headed as follows:

> ABC Organization
> Schedules of Functional Expenses
> Years Ended December 31, 20X7 and 20X6

Format

Other than noting it should be in a matrix format and should report information about expenses by their functional classification as well as their natural expense classification, FASB ASC 958-205–45.6, does not prescribe any specific format or provide an illustrative example for a statement of functional expenses. The following paragraphs discuss format considerations for the statement or schedule of functional expenses.

Classification of Expenses. Expenses of nonprofit organizations are classified in the following two ways on the statement or schedule of functional expenses:

- *Natural Expense Classification.* The natural expense classification involves grouping expenses, according to the kinds of economic benefits received in incurring those expenses (e.g., salaries and employee

benefits, professional fees, occupancy, postage and shipping, supplies, telephone, and travel). Even expenses grouped as "Cost of sales" or "Cost of special events" in the statement of activities should be itemized and classified by their natural expense classification in the statement of functional expenses. Natural expense classifications are typically not the same as functional classifications. Captions for the natural expense classification of expenses are generally listed down the left side of the statement or schedule of functional expenses.

- *Functional Classification.* The functional classification involves grouping expenses according to the purpose for which the expenses are incurred. The primary functional classifications are program services and supporting services. Program service expenses are the direct and indirect costs related to providing a nonprofit organization's programs or social services, i.e., the costs of the activities for which purpose the organization exists. Supporting service expenses are costs for activities not directly related to the purpose for which the organization exists. They are broadly categorized as management and general expenses, fund-raising expenses, and membership development expenses. Although those functional classifications will be those predominately used in practice, other functional classifications may be used, such as cost of sales or investing. Captions for functional classification of expenses are generally listed from left to right as column headings across the top of the statement or schedule of functional expenses.

The functional classification of expenses usually requires allocation of natural expense classifications to the proper functions, and the statement or schedule of functional expenses shows how those expenses are allocated. The allocation of expenses is discussed later in this lesson.

Captions. Captions, or natural expense categories classifications, within the statement or schedule of functional expenses will vary based on the nature of a nonprofit organization's activities and programs. The level of detail provided in the statement of functional expenses should be sufficient for the user to obtain a general understanding of the nature of the expenses incurred in carrying out the programs and activities of the organization.

Column Headings and Totals. The captions for column headings that are included on the statement or schedule of functional expenses should usually be in the same order as they are listed on the statement of activities. In addition, the totals for the various columns on the statement or schedule of functional expenses will generally agree to similar totals on the statement of activities.

The statements are more meaningful and understandable if the user of the financial statements can agree expense information on the statement or schedule of functional expenses to the statement of activities. Therefore, the captions and totals included on the statement of activities should generally dictate which captions and totals are included on the statement or schedule of functional expenses. For example, column headings and totals for "Total program services" and "Total supporting services" on the statement or schedule of functional expenses should be used if those same captions and totals are included on the statement of activities. Conversely, if an organization has chosen not to include such captions and totals on its statement of activities because it has interspersed expenses throughout the related revenues, the organization should consider only including a total column for "Total expenses" on its statement or schedule of functional expenses. One exception is when the organization's statement of functional expenses serves as its disclosure of total program expenses. In that case, it should include total columns for "Total program services" and "Total supporting services," even though the statement of activities does not reflect those same captions and totals.

FASB ASC 958-720-45-5 states that if total program expenses are not evident on the face of the statement of activities (i.e., because of interspersed expenses), the notes to the financial statements should disclose total program expenses and explain why that amount does not articulate to the statement of activities. Therefore, if a statement of functional expenses (which is required to include *all* expenses regardless of placement within the statement of activities as described earlier in this lesson) is presented and reconciled to the statement of activities, further explanation in the notes to the financial statements would not be required. Preparers should note that if a statement of functional expenses is not presented or only a *schedule* of functional expenses is presented, the notes to the financial statements should provide the additional explanation and disclosure.

In cases where the statement of activities and the statement (or schedule) of functional expenses do not easily articulate, those statements can be reconciled by including a subtotal for "Total expenses" on the statement or schedule of functional expenses. From that subtotal, expenses deducted from revenues on the statement of

activities would be subtracted, leaving only total expenses included in the expense section of the statement of activities.

As an example, assume that ABC Organization includes the following captions and totals in its statement of activities:

		Unrestricted
REVENUES, GAINS, AND OTHER SUPPORT		
Contributions		$ 354,289
Grant revenues		116,390
Membership dues		225,600
Shop revenues	$ 125,990	
Less: Shop cost of sales	(93,225)	32,765
Gala	55,378	
Less: Cost of direct benefits to donors	(41,632)	13,746
Investment return (net of $5,500 investment expenses)		98,678
REVENUE, GAINS, AND OTHER SUPPORT		841,468
EXPENSES		
Program services		
Exhibits		281,749
Education		207,975
Supporting services		
Management and general		43,683
Membership development		20,095
Fund-raising		22,087
EXPENSES		575,589
INCREASE IN NET ASSETS		$ 265,879

Assume also that ABC Organization has determined that the statement of functional expenses will serve as its disclosure of total program expenses. Given those assumptions, Exhibit 2-1 shows one alternative for presenting the column headings and totals on the statement of functional expenses. The shaded amounts represent the interspersed expenses by their natural expense classification. The statement also presents a reconciliation of total expenses to expenses reported on the statement of activities.

Order of Presentation and Subtotals. The statement or schedule of functional expenses can present expenses in whatever order best presents the activities of the organization and can include various subtotals. Best practices suggest using a subtotal to reconcile certain statements of activities to their related statements or schedules of functional expenses. (Exhibit 2-1 illustrates that suggestion.) Another common subtotal is "Total expenses before depreciation." Depreciation is then included as a separate line and a caption for "Total expenses" is included after depreciation. The caption could also be labeled "Total functional expenses." An organization might also decide to segregate other noncash expenses (e.g., in-kind expenses) in the statement or schedule of functional expenses. For example, occupancy expense and in-kind occupancy expense can be included as two separate lines on the statement or schedule of functional expenses. Alternatively, the organization can include an intermediate total and then present all in-kind expenses under the caption "In-kind expenses" before presenting a caption for "Total functional expenses." Other subtotals that might be presented in the statement of functional expenses include totals for personnel (salaries, benefits, insurance), occupancy (rent, building, utilities, repairs and maintenance, telephone, property insurance, property taxes), administration (postage, office supplies, accounting), and program services.

Exhibit 2-1

Example Statement of Functional Expenses before the Effective Date of ASU 2016-14[a]

ABC ORGANIZATION
STATEMENT OF FUNCTIONAL EXPENSES
Year Ended June 30, 20X7

	Program Services				Supporting Services					
	Exhibits	Education	Shop	Total	Management & General	Membership Development	Fund-raising	Direct Benefits to Donors	Total	Total
Salaries	$ 126,739	$ 95,298	$ 20,029	$ 242,066	$ 16,195	$ 8,249	$ 7,633	$ —	$ 32,077	$ 274,143
Payroll taxes and employee benefits	26,696	15,296	4,539	46,531	1,403	661	594	—	2,658	49,189
Total compensation	153,435	110,594	24,568	288,597	17,598	8,910	8,227	—	34,735	323,332
Fees	25,000	—	—	25,000	—	—	—	—	—	25,000
Printing	35,565	29,313	—	64,878	5,563	3,517	4,278	—	13,358	78,236
Mailing, postage, and shipping	24,260	13,627	—	37,887	2,487	1,013	946	—	4,446	42,333
Rent	12,000	10,000	3,000	25,000	5,000	2,500	3,500	—	11,000	36,000
Utilities	8,954	6,882	1,004	16,840	2,902	1,242	1,587	—	5,731	22,571
Cost of meals	—	—	—	—	—	—	—	35,000	35,000	35,000
Entertainment	—	—	—	—	—	—	—	6,632	6,632	6,632
Conferences and training	2,721	13,244	—	15,965	986	—	—	—	986	16,951
Legal and audit	6,413	2,917	—	9,330	2,400	—	—	—	2,400	11,730
Investment custodial fees	—	—	—	—	5,500	—	—	—	5,500	5,500
Books and stationery	—	—	61,541	61,541	—	—	—	—	—	61,541
Supplies	4,328	13,630	3,112	21,070	847	519	726	—	2,092	23,162
Depreciation	3,956	2,961	—	6,917	1,604	286	377	—	2,267	9,184
Other	5,117	4,807	—	9,924	4,296	2,108	2,446	—	8,850	18,774
Total expenses	281,749	207,975	93,225	582,949	49,183	20,095	22,087	41,632	132,997	715,946
Less expenses included with revenues on the statement of activities	—	—	(93,225)	(93,225)	(5,500)	—	—	(41,632)	(47,132)	(140,357)
Total expenses included in the expense section of the statement of activities	$ 281,749	$ 207,975	$ —	$ 489,724	$ 43,683	$ 20,095	$ 22,087	$ —	$ 85,865	$ 575,589

Note:

[a] This exhibit does not reflect the requirements of ASU 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities* 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.

* * *

Comparative Financial Statements. FASB ASC 205-10-45 encourages but does not require comparative financial statements. When the statement of functional expenses is presented for the current period, most nonprofit organizations present only comparative totals for the prior period because of space limitations and to avoid the confusion that a second multiple column statement might cause. The statement of functional expenses can present comparative totals for the functional classifications for the prior year listed across the bottom in addition to comparative totals for the natural expense classifications that are listed down the right hand side of the statement. FASB ASC 958-205-45-8 cautions that such comparative totals may not present enough detail for the prior-period financial statements to be in conformity with GAAP. The prior year's financial statements must include the minimum information required by FASB ASC 958 to be in conformity with GAAP. For voluntary health and welfare organizations required to present a statement of functional expenses, this means a complete statement in matrix format would be required for the prior year for the comparative financial statements to be in conformity with GAAP. If complete comparative statements are presented, the information for both years can be reduced and included side by side on one page, or the information can be presented in two separate statements.

If an organization chooses to present only comparative totals for the prior period, the financial statements require an appropriate title and a note to the financial statements, both describing the nature of the prior-period financial information. The title might include a phrase such as "with comparative totals for the year ended June 30, 20X6."

The often used label, "for comparative purposes only" would not be sufficient. The following is an example of a footnote that could be used.

> The financial statements include certain prior-year summarized comparative information. Such information does not include sufficient detail to constitute a presentation in conformity with generally accepted accounting principles. Accordingly, such information should be read in conjunction with the organization's financial statements for the year ended June 30, 20X6, from which the summarized information was derived.

As previously discussed, nonprofit organizations that are not voluntary health and welfare organizations are not required to present a statement of functional expenses as a basic financial statement. The organization may include that information as either a basic financial statement or in a supplementary schedule of functional expenses. The supplementary information is not required for a fair presentation in accordance with GAAP. Therefore, the schedule may include information in whatever form the organization decides, which could be only one year of information, one year of information with comparative totals for the prior year, or a complete presentation for both years, either on one page or two separate pages.

Percentages. The authoritative literature for nonprofit organizations does not address the presentation of percentage information in the statement or schedule of functional expenses. However, some organizations choose to present percentages of functional expense classifications to total expenses within the statement or schedule of functional expenses. This percentage information by function may also be accompanied by percentage information for the natural expense classifications. The statement of functional expenses can present percentages for the functional expense classifications for the current year (and prior year, if comparative information is presented) listed across the bottom of the statement, immediately below the total expense amount for each function. In addition, percentages for the natural expense classifications may be listed down the right hand side of the statement.

Allocating Expenses

According to Paragraph 13.72-.73 of the Audit Guide, expenses pertaining to more than one program or supporting service (e.g., salaries and occupancy costs) should be allocated to the applicable functions. Therefore, to present a statement or supplementary schedule of functional expenses, direct costs must be identified and indirect costs must be allocated to the programs and supporting functions. Some costs can be identified as pertaining to a specific program, such as the salary of an individual who works exclusively on a particular program service or the cost of special supplies used only in a particular program. Other costs may apply to more than one program or supporting service, such as the salary of the executive director whose responsibilities include both overall management and general matters and supervision of one or more program services. As another example, if both program and supporting services are performed in the same building, occupancy costs would be allocated.

It is not necessary to maintain detailed records for the purpose of allocating expenses—reasonable estimates may be used. However, FASB ASC 958-720-45-54 indicates the basis for allocating expenses should be consistent

given similar facts and circumstances. An objective basis based on related financial or nonfinancial data is preferable to a subjective basis. For example, occupancy expenses (e.g., rent, utilities, insurance, and maintenance) may be allocated based on the square footage of space occupied by each program and supporting service. As previously mentioned, if it is impractical to measure space and calculate precise allocations, an estimate of the relative portion of the building occupied by each function may be made.

Although it is not required, disclosing the nature of costs that have been allocated is recommended. Disclosing in the notes to the financial statements the general allocation methods such as allocations based on time estimates is also recommended.

As discussed in Paragraph 13.78 of the Audit Guide, management should review its expense allocations periodically and revise them as necessary to accurately reflect significant changes in the nature and level of the nonprofit organization's current activities. Once an allocation method has been established, a change in allocation method is generally considered a change in accounting principle under FASB ASC 250 unless the facts and circumstances transactions or events related to the basis for the allocation are clearly different in substance than those that previously occurred.

SELF-STUDY QUIZ

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

9. Where must all organizations present expense information by their functional classification according to FASB ASC 958-720-45-2?

    a. As an additional basic financial statement.

    b. In a schedule of functional expenses included as a supplementary schedule.

    c. In either the notes to the financial statements or the statement of activities.

10. ABC Organization is a nonprofit organization. It is not required to present a statement of functional expenses with its basic financial statements, but voluntarily presents the information. When reporting its functional expenses, what would be the most commonly used title?

    a. Statement of Functional Expenses—Cash Basis.

    b. Statement of Functional Expenses—Tax Basis.

    c. Statement of Functional Expenses.

    d. Schedule of Functional Expenses.

11. XYZ Organization is a nonprofit organization with a new controller, Caroline. Caroline is preparing the organization's financial statements. What is required?

    a. She must allocate expenses pertaining to more than one supporting service or program to the applicable functions.

    b. She must present percentage information by function on the statement of functional expenses.

    c. She must disclose the general allocation methods used to allocate expenses.

    d. She must maintain detailed records concerning expense allocation.

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.)**

9. Where must all organizations present expense information by their functional classification according to FASB ASC 958-720-45-2? **(Page 171)**

    a. As an additional basic financial statement. [This answer is incorrect. FASB ASC 958-205-05-5 requires voluntary health and welfare organizations to present a statement of functional expenses, which shows information about natural and functional classifications, as a basic financial statement. This is not required by all organizations.]

    b. In a schedule of functional expenses included as a supplementary schedule. [This answer is incorrect. While not required, large donors to nonprofit organizations that are not voluntary health and welfare organizations often request the type of information contained in a functional expense statement. Nonprofit organizations should consider including a schedule of functional expenses as a supplementary schedule to the financial statements.]

    c. In either the notes to the financial statements or the statement of activities. [This answer is correct. FASB ASC 958-720-45-2 requires all organizations to present information about expenses (but not losses) by their functional classification in either the statement of activities or the notes to the financial statements.]

10. ABC Organization is a nonprofit organization. It is not required to present a statement of functional expenses with its basic financial statements, but voluntarily presents the information. When reporting its functional expenses, what would be the most commonly used title? **(Page 172)**

    a. Statement of Functional Expenses—Cash Basis. [This answer is incorrect. This title would be used by an organization that is preparing their financials on the cash basis of accounting and is required to present its functional expenses as a statement. ABC Organization's situation is different.]

    b. Statement of Functional Expenses—Tax Basis. [This answer is incorrect. This title would be used by an organization that is preparing their financials on a comprehensive basis of accounting other than GAAP. This does not apply to ABC Organization.]

    c. Statement of Functional Expenses. [This answer is incorrect. In current practice, the most widely used title is "statement of functional expenses" for voluntary health and welfare organizations that are required to include the statement as one of the required financial statements. ABC Organization is not a voluntary health and welfare organization and is, therefore, not required to include the statement.]

    d. Schedule of Functional Expenses. [This answer is correct. ABC Organization is not required to present the statement as a basic financial statement and elects to provide the information in a supplementary schedule. The most commonly used title in this situation is "schedule of functional expenses."]

11. XYZ Organization is a nonprofit organization with a new controller, Caroline. Caroline is preparing the organization's financial statements. What is required? **(Page 177)**

    a. **She must allocate expenses pertaining to more than one supporting service or program to the applicable functions. [This answer is correct. Allocation of salaries and other expenses pertaining to more than one program are required to be allocated to the applicable functions. To present a statement or supplementary schedule of functional expenses, direct costs must be identified and indirect costs must be allocated to the programs and supporting functions.]**

    b. She must present percentage information by function on the statement of functional expenses. [This answer is incorrect. The authoritative literature for nonprofit organizations does not address the presentation of percentage information in the statement or schedule of functional expenses. However, some organizations choose to present percentages of functional expense classifications to total expenses within the statement or schedule of functional expenses.]

    c. She must disclose the general allocation methods used to allocate expenses. [This answer is incorrect. It is recommended that the notes to the financial statement include a disclosure concerning general allocation methods used, but it is not a requirement.]

    d. She must maintain detailed records concerning expense allocation. [This answer is incorrect. It is not necessary to maintain detailed records for the purpose of allocating expenses—reasonable estimates may be used. The requirement is that the basis for allocation be consistent from period to period.]

Lesson 3: The Statement of Cash Flows

INTRODUCTION

FASB ASC 958-205-05-5 requires that external financial statements of nonprofit organizations include a statement of cash flows. A statement of cash flows is required to be presented as part of a full set of financial statements prepared in accordance with generally accepted accounting principles. The statement shows an organization's cash receipts and payments during a period, classified by principal sources and uses. The cash receipts and payments are categorized as operating, investing, and financing activities. In addition, noncash transactions that affect financial position must be disclosed. This lesson discusses the GAAP requirements as they relate to nonprofit organizations, including the presentation of specific types of transactions in statements of cash flows and the disclosure of noncash transactions. The lesson also illustrates alternative formats for presenting statements of cash flows that are permitted by GAAP.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize the authoritative guidance and form and style considerations as they relate to preparing a nonprofit's statement of cash flows.
- Identify cash flows from operating activities and how they are presented.
- Identify cash flows from investing activities, financing activities, and noncash investing and financing activities and how they are presented.

When to Present the Statement

FASB ASC 230-10-15-3 requires a statement of cash flows to be presented when both of the following conditions are met:

a. *The Financial Statements Are Prepared in Accordance with Generally Accepted Accounting Principles.* A statement of cash flows is not required if the financial statements are prepared on a basis of accounting other than GAAP (e.g., cash basis or tax basis).

b. *Both a Statement of Financial Position and a Statement of Activities Are Presented.* If a statement of financial position or a statement of activities is presented separately, a statement of cash flows is not required.

Authoritative literature does not prohibit presenting a statement of cash flows when two the conditions above are not met. Thus, for example, a nonprofit organization could present a statement of cash flows and not present a statement of financial position or statement of activities.

Entities meeting the requirements in FASB ASC 230-10-15-3 are required to present a statement of cash flows regardless of their legal form or whether they normally classify their assets and liabilities as current and noncurrent. In addition, the requirement to present a statement of cash flows applies to both interim and annual financial statements.

How Cash Is Defined

A statement of cash flows shows the change in cash and cash equivalents during the period. Cash and cash equivalents are defined as follows:

Cash

Definition (FASB ASC 230-10-20)

. . . cash includes not only currency on hand but demand deposits with banks or other financial institutions. Cash also includes other kinds of accounts that have the general characteristics of demand deposits in that the customer may deposit additional funds at any time and also effectively may withdraw funds at any time without prior notice or penalty. . . .

Cash Equivalents

Definition (FASB ASC 230-10-20)

. . . short-term, highly liquid investments that are both (a) readily convertible to known amounts of cash and (b) so near to their maturity that they present insignificant risk of changes in value because of changes in interest rates.

Examples—Certificates of deposit, money market accounts, and repurchase agreements that have the characteristics described above.	*Examples*—U.S. Treasury bills, commercial paper, money market accounts that are not classified as cash, and other short-term investments whose original maturity is three months or less. (Note that equity securities never meet the definition of cash equivalents.)

FASB ASC 230-10-45-4 requires that the amounts of cash and cash equivalents reflected in the statement of cash flows be the same amounts as those similarly titled amounts in the statement of financial position. However, cash and cash equivalents that have been designated for long-term purposes or received with donor-imposed restrictions limiting their use to long-term purposes should be segregated on the statement of financial position and not aggregated with cash that is available for current use. As a result, in order to maintain consistent classification between the statements of financial position and cash flows, cash and cash equivalents designated for long-term purposes or received with donor-imposed restrictions limiting their use to long-term purposes, properly segregated in the statement of financial position, should be excluded from the definition of cash and cash equivalents for purposes of the statement of cash flows.

To illustrate, assume that a contribution of $5,000 is received from a donor who stipulates that the gift is to be maintained in perpetuity and that the contribution is made on the last day of the fiscal year and therefore reported as restricted cash on the statement of financial position (i.e., it is not yet invested at year end). Because the cash received is for investment in a perpetual endowment fund, the contribution would not be reflected in net cash flows from operating activities nor would it be included in "Cash and cash equivalents at end of period." Instead, it would be reflected as a source of cash flows from financing activities, "Collections of contributions restricted for investment in endowment," with a corresponding amount shown as a use of cash flows from investing activities, "Purchase of assets restricted for investment in endowment," or some other appropriate title. Thus, there is no net effect on cash and cash equivalents for the period resulting from the contribution.

Some nonprofit organizations do not include cash overdrafts in the definition of cash. Instead, they consider overdrafts to be liabilities similar to accounts payable. Thus, they may present cash overdrafts as an operating activity or a financing activity in the statement of cash flows. The Audit Guide, in Exhibit 3-1 at paragraph 3.47, indicates that changes in cash overdrafts are generally financing activities rather than operating activities. Alternatively, a cash overdraft could be included in the definition of cash because the time required for the overdraft to be eliminated is insignificant. Both methodologies can be found in practice today. Should a nonprofit organization decide to include a cash overdraft in cash, it should consider the following guidance. As previously discussed, FASB ASC 230-10-45-4 requires that the total amounts of cash and cash equivalents at the beginning and end of the period agree with similarly titled line items or subtotals shown in the statement of financial position. If the statement of financial position reports a single net negative cash balance in its liabilities, the captions in the statement of cash flows should be revised accordingly [e.g., "Cash (cash overdraft) at end of year"]. If the statement of financial position for a single year reports both a positive balance in its assets and a negative balance in its liabilities, best practices indicate a reconciliation should be provided.

Not all investments that generally qualify under the definition of cash equivalents are required to be treated as such for purposes of the statement of cash flows. For example, if a nonprofit organization invests principally in short-term investments (i.e., less than one year in maturity), it may decide to treat all of those items as investments rather than segregate the investments according to those that qualify as cash equivalents (i.e., investments whose original maturity is three months or less) and those that do not. Consequently, it would reflect only the changes in cash on the statement of cash flows; all proceeds from the sale of and purchases of investments would be reflected as investing activities. Short-term, quasi-endowment funds may also be excluded from cash and cash equivalents. Similarly, cash held temporarily in a long-term investment portfolio, until an appropriate investment is found, is excluded from cash and cash equivalents according to FASB ASC 958-205-55-7.

A nonprofit organization is required to disclose its policy for determining which items are treated as cash equivalents and which are not. Any subsequent change to that policy is considered a change in accounting principle requiring restatement of any prior year financial statements presented for comparative purposes. A nonprofit organization should disclose that cash and cash equivalents designated for long-term purposes or received with

donor-imposed restrictions limiting their use to long-term purposes are not considered cash and cash equivalents for purposes of the statement of cash flows.

Throughout this lesson, the term *cash* is used to include cash equivalents. Distinguishing between cash equivalents and short-term investments is discussed.

Basic Elements

A statement of cash flows has five basic elements:

- Cash flows from operating activities.
- Cash flows from investing activities.
- Cash flows from financing activities.
- Net change in cash during the period.
- Supplemental disclosure of noncash investing and financing activities.

Accordingly, all cash receipts and payments should be classified as operating, investing, or financing activities, and noncash transactions involving investing and financing activities, such as acquiring assets by assuming liabilities, should be disclosed separately rather than within the body of the statement. Note that although GAAP requires the statement of financial position to disclose the categories of net assets and the statement of activities is required to disclose the changes in those categories, no distinction is required to be made in the statement of cash flows. That is, all information regarding cash and cash equivalents is generally expected to be aggregated except cash and cash equivalents designated or restricted for long-term purposes.

Generally, cash receipts and disbursements should be classified in the statement of cash flows without regard to whether they stem from an item intended as a hedge. For example, the proceeds from a borrowing should be classified as a financing activity even though the debt is considered a hedge of an investment. However, FASB ASC 230-10-45-27 allows nonprofit organizations to classify cash flows from derivative instruments accounted for as fair value hedges in the same category as the cash flows from the hedged item (provided that the derivative instrument does not include an other-than-insignificant financing element at inception) so long as the accounting policy is disclosed. If hedge accounting is discontinued for an instrument that hedges an identifiable transaction or event, any cash flows subsequent to the date of discontinuance should be classified consistent with the nature of the derivative instrument.

Types of Cash Flows. Exhibit 3-1 shows how a typical nonprofit organization's transactions would be classified into operating, investing, and financing activities according to the GAAP criteria.

New Authoritative Guidance for Presenting the Statement of Cash Flows in ASU 2016-14

600.15 As discussed later in this section, before the effective date of ASU 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities*, if the cash flows from operating activities is presented using the direct method, a reconciliation of the change in net assets to net cash flows from operating activities is required to be presented in a separate schedule showing all major classes of operating items, including, at a minimum, changes in receivables and payables related to operating activities and changes in inventories. After the adoption of ASU 2016-14, nonprofit organizations that choose to report cash flows from operating activities using the direct method have the option of omitting the reconciliation of the change in net assets to net cash flows from operating activities.

600.16 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. The guidance in this lesson does not reflect implementation of ASU 2016-14.

Exhibit 3-1
Types of Cash Flows

STATEMENT OF CASH FLOWS			NONCASH INVESTING AND FINANCING TRANSACTIONS
OPERATING	**INVESTING**	**FINANCING**	
CASH RECEIPTS FROM: • Contribution without donor restrictions • Collection of unconditional promises to give (other than those restricted for long-term purposes) • Sale of publications and inventory items • Service recipients • Grants • Interest and dividends without donor restrictions available for current use • Agency transactions • Other cash receipts not arising from investing or financing activities • Sale of certain donated financial assets **CASH PAYMENTS FOR:** • Wages • Supplies • General and administrative expenses • Interest (excluding amounts capitalized as long-lived assets) • Grants awarded to others • Agency Transactions • Settlement of an asset retirement obligation • Other cash payments not related to investing or financing activities	**CASH RECEIPTS FROM:** • Sale of property and equipment • Sale or maturity of investments other than certain donated financial assets • Collections on loans • Sale or insurance recoveries of collection items • Installment sales • Sale of subsidiary **CASH PAYMENTS FOR:** • Property and equipment (including capitalized interest) • Investments • Loans • Collection items • Purchase of subsidiary	**CASH RECEIPTS FROM:** • Contributions restricted for long-term purposes • Short-term borrowings • Long-term borrowings • Interest and dividends restricted for long-term purposes • Issuance of membership shares • Derivatives that include a financing element **CASH PAYMENTS FOR:** • Repayment of amounts borrowed (e.g., short-term debt and long-term debt) • Annuity obligations • Repurchase or redemption of membership shares • Distributions to counterparties of derivatives that include a financing element • Debt issue costs.	• Acquiring nonoperating assets (e.g., property and equipment) by assuming liabilities • Obtaining a building, securities, or collection items by receiving a gift • Recognizing donated services, inventory, supplies, etc. • Settling liabilities by transferring noncash assets or issuing membership shares • Non-incremental portion of debt refinancing and refundings.

* * *

New Authoritative Guidance for Presenting the Statement of Cash Flows in ASU 2016-15 and ASU 2016-18

In April 2015, the FASB decided to have the Emerging Issues Task Force (EITF) consider nine issues related to the classification of certain items in the cash flow statement, including debt extinguishment, restricted cash, and distributions from equity method investees. The objective of the project was to provide guidance that would reduce diversity in practice. During its deliberations, the EITF decided to consider issues related to the presentation of restricted cash separately from the other cash flow issues. The following paragraphs describe the two ASUs issued in 2016 as a result of this project.

Guidance on Classifying Certain Cash Inflows and Cash Outflows in ASU 2016-15. In August 2016, the FASB issued ASU 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments*, to provide guidance on the classification of certain transactions in the statement of cash flows and reduce diversity in practice. This *Course* has not been fully updated to incorporate the requirements of ASU 2016-15 due to the delayed effective date. As the effective date nears, this *Course* will fully implement the amendments summarized in the following paragraphs.

The amendments to FASB ASC 230-10-45-22 indicate that when cash receipts or payments could be classified in more than one class of cash flows, in the absence of specific guidance in GAAP, the cash flows should separately identify each source or use based on the nature of the underlying cash flows, then classify each source or use based on its nature. Judgment may be used to estimate the amount attributable to each separate source or use. FASB ASC 230-10-45-22A gives accountants the ability to classify the amounts according to the predominant nature of the source or use when they are not separately identifiable. ASU 2016-15 also provides the following guidance related to specific types of cash flow issues:

- *Debt-related.* Amendments to FASB ASC 230-10-45-15 clarify that debt prepayment or extinguishment costs, excluding accrued interest, should be classified as financing activities. Examples include premiums paid, third-party costs, and other fees paid to lenders due to debt prepayments or extinguishments. FASB ASC 230-10-45-15 and 45-17 are amended to provide specific guidance on zero-coupon debt instruments or similar instruments with minimal coupon interest rates. The guidance indicates the principal portion of such debt payments should be classified as financing activities while the portion of the payments attributable to accreted interest related to the debt discount should be classified as operating activities and included with the amount of interest paid.

- *Contingent Consideration in a Business Combination.* FASB ASC 230-10-45-13, 230-10-45-15, and 958-805-45-12 are amended to provide specific guidance on the classification of cash outflows associated with contingent liabilities in a business combination. Payments of contingent consideration liabilities shortly after the acquisition date should be classified as investing activities. Payments *not* made soon after the acquisition date should be separated between amounts up to the remaining balance of the contingent consideration liability recorded at the acquisition date (including any measurement-period adjustments) and amounts in excess of the remaining balance of the liability recorded at acquisition. Payments of the amounts up to the remaining balance of the liability should be classified as financing activities, while amounts that exceed the remaining balance of the contingent consideration liability should be classified as operating activities.

- *Insurance.* Guidance is added at FASB ASC 230-10-45-21B to clarify that cash received for insurance claim settlements should be classified according to the nature of the loss (e.g., proceeds from a claim on a damaged building would be classified as an investing activity). New guidance at FASB ASC 230-10-45-21C indicates that cash received for settlements of corporate-owned life insurance policies (that is, policies owned by the nonprofit organization) should be classified as investing activities, and payments of premiums on such policies may be classified as investing, operating, or a combination of investing and operating activities.

- *Equity Method Investments.* FASB ASC 230-10-45-21D provides new guidance for two methods of classifying distributions received on equity method investments. An organization should elect an accounting policy to classify distributions received using either of these methods:

  - *Cumulative earnings approach.* With this method, distributions are considered returns *on* investment and classified as operating activities. However, when distributions received to date (including all prior periods) exceed the cumulative equity in earnings recognized by the investor, the excess is considered a return *of* investment and classified as an investing activity.

  - *Nature of the distribution approach.* Under this method, when such information is available, distributions are classified according to the nature of the investee's activity that results in the distribution (i.e., returns *on* investment are operating activities, and returns *of* investment are investing activities).

  Organizations that have equity method investments should disclose the approach elected in the notes to their financial statements in accordance with FASB ASC 235-10-50. An illustrative disclosure is as follows:

  Distributions Received from Equity Method Investees

  The Organization has elected to classify distributions received from equity method investees in the statement of cash flows based on the nature of the investee's activity that resulted in the distribution. Returns on investment are classified as operating activities in the statement of cash flows, while returns of investment are classified as investing activities.

- *Beneficial Interest in a Securitization of Financial Assets.* FASB ASC 230-10-45-12 is amended to indicate that cash received on the collections of a beneficial interest in a transferor's trade receivables should be classified as investing activities in the statement of cash flows. Amendments in FASB ASC 230-10-50-4 state that any beneficial interest received in a securitization transaction should be disclosed as a noncash investing and financing activity.

For nonprofit organizations, the amendments in ASU 2016-15 are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years after December 15, 2019. Early adoption is permitted; however, an organization must adopt all of the amendments in ASU 2016-15 in the same period. The amendments in the ASU should be applied using a retrospective basis to all periods presented unless considered impractical for some of the issues. In such instances, the amendments for those issues should be applied prospectively as of the earliest date practical.

Guidance on Restricted Cash in ASU 2016-18. In November 2016, the FASB issued ASU 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash*.

The ASU amends FASB ASC 230-10-45-4 to require that restricted cash and cash equivalents be included in the total cash and cash equivalents at the beginning and end of the period for which changes are shown in the statement of cash flows. The ASU clarifies that transfers between cash and cash equivalents and restricted cash and cash equivalents are not part of an entity's operating, investing, and financing activities and should not be reported as cash flow activities in the statement of cash flows.

ASU 2016-18 requires cash, cash equivalents, restricted cash, and restricted cash equivalents that are presented in more than one line on the statement of financial position to either be presented on the face of the statement of cash flows or disclosed in the notes to the financial statements. The presentation, whether on the face of the statement of cash flows or in the notes, should allow the users of the financial statements to identify or reconcile the amounts in the statement of financial position that are included in the total cash, cash equivalents, restricted cash, and restricted cash equivalents in the statement of cash flows. This information must be presented for all periods included in the financial statements. In addition, the nature of any restrictions on cash and cash equivalents should

be disclosed. For example, a nonprofit organization has the following line items on its statement of financial position as of December 31, 20X7 and 20X6:

	20X7	20X6
Cash and cash equivalents	$ 40,000	$ 35,000
Cash restricted for acquisition of property	100,000	114,000

The following illustrates an appropriate presentation of a nonprofit organization's statement of cash flows and the related note to the financial statement for the years ended December 31, 20X7 and 20X6 that would satisfy the requirements of ASU 2016-18:

	20X7	20X6
Net decrease in cash, cash equivalents, and restricted cash	9,000	1,000
Cash, cash equivalents, and restricted cash at beginning of year	149,000	150,000
Cash, cash equivalents, and restricted cash at end of year	$ 140,000	$ 149,000

NOTE X—CASH AND CASH EQUIVALENTS

Cash and cash equivalents as of December 31, 20X7 and 20X6 consist of the following:

	20X7	20X6
Cash and cash equivalents	$ 40,000	$ 35,000
Cash restricted for acquisition of property	100,000	114,000
Cash, cash equivalents, and restricted cash shown in the statement of cash flows	$ 140,000	$ 149,000

Restricted cash represents cash received with a donor-imposed restriction that limits the use of that cash to the acquisition of property. Unless donor stipulations limit the use of the assets for a period of time or for a particular purpose, the donor-imposed restriction expires when the assets are placed in service in accordance with FASB ASC 958-205-45-12.

For nonprofit organizations, the amendments in ASU 2016-18 are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted, including adoption in an interim period. The ASU is required to be applied on a retrospective basis to all periods presented. If the amendments are early adopted in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes the interim period. This *course* has not been updated to incorporate the requirements of ASU 2016-18 due to the delayed effective date. As the effective date nears, this *course* will fully implement the amendments summarized in the preceding paragraphs.

FORM AND STYLE CONSIDERATIONS

Required Format

Cash flow statements should report the total amounts of cash and cash equivalents at the beginning and end of the period, and those amounts should be the same as similarly titled line items or subtotals in the statement of financial position as of those dates. In other words, the net change in cash during the period should be added to cash at the

beginning of the period to obtain cash at the end of the period. While most preparers follow the ending cash format, they may revise the format of the statement to begin with "Cash at beginning of year."

GAAP does not prohibit or require the use of fund accounting. Accordingly, because fund accounting is not prohibited, some nonprofit organizations may present disaggregated fund information in the statement of financial position and statement of activities. In that situation, the nonprofit organization may elect to display disaggregated fund information in the statement of cash flows, similar to the other financial statements. It also might elect to aggregate all of the fund information and present a single-column statement of cash flows. Note, however, that for most nonprofit organizations, the financial statements most informative to their users will be those that do not use fund accounting.

Title

GAAP does not specify a title for statements of cash flows; however, FASB ASC 230, *Statement of Cash Flows,* generally refers to the statement in this form, and the illustrative examples use the title "statement of cash flows." In addition, FASB ASC 958-205-55-2 states that current practice and the statement's purpose suggest that the statement only be titled "statement of cash flows." As such, this title is recommended.

Order of Presentation

The order for presenting operating, investing, and financing activities in statements of cash flows is not addressed in GAAP. Current practice, however, suggests that a statement of cash flows report cash flows from operating activities first, similar to commercial enterprises. Another preference is to follow the format used in the illustrations included in FASB ASC 958-205-55 and, thus, to show investing activities following operating activities and to present financing activities last. It also is acceptable, however, to present financing activities before investing activities.

Captions

Because statements of cash flows are classified according to cash flows from operating, investing, and financing activities, captions are used to identify each section. Some typical examples are as follows:

- Cash Flows from Operating Activities, Cash Flows from Investing Activities, Cash Flows from Financing Activities
- Cash Provided (Used) by Operations, Cash Provided (Used) by Investments, Cash Provided (Used) by Financing
- Operations, Investments (or Investment Activities), Financing (or Financing Activities)

Throughout this lesson, the captions "Cash flows from operating activities," "Cash flows from investing activities," and "Cash flows from financing activities" are used to identify each section because those captions are used by many nonprofit organizations and are used in the illustrative statements of cash flows in FASB ASC 958-205-55. In addition, for each classification of cash flows (i.e., operating, investing, and financing) a captioned subtotal shows the net cash flow provided or used by that classification. Captions that relate to line items in the statement of activities should generally agree with those used in that statement. For example, "Change in net assets" and "Increase (decrease) in net assets" are both used because the related statement of activities may use either. Finally, the caption "Net increase (decrease) in cash" is used to identify the total change in cash during the period.

Comparative Presentations. Captions used within the statement of cash flows should be modified when comparative financial statements are presented and the net results in each period are not the same, such as an increase in net assets in one period and a decrease in net assets in another or an increase in cash in one period and a decrease in cash in another. One option would be to use "Change in net assets" if, in differing periods, net assets increased and decreased assuming that the statement of activities also used "Change in net assets." The following comparative statement illustrates captions that may be used.

	20X7	20X6
CASH FLOWS FROM OPERATING ACTIVITIES		
Increase (decrease) in net assets	$ (38,000)	$ 20,000
Adjustments to reconcile increase (decrease)in net assets to net cash provided (used) by operating activities:		
Depreciation	12,100	14,100
(Gain) loss on sale of equipment	2,000	(3,300)
(Gain) loss on sale of investments	(2,200)	600
(Increase) decrease in:		
Interest receivable	(7,500)	1,500
Inventories	4,200	2,800
Increase (decrease) in:		
Accounts payable	8,000	(6,300)
Accrued liabilities	(2,200)	6,150
Contributions restricted for investment in endowment	(5,000)	(3,500)
NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES	(28,600)	32,050
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from sale of investments	19,200	9,800
Purchase of investments	(8,200)	(14,800)
Purchase of equipment	(2,000)	(3,700)
Proceeds from sale of equipment	1,800	4,000
NET CASH PROVIDED (USED) BY INVESTING ACTIVITIES	10,800	(4,700)
CASH FLOWS FROM FINANCING ACTIVITIES		
Reduction of long-term debt	(9,500)	(19,000)
Long-term borrowings	7,500	—
Collections of contributions restricted for investment in endowment	5,000	3,500
NET CASH PROVIDED (USED) BY FINANCING ACTIVITIES	3,000	(15,500)
NET INCREASE (DECREASE) IN CASH	(14,800)	11,850
CASH AT BEGINNING OF YEAR	39,150	27,300
CASH AT END OF YEAR	$ 24,350	$ 39,150

When comparative statements are presented, it is recommended to group immaterial items under an "Other" caption, even if the items were presented separately in prior years.

Making the Statement Understandable

The following matters also should be considered when preparing statements of cash flows:

- Except for requiring that the operating activities section start with the change in net assets when the indirect method is used, the order in which items should appear within the three cash flows activities sections—operating, investing, and financing is not specified by GAAP. The operating activities section under the indirect method usually first adjusts the change in net assets for noncash revenues and expenses, then for changes in operating assets, and finally for changes in operating liabilities. While there is more variety in the presentation of cash flows from investing and financing activities, three approaches are common in practice—(a) presenting the changes in the order in which the assets and liabilities appear in the statement of financial position, (b) presenting items in the order of significance, and (c) presenting

payments together and receipts together. The method used should be the one that is likely to be the easiest for the primary users to understand.

- Related or immaterial items should be grouped together or combined. Certain items may be shown separately when material or combined in an "Other" caption when not material.

- Subtotals should be used to show cash flows from operating, investing, and financing activities, except when a category consists of a single item.

- Preferably, the entire statement should be presented on one page. If more detail is required for adequate disclosure, certain items may be included in the notes to the financial statements or in a separate schedule (such as disclosure of noncash investing and financing transactions).

- Disclosures made in other financial statements or in the notes need not be repeated. Similarly, disclosures made on the face of the statement of cash flows (e.g., depreciation for the period) need not be repeated.

Reclassification and Restatements

If a nonprofit organization has decided to present a classified statement of financial position, reclassifications of amounts between current and noncurrent assets and liabilities, either because of changes in conditions or because of classification errors in prior years, may affect the statement of cash flows. The following paragraphs present recommendations for handling those types of reclassifications. Note, however, that reclassifications between temporarily restricted net assets and unrestricted net assets (net assets with donor restrictions and net assets without donor restrictions after the implementation of ASU 2016-14) that occur when such restrictions have been satisfied do not affect the statement of cash flows and, accordingly, are not considered in the discussions below.

Reclassifications Resulting from Changed Conditions. Reclassifications resulting from changed conditions represent the effects of noncash activities and, thus, would not affect statements of cash flows. For example, reclassifying a long-term liability to current liabilities as a result of a violation of restrictive covenants does not affect cash and, accordingly, would not be shown in the statement of cash flows. The reclassification need not be shown in the schedule summarizing noncash investing and financing transactions because the cash effects of the transaction were previously recognized when the initial liability was incurred. However, reclassifications, if material, generally would be disclosed in the notes to the financial statements.

Classification Errors in Prior Years. Prior-period financial statements presented for comparative purposes should be restated when reclassifications are made to correct errors in prior years. For example, if a demand note previously classified as long-term was reclassified because it is callable at the option of the creditor, prior-period statements (the statement of financial position and the statement of cash flows) should treat the amount as a current liability. Thus, the statement of cash flows, as originally presented, would have shown cash flows from long-term borrowings, and the restated financial statements would show cash flows from short-term borrowings. (The reclassification also should be disclosed in the notes to the financial statements, if material. Alternatively, if several immaterial reclassifications were made in the current-year and prior-year financial statements are restated to reflect the current-year classification, a single disclosure could be made noting that certain amounts in the prior-year financial statements have been reclassified to conform to the current-year presentation.)

SELF-STUDY QUIZ

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

12. A donor makes a $20,000 contribution to The Clark Foundation with the stipulation that the gift is to be maintained in perpetuity. The contribution was made the last day of the foundation's fiscal year. Where will the $20,000 be included on the statement of cash flows?

    a. Reflected in net cash flows from operating activities.

    b. Reflected as a source of cash flows from financing activities.

    c. Included in "Cash and cash equivalents at end of period."

13. Which of the following is considered a financing activity?

    a. Cash payments for supplies.

    b. Cash payments for annuity obligations.

    c. Cash payment for loans.

    d. Cash receipts from grants.

14. A material classification error that affects the statement of cash flows was made in prior-period financial statements which are being presented for comparative purposes. How will this affect the statement of cash flows?

    a. The prior-period financial statements must be restated, and the reclassification is not disclosed in the notes.

    b. Disclose the reclassification in the notes to the financial statements, and no restatement of prior-period financial statements is necessary.

    c. The prior-period financial statements must be restated, and the reclassification should be disclosed in the notes.

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. A donor makes a $20,000 contribution to The Clark Foundation with the stipulation that the gift is to be maintained in perpetuity. The contribution was made the last day of the foundation's fiscal year. Where will the $20,000 be included on the statement of cash flows? **(Page 184)**

    a. Reflected in net cash flows from operating activities. [This answer is incorrect. The cash received is for investment in a perpetual endowment fund, so the contribution would not be reflected in net cash flows from operating activities.]

    b. Reflected as a source of cash flows from financing activities. [This answer is correct. It would be reflected as a source of cash flows from financing activities, "Collections of contributions restricted for investment in endowment," with a corresponding amount shown as a use of cash flows from investing activities, "Purchase of assets restricted for investment in endowment," or some other appropriate title. Thus, there is no net effect on cash and cash equivalents for the period resulting from the contribution.]

    c. Included in "Cash and cash equivalents at end of period." [This answer is incorrect. Since the cash received is for investment in a perpetual endowment fund, the contribution would not be included in "Cash and cash equivalents at end of period."]

13. Which of the following is considered a financing activity? **(Page 175)**

    a. Cash payments for supplies. [This answer is incorrect. Cash payments for supplies are considered an operating activity according to the GAAP criteria.]

    b. Cash payments for annuity obligations. [This answer is correct. According to the GAAP criteria, cash payments for annuity obligations are considered a financing activity.]

    c. Cash payment for loans. [This answer is incorrect. Cash payments for loans are considered an investing activity under the GAAP criteria.]

    d. Cash receipts from grants. [This answer is incorrect. According to the GAAP criteria, cash receipts from grants are considered an operating activity.]

14. A material classification error that affects the statement of cash flows was made in prior-period financial statements which are being presented for comparative purposes. How will this affect the statement of cash flows? **(Page 192)**

    a. The prior-period financial statements must be restated, and the reclassification is not disclosed in the notes. [This answer is incorrect. If the classification error was immaterial, this would be the proper treatment.]

    b. Disclose the reclassification in the notes to the financial statements, and no restatement of prior-period financial statements is necessary. [This answer is incorrect. This is the proper treatment if this reclassification was due to a changed condition. However, a different course of action is required for a classification error.]

    c. The prior-period financial statements must be restated, and the reclassification should be disclosed in the notes. [This answer is correct. Prior-period financial statements presented for comparative purposes should be restated when reclassifications are made to correct errors in prior years. The reclassification also should be disclosed in the notes to the financial statements.]

CASH FLOWS FROM OPERATING ACTIVITIES

What Is Included?

FASB ASC 230-10-20 defines cash flows from operating activities by exception; operating activities include all transactions and events that are not investing or financing activities. Generally, however, operating activities must meet the following three criteria:

a. The amounts represent the *cash effects* of transactions or events.

b. The amounts result from an organization's normal operations of providing services, making or receiving contributions, and delivering or producing goods for sale.

c. The amounts are derived from activities that enter into the determination of a net increase or decrease in net assets.

Thus, cash flows from operating activities include cash received from service recipients, contributors, and sales of goods or services and cash used to provide services, solicit funds, and generate goods for sale (such as for salaries, occupancy, inventory, administrative, and other operating costs). In addition, interest and dividend income not restricted for long-term purposes, interest expense, the cash effects of agency transactions, cash payments made to settle an asset retirement obligation, and landlord incentive allowances in operating leases of lessees are considered to be operating activities even though they are not precisely consistent with the preceding criteria. Note that contributions, interest, and dividends that are donor-restricted for long-term purposes are not part of operating cash receipts; instead, they are considered a financing activity. Furthermore, the definition of "operating activities" as used in the statement of cash flows does not necessarily correspond to the definition of "operations" that an organization might use in its statement of activities. If an organization chooses to use an intermediate measure of "operations" in its statement of activities, it may define it in whatever manner it believes is most meaningful. In contrast, "operating activities" as used in the statement of cash flows is defined by GAAP, as previously explained in this paragraph. (Exhibit 3-1 lists some typical examples of cash flows from operating activities.)

Nonprofit organizations also report the cash flows from sales of certain financial assets as operating, rather than investing, activities. According to FASB ASC 230-10-45-21A, an organization generally reports cash received from the sale of donated financial assets, such as debt and equity securities, as an operating activity if, (a) the donated securities are directed for sale upon receipt without any limitations imposed by the organization and (b) the securities are converted nearly immediately into cash. The phrase *without any limitations imposed by the organization* means that the organization did not instruct the broker to sell the investment at a specified price or better (for example, a limit order). That type of instruction would be a limitation indicative of an investing decision, which would result in classification as investing cash flows for the related proceeds. If, however, the donor restricted the use of the proceeds from the sale of the donated financial assets to a long-term purpose, the cash receipt is a financing activity.

What Is Excluded?

Cash flows from operating activities exclude (a) amounts that are not derived from cash receipts and cash payments, such as accruals, deferrals, in-kind (noncash) operating contributions, and allocations such as amortization and depreciation; and (b) amounts that are considered to be derived from investing or financing activities rather than from operations, such as cash receipts and payments related to property and equipment and contributions restricted for long-term investment. For nonprofit organizations, the definition of cash flows from financing activities includes cash contributions and investment income (i.e., interest and dividends) that are donor restricted for long-term purposes (FASB ASC 958-230-55-3). For example, contributions restricted for the purchase of a building or for establishing a perpetual endowment are considered cash flows from financing activities, not cash flows from operating activities.

Basic Format

Cash flows from operating activities may be presented in either of two basic formats: the direct method or the indirect method. The following paragraphs describe both methods and explain their advantages and disadvantages.

Direct Method. The direct method begins with gross cash receipts and deducts gross cash payments for operating costs and expenses, individually listing the cash effects of each major type of operating activity. At a minimum, FASB ASC 230-10-45-25 indicates the following categories of cash receipts and cash payments should be presented:

- Cash collected from customers, (e.g., cash received from service recipients, grants, and contributors) that is not donor-restricted for long-term purposes.
- Interest and dividends received that are not donor-restricted for long-term purposes.
- Other operating cash receipts, if any.
- Cash paid to employees and other suppliers of goods or services, including suppliers of insurance and advertising.
- Interest paid (net of amounts capitalized).
- Unrelated business income taxes or excise taxes paid, if any.
- Other operating cash payments (e.g., cash paid to grant recipients), if any.

Because the direct method explicitly shows only cash receipts and payments, no adjustments are necessary for noncash revenues and expenses such as contributions of property and depreciation. The following example illustrates the direct method:

CASH FLOWS FROM OPERATING ACTIVITIES	
Cash received from contributors and grants	$ 348,000
Cash received from service recipients	76,000
Interest received	8,250
Cash paid to employees and suppliers	(364,700)
Grants paid	(56,600)
Interest paid	(860)
NET CASH PROVIDED BY OPERATING ACTIVITIES	10,090

If the direct method is used, a reconciliation of the change in net assets to net cash flows from operating activities is required to be presented in a separate schedule showing all major classes of reconciling items. The reconciling items should include, at a minimum, such operating items as changes in any receivables and payables related to operating activities and changes in inventories. They should also include items whose cash effects are investing or financing activities, such as depreciation, contributions and interest and dividends restricted to long-term investment, net unrealized and realized gains on investments, and gains or losses from sales of property.

GAAP encourages the use of the direct method but the indirect method is allowed. Proponents of the direct method believe it is preferable because it shows the actual sources and uses of cash from operating activities and, therefore, provides meaningful information. In addition, some accountants believe the statement of cash flows is easier to understand because there is no need to adjust for noncash items, such as depreciation. The direct method may be preferable to the indirect method in the following circumstances:

- Information required for the direct method is readily available or can be obtained without significant cost. For example, a nonprofit organization that maintains its general ledger on the cash basis during the year

and adjusts to accrual basis only when it is preparing its financial statements at the fiscal year-end often can produce the information easily.

- The numerous reconciling items between the change in net assets and cash flows from operating activities make the indirect presentation cluttered and cumbersome to analyze.

- Management or banks with which the nonprofit organization obtains financing find the relationship of specific cash receipts and payments to cash flows from operating activities useful for making decisions.

- A nonprofit organization that receives significant resources from agency transactions can include those cash inflows in total cash receipts, and, thus, reflect the results of fund-raising efforts more completely. (Cash received from agency transactions would ordinarily not be reported in the indirect presentation.

Preparers generally find that it takes more time to prepare a statement using the direct method than using the indirect method. Prior to the implementation of ASU 2016-14, additional time is necessary because a separate reconciliation of the change in net assets to operating cash flows is required, thus operating cash flows are presented both directly and indirectly. (After the adoption of ASU 2016-14, nonprofit organizations that choose to report cash flows from operating activities using the direct method have the option of omitting the reconciliation of the change in net assets to net cash flows from operating activities.) Nevertheless, some nonprofit organizations may find statements of cash flows that use the direct method easier to understand and more useful. In those cases, its use is recommended.

Indirect Method. The indirect method starts with the change in net assets and adjusts for (a) noncash items or items related to investing or financing activities, such as depreciation, amortization, and net unrealized and realized gains on investments and (b) changes during the period in operating assets and liabilities, such as receivables and inventories. (As previously explained, the reconciliation should show all major classes of operating items. Although FASB ASC 230-10-45-29 literally requires presenting changes in receivables, payables, and inventories separately in the reconciliation, some accountants believe that amounts may be combined if they affect a single line item under the direct method, such as an increase in accounts payable and accrued expenses.) Note that the change in net assets should only be adjusted for changes in operating assets and liabilities. Changes in assets and liabilities that are not related to operating activities (e.g., short-term loans or notes receivable or payable) should be shown as investing or financing activities, as appropriate. In addition, preparers need to consider that the net change in some accounts, such as accounts payable, may have aspects of noncash financing or investing activity. For example, the change in accounts payable may include an increase due to equipment purchased on account, and it would not be appropriate to include that noncash financing activity in the adjustment to arrive at cash flows from operating activities. The following example illustrates the indirect method:

CASH FLOWS FROM OPERATING ACTIVITIES	
Change in net assets	$ 123,000
Adjustments to reconcile change in net assets to net cash provided by operating activities:	
Depreciation	9,400
Gain on sale of equipment	(700)
(Increase) decrease in:	
Receivables	(10,200)
Inventories	3,450
Prepaid expenses	1,100
Increase (decrease) in:	
Accounts payable	7,250
Accrued liabilities	(1,500)
Contributions restricted for long-term investment	(28,250)
Interest and dividends restricted for long-term investment	(5,400)
Net unrealized and realized gains on investments	(85,800)
NET CASH PROVIDED BY OPERATING ACTIVITIES	12,350

Note that the indirect method begins with the change in *net assets*. The change in net assets includes the change in all net asset classifications. It represents the *total* change in net assets for the organization as a whole and should agree to the similarly titled balance on the statement of activities.

Items that reconcile the change in net assets to net cash flows from operating activities are allowed to be presented in the statement of cash flows itself, as illustrated in the preceding paragraph, or in a separate schedule. If the reconciling items were presented in a separate schedule, the statement of cash flows would show a single line item for cash flows from operating activities such as the following:

Net cash flows provided by operating activities	$ 12,350

In that case, a separate schedule would present a reconciliation of the change in net assets to net cash flows from operating activities, such as the following:

RECONCILIATION OF CHANGE IN NET ASSETS TO NET CASH FLOWS FROM OPERATING ACTIVITIES	
Change in net assets	$ 123,000
Adjustments to reconcile change in net assets to net cash provided by operating activities:	
Depreciation	9,400
Gain on sale of equipment	(700)
(Increase) decrease in:	
Receivables	(10,200)
Inventories	3,450
Prepaid expenses	1,100
Increase (decrease) in:	
Accounts payable	7,250
Accrued liabilities	(1,500)
Contributions restricted for long-term investment	(28,250)
Interest and dividends restricted for long-term investment	(5,400)
Net unrealized and realized gains on investment	(85,800)
NET CASH PROVIDED BY OPERATING ACTIVITIES	$ 12,350

If the indirect method is used, interest and income taxes, including unrelated business income taxes and excise taxes, paid, if any, are required to be disclosed. The recommendations for those disclosures are as follows:

a. Interest payments generally can be derived by adjusting interest charged to operations by the change in accrued interest expense.

b. FASB ASC 230-10-50-2 requires interest paid (net of amounts capitalized) to be disclosed. Since interest paid is classified as an operating activity, the objective of the disclosure is to allow financial statement users to consider interest paid as a financing cash outflow if that better suits their purposes. Thus, the amount to be disclosed is the amount of interest reflected in operating cash outflows. If interest is capitalized as part of the cost of property and equipment, the amount capitalized should be subtracted from total interest paid when calculating the interest payments to disclose. The resulting amount is the interest payments that are classified as an operating cash disbursement. (Total interest payments need not be reduced for interest amounts capitalized into inventory, however, since those amounts would be included in operating cash flows.) As an example, if interest payments total $75,000 and interest of $30,000 is capitalized as a cost of constructing a building, cash flows from operations reflect interest payments of $45,000. Thus, $45,000 should be disclosed as interest paid. (Normally, the amount of interest capitalized is calculated using interest costs determined on the accrual basis; it is not based on payments, and accrued interest is not allocated between capitalized amounts and amounts charged against unrestricted net assets (net assets without donor restrictions after the adoption of ASU 2016-14). Therefore, best practices indicate that it is appropriate to determine the amount to disclose by subtracting the amount of interest capitalized from total

interest payments.) Disclosing the amount of interest payments capitalized is not required; however, FASB ASC 835-20-50 does require disclosing the amount of interest *cost* that has been capitalized.

c. The disclosure of income taxes paid should include any unrelated business income tax or excise tax paid for the period. That amount can be calculated by adjusting any tax charged to operations by the change in accrued taxes payable. If a nonprofit organization does not have a for-profit subsidiary generating taxable income, does not pay excise taxes, and has no unrelated business income and, therefore, no taxes are payable, no disclosure is necessary.

d. GAAP does not address how income tax refunds affect disclosure of income taxes paid. Best practices indicate that the amount disclosed should be net of receipts of income tax refunds. (In some years, that might result in disclosing net receipts.) Furthermore, it is unnecessary to disclose either (1) the gross amount of receipts and payments or (2) that a net amount is presented.

The disclosures may be made on the face of the statement or in the notes. Illustrations of disclosures that are presented in the notes are as follows:

a. Interest paid during 20X7 and 20X6 (net of capitalized interest of $2,800 in 20X6) amounted to $15,300 and $13,100, respectively.

   Unrelated business income taxes paid amounted to $5,900 and $4,100 during 20X7 and 20X6, respectively.

b. Cash flows from operating activities reflect interest payments of $75,300 in 20X7 and $69,400 in 20X6, unrelated business income tax payments of $6,300 in 20X7, and receipts of $2,200 in 20X6 from unrelated business income tax refunds.

The disclosures could be added to existing long-term debt and income tax notes or disclosed in a separate note of supplemental cash flow disclosures.

Generally, the indirect method is the predominant method used in practice. It is more widely used because it is generally easier and takes less time to prepare.

Change in Methods. A nonprofit organization that uses the direct method one year may decide to change to the indirect method the next (or vice versa). The nonauthoritative guidance at Q&A 1300.20 of the AICPA Technical Questions and answers indicates the change from one method to another is considered a change in classification. As a result, the financial statements or the notes to the financial statements should disclose the change. Furthermore, if the statement of cash flows is presented for the previous year in comparative statements, the prior year's statement of cash flows should be restated using the current-year method. Again, the prior-period restatement should be disclosed.

Agency Transactions

Changes in certain assets and liabilities do not affect the statement of activities and, therefore, theoretically, do not affect cash provided from operating activities. However, FASB ASC 958-230-55-4 requires the cash effects of agency transactions to be reported as cash flows from operating activities. Examples of common agency or custodial transactions include federated fund-raising organizations that receive cash designated for particular organizations or other organizations that collect and disburse funds on behalf of a third party. Agency transactions may be reported net in the statement of cash flows. It is acceptable to report only the net changes in those types of assets and liabilities because knowledge of gross amounts generally is not essential to understanding the nonprofit organization's operating, investing, and financing activities. However, an organization that receives significant resources from agency transactions (such as federated fund-raising organizations) may choose to report the gross cash receipts and payments on the statement of cash flows to more completely reflect the results of its fund-raising efforts.

Whether agency transactions affect the statement of cash flows depends on whether, on the statement of financial position, the nonprofit organization segregates the cash and other assets held as agent for other entities. If it does so, the change in the assets held for others asset account will equally offset the change in the agency obligations liability account, and many organizations will not show either change on the face of the statement of cash flows. However, if the organization combines the cash, receivables, or other assets held for the other entities with its own, the change in the liability account will be reported in the statement of cash flows. If the direct method is used, the cash inflows and outflows could be netted and reported under one caption, such as "Net cash payments to XYZ Organization," or they could be reported gross as separate cash inflows and cash outflows. If the indirect method is used, only the changes in the assets and corresponding liabilities will be reflected; yet, even those may be netted so that one caption, "Increase in net payable to XYZ Organization," for example, is reported on the statement.

Nonprofit organizations that receive significant resources from agency transactions may choose to use the direct method to more completely reflect the results of fund-raising efforts (cash received from agency transactions would ordinarily not be reported if the indirect method were used). The Audit Guide, Paragraph 3.49, notes that organizations that have a primary mission component of receiving resources as agents might consider placing the statement of cash flows as the first statement in their financial statements to emphasize the information about agency transactions.

Other Adjustments to Arrive at Net Cash Flows from Operating Activities

The following paragraphs discuss other adjustments to arrive at net cash flows from operating activities when the indirect method is used to present cash flows. The objective of the adjustments is to present net cash flows generated by operating activities by adding noncash expenses to and subtracting noncash revenues from the change in net assets. The adjustments should be reflected either in the statement itself or in a separate schedule. Except, when the direct method is used, the following items are not reported in the statement of cash flows because the direct approach only reflects cash receipts and payments. (However, the items would be shown in the reconciliation of change in net assets to net cash provided by operating activities, if one is presented.)

Operating Assets and Liabilities. Noncash changes in operating assets and liabilities generally should be presented as separate adjustments to the change in net assets in arriving at cash flows from operating activities. A common example of a noncash transaction affecting an operating asset is recording an allowance for uncollectible receivables (including loans receivable) or unconditional promises to give to recognizing a decrease in the amount of cash expected to be received. To illustrate, assume that a nonprofit organization's activities related to unconditional promises to give, that are not restricted for long-term purposes are summarized as follows:

	Receivable for Unconditional Promises to Give	Allowance for Uncollectible Promises to Give
Balance 1/1/X6	$ 50,000	$ 10,000
Promises received	300,000	—
Cash collected	(250,000)	—
Increase in allowance for uncollectible promises to give	—	25,000
Write-offs	(20,000)	(20,000)
Balance 12/31/X6	$ 80,000	$ 15,000

Assuming a $50,000 increase in net assets, the operating activities section of the statement of cash flows would be presented as follows:

CASH FLOWS FROM OPERATING ACTIVITIES	
Increase in net assets	$ 50,000
Adjustments to reconcile increase in net assets to net cash provided by operating activities:	
Bad Debt Expense	25,000
Increase in receivable for unconditional promises to give	(50,000)
NET CASH PROVIDED BY OPERATING ACTIVITIES	25,000

The increase in the receivable for promises to give is calculated as the new promises received ($300,000) less the cash collected ($250,000). The increase can also be calculated indirectly as the difference between the net receivable at January 1, 20X6, of $40,000 and those at December 31, 20X6, of $65,000 (or a $25,000 increase) plus the $25,000 increase in the allowance for uncollectible promises to give already identified, resulting in an increase of $50,000. If noncash activity is not material for some operating assets and liabilities, generally it is appropriate to present only the net change in those accounts as adjustments to arrive at net cash flows from operating activities.

Allowance for Uncollectible Unconditional Promises to Give. In the preceding example under the indirect method an increase in the allowance for uncollectible promises to give is added back to the change in net assets to arrive at cash flows from operating activities. Under the direct method, the noncash increase in the allowance is not reported in cash flows from operating activities. In addition, however, nonprofit organizations that choose to use the direct method must also reconcile changes in net assets to cash flows from operating activities and the increase in the allowance would be reflected as a reconciling item.

The example presented assumes the unconditional promises to give are not restricted for long-term purposes and, accordingly, are considered operating assets. In contrast, unconditional promises to give that *are* restricted for long-term purposes are considered financing assets. Any increase in the related allowance for uncollectible promises to give restricted for long-term purposes should be considered a noncash financing transaction To clearly identify the noncash financing transactions, any bad debt expense related to promises to give restricted for long-term purposes should be reported separately from bad debt expense related to other promises to give in the adjustments to derive cash flows from operating activities.

Amortization of Discount on Unconditional Promises to Give. Nonprofit organizations are required to measure unconditional promises to give that are expected to be collected in more than one year at fair value. If a present value technique is used to initially measure fair value, the organization recognizes the amortization of the associated discount in the statement of activities each reporting period, and the only cash activity relates to payments received on the unconditional promises to give. The presentation of the discount amortization in the statement of cash flows depends on whether or not it relates to unconditional promises to give that are restricted for long-term purposes.

Unconditional promises to give that are donor-restricted for long-term purposes are considered financing assets. Consequently, best practices indicate that amortization of the discount on such promises to give should be considered a noncash financing transaction. Under the direct method, the amortization of the discount would not be reported in cash flows from operating activities, but it would be reflected as an adjustment to reconcile changes in net assets to cash flows from operating activities. Similarly, under the indirect method, the amortization must be deducted from the change in net assets to arrive at cash flows from operating activities.

Amortization relating to unconditional promises to give that are *not* restricted for long-term purposes represents an operating activity, not a financing activity. Therefore, to clearly identify noncash financing transactions, any amortization relating to unconditional promises to give that are restricted for long-term purposes should be reflected on the statement of cash flows separately from amortization related to other unconditional promises to give that are considered operating assets.

To illustrate, assume that a nonprofit organization's activities relating to promises to give are in the following table. Also assume that the organization does not need an allowance for uncollectible promises.

	Unconditional Promises to Give Restricted for Long-term Purposes	Other Unconditional Promises to Give
Balance 1/1/X6	$ 115,000	$ 94,000
Net unconditional promises received, at fair value	240,000	165,000
Amortization of discount	21,000	14,500
Cash collected	(184,000)	(129,000)
Balance 12/31/X6	$ 192,000	$ 144,500

The increase in the unconditional promises restricted for long-term purposes ($240,000) is reported as an adjustment to reconcile to operating cash flows and the cash collections on the promises restricted for long- term purposes ($184,000) will be reported elsewhere as a financing cash inflow. The cash collections on the other promises receivable ($129,000) are netted against the new promises received ($165,000) and the net increase ($36,000) is reported as an adjusting item. The discount amortization related to the financing assets is reported separately from the amortization related to other unconditional promises to give. Assuming a $350,000 increase in net assets, the operating activities section of the statement of cash flows would be presented as follows:

CASH FLOWS FROM OPERATING ACTIVITIES	
Increase in net assets	$ 350,000
Adjustments to reconcile increase in net assets to net cash provided by operating activities:	
Contributions restricted for long-term purposes	(240,000)
Increase in other promises to give	(36,000)
Amortization of discount:	
Unconditional promises to give restricted for long-term purposes	(21,000)
Other unconditional promises to give	(14,500)
NET CASH PROVIDED BY OPERATING ACTIVITIES	38,500

Restricted Contributions and Investment Income. Contributions and investment income that are donor-restricted for long-term purposes are considered financing transactions, not operating transactions. Contributions restricted to long-term purposes include contributions restricted to endowment, the purchase of long-lived assets, and the creation of split-interest trusts. Accordingly, when the indirect method is used, those activities must be subtracted from the change in net assets to derive cash flows from operating activities. To the extent this income was received as cash it is reported in cash flows from financing activities. If contributions restricted for long-term purposes are in the form of unconditional promises to give or if the organization receives current-year payments on prior-period promises to give that have long-term restrictions, the amount subtracted from the change in net assets to arrive at cash flows from operating activities will not be the same as the amount reflected as cash flows from financing activities. This is because the amount from the statement of activities reflected as an adjustment to reconcile the change in net assets to operating cash flow could include both cash and noncash activity while, as previously stated, only the cash received as contributions and collections of promises to give that are restricted for long-term purposes is reported as a financing cash flow.

If the direct method is used, only collections of contributions and investment income that are restricted for long-term purposes are included in cash flows from financing activities, if one is presented. (However, the items would be shown in the reconciliation of the change in net assets to net cash provided by operating activities.)

Amortization of Intangible Assets and Deferred Charges. Intangible assets and deferred charges (expenditures expected to yield benefits for several accounting periods) are classified as assets and may be periodically charged to expense over some period of time depending on the nature of the intangible asset or deferred charge. Some examples of intangible assets are goodwill, copyrights, franchises, licenses, trademarks, formulas, mailing lists, and film rights. While many types of intangible are uncommon for most nonprofit organizations, an organization might purchase a mailing or donor list, a copyright, or it may record goodwill that results from a merger with another nonprofit organization. The amortization or impairment of intangible assets and deferred charges do not use cash, and any amortization expense or impairment loss recognized in the statement of activities should be added back to the change in net assets to arrive at cash flows provided by operating activities.

Cash Value of Life Insurance. Nonprofit organizations rarely own the cash value of life insurance. However, should a nonprofit organization happen to own it, cash value of life insurance is reported in the statement of financial position as an asset, and increases in cash value that are allowed to accumulate are included in the change in net assets as a reduction of insurance expense (if the insurance is on the life of a key employee) or as contribution revenue (if the insurance is on the life of a donor that contributed the policy). Since the increases do not provide cash, however, they should be subtracted from the change in net assets to arrive at cash flows from operating activities. Life insurance that accumulates value has both operating and investing characteristics. Whether the transaction is reported as operating or investing depends on the reason why the insurance policy is owned. The primary reason for life insurance is to reduce the risk of decreases in net assets resulting from the death of a key employee the life insurance transactions should be classified as operating activities. However, if the purpose of owning the policy is as an investment contributed by a donor, the change in the value of that policy is a noncash investing transaction. In either case, the increase in the value of the policy is an adjustment to the change in net assets to arrive at net cash provided by operations. The following is an example of the operating activities section of the statement of cash flows in those circumstances.

CASH FLOWS FROM OPERATING ACTIVITIES	
Change in net assets	$ 38,000
Adjustment to reconcile change in net assets to net cash provided by operating activities:	
Increase in cash value of life insurance	(2,000)
NET CASH PROVIDED BY OPERATING ACTIVITIES	36,000

If the organization opts to apply life insurance earnings to reduce premium payments rather than to increase cash surrender value, the effect is that the cash surrender value of life insurance account is neither increased for the earnings nor decreased for the payment of the premiums. Theoretically, noncash changes in operating assets applies if the life insurance is on a key employee; the offset is a noncash investing transaction if the life insurance is an investment. In most circumstances the noncash aspects attributable to the offset would not be material. Accordingly, the offset would not be disclosed as a separate item.

Upon the death of the insured individual, the organization will receive the face amount of the policy. If the insured is a key employee, the receipt of the policy's proceeds is an operating cash flow, and the only effect on the statement of cash flows is the adjustment to reconcile the change in net assets to net cash provided by operating activities for the decrease in the cash value of the life insurance policy. If the insured is a donor, the receipt of the policy's proceeds is an investing cash flow. The gain on maturity of the life insurance policy would be reported as an investing cash flow, and an adjustment to reconcile the change in net assets to net cash provided by operating activities would remove that gain from the cash flows from operating activities. The following is an example of the receipt of the proceeds of a $250,000 face value policy on the life of a donor when the cash surrender value was $50,000.

CASH FLOWS FROM OPERATING ACTIVITIES	
Change in net assets	$ 1,425,000
Adjustment to reconcile change in net assets to net cash provided by operating activities:	
Gain on maturity of life insurance policy	(200,000)
NET CASH PROVIDED BY OPERATING ACTIVITIES	1,245,000
CASH FLOWS FROM INVESTING ACTIVITIES	
Proceeds on maturity of life insurance policy	$ 250,000

When the life insurance policy is held as an investment contributed by a donor, the gain recognized upon the death of the insured donor is reported similar to a gain on sale or maturity of an investment and the transaction could be combined with other realized gains on sales of investments for reporting purposes, especially if the amount were immaterial.

Deferred Income Taxes. Nonprofit organizations could have deferred taxes as a result of unrelated business taxable income or net investment income subject to excise taxes. For example, deferred income taxes could arise as a result of a nonprofit organization using a different depreciation method for book purposes than for the Form 990-T on assets generating unrelated business taxable income or investment income. Also common are deferred taxes resulting from unrealized appreciation on investment portfolios of private foundations. Private foundations are subject to excise taxes on net investment income, but taxes are only payable currently on net realized gains. If a nonprofit organization does have deferred taxes, they are noncash expenses and should be added back to, or subtracted from, the change in net assets to arrive at net cash flows from operating activities.

Deferred Revenue. Deferred revenue represents revenue that has been received or is receivable before it is earned (i.e., before the performance obligations are satisfied). Nonprofit organizations that sell season tickets or collect annual membership dues often have substantial amounts of deferred revenue. However, nonprofit organizations are not typically paid in advance for services to be rendered or goods to be delivered. Deferred revenue relating to season ticket sales or membership dues, for example, would be reported as cash received from the sale of season tickets or cash collected from members if the organization uses the direct method of reporting cash flows from operating activities. (Either of those captions could also include the corresponding year if the organization wishes to segregate the cash receipts relating to the prior year from those relating to the current year on the statement of cash flows.) Using the indirect method, the change in the balance of deferred revenue would be added to or subtracted from the change in net assets to arrive at net cash flows from operating activities. For example, assume that in 20X6 cash received from season ticket sales for the next year amounted to $35,000, and in 20X7 cash received from season ticket sales for the next year amounted to $40,000. Both amounts were properly recorded as deferred revenue at each respective year end; no other transactions occurred. The operating activities section of the 20X7 statement of cash flows, using the indirect method, would be presented as follows:

CASH FLOWS FROM OPERATING ACTIVITIES	
Increase in net assets	$ 35,000
Adjustment to reconcile increase in net assets to net cash provided by operating activities:	
Increase in deferred revenue	5,000
NET CASH PROVIDED BY OPERATING ACTIVITIES	40,000

Deferred revenue may result from cash collected in advance or a related accounts receivable. For example, some grantors pay in advance of incurring the specified costs. The amounts of deferred revenue and related accounts receivable that have not been collected at the end of the year would not be reflected in the statement of cash flows because they represent noncash items. Preparers should note that no disclosure of the transaction would be required because only supplemental disclosure of noncash *investing* and *financing* transactions is required. Under the indirect method of presenting cash flows from operating activities, most organizations would report both the change in the accounts receivable and the change in the deferred revenue accounts as adjustments, although some might net the two amounts and report only the cash received as the increase in deferred revenue.

Depreciation. Productive assets that are economically useful for longer than one year may be capitalized and charged to operations as depreciation over their estimated useful lives. Since depreciation is a noncash expense, it should be added back to the change in net assets in arriving at cash flows from operating activities.

Disposal, Sale, and Retirement of Property and Other Long-term Assets. When long-term assets are sold or retired, the cash effects of the transaction are equal to the proceeds received. Thus, any gain or loss associated with the disposal of long-term assets should be subtracted from or added back to the change in net assets in arriving at net cash flows from operating activities, and proceeds from the sale should be shown as cash inflows from investing activities. Any expenses incident to the sale also should be added back to the change in net assets and shown as an investing activity. That approach should be followed regardless of whether there is a gain or loss on the disposal or whether assets are sold or retired (i.e., no proceeds are received).

Earnings from Investments in Common Stock. The classification of earnings from investments in common stock by nonprofit organizations in the statement of cash flows is determined in part on the method of accounting for the related investments.

For nonprofit organizations accounting for investments in common stock under the equity method of accounting, investment earnings are recognized as income when they accrue rather than when they are distributed as dividends. Thus, the investor's share of *undistributed* earnings or loss of an investee (i.e., equity pick up less dividends) should be subtracted from (for earnings) or added back (for losses) to the change in net assets to arrive at cash flows from operating activities. Assuming a nonprofit organization's share of earnings in 20X7 was $40,000, its share of net loss in 20X6 was $15,000, and dividends of $5,000 were received in both years, cash flows from operating activities would be presented as follows:

	20X7	20X6
CASH FLOWS FROM OPERATING ACTIVITIES		
Change in net assets	$ 63,000	$ 42,000
Adjustment to reconcile change in net assets to net cash provided by operating activities:		
(Equity in earnings) share of loss of ABC Company, net of dividends received of $5,000 in 20X7 and 20X6	(35,000)	20,000
NET CASH PROVIDED BY OPERATING ACTIVITIES	28,000	62,000

If investments are accounted for by the cost method or are reported at fair value, dividends received are generally recorded as investment earnings and are, therefore, considered to be cash inflows from operating activities. Accordingly, no adjustment to the change in net assets related to dividends received is required to arrive at cash flows from operating activities.

Transfers of Assets to Organizations that Raise or Hold Contributions for Others. Under certain situations, the accounting for transactions involving transfers of assets to a nonprofit organization that raises or holds contributions for others is similar to the accounting for equity in earnings from investments in common stock under FASB ASC 958-20-25-2 . Accordingly, those transactions are recorded on the accrual basis rather than when the cash is actually distributed or received. For example, in a transaction involving related but separate organizations, the beneficiary's share of the change in the interest in the net assets of the recipient organization is recognized as income when it accrues rather than when it is distributed to the beneficiary. When determining cash flows from operations, the impact of transactions accounted for similar to using FASB ASC 323-10 needs to be considered. Thus in the previous example, the beneficiary's share of the change in the interest in the net assets of the recipient organization (i.e., equity pick up less distributions) should be subtracted from or added back to the change in net assets to arrive at cash flows from operating activities. If a portion of the distributions from the recipient organization were for long-term purposes (such as for the purchase of property and equipment or for endowment), that portion would be subtracted from the change in net assets and reported as financing cash inflows, similar to restricted contributions.

Realized and Unrealized Gains and Losses on Investments. Regardless of the method of accounting used by a nonprofit organization to account for investments, realized gains or losses are recognized in the statement of activities when the investments are sold, yet the only cash effects of the transactions are the proceeds received. Thus, any gain or loss associated with the sale of investments should be subtracted from or added back to the change in net assets in arriving at net cash flows from operating activities, and proceeds from the sale should be shown as cash inflows from investing activities.

Investments measured at fair value will generate unrealized gains and losses in the statement of activities. Because unrealized gains and losses are noncash items, under the indirect method of presenting the statement of cash flows, the change in net assets should be adjusted for their effects by adding back unrealized losses and subtracting unrealized gains to arrive at cash flows from operating activities. Under the direct method, unrealized gains and losses will not be reported in the statement of cash flows; instead, they should be disclosed as noncash investing and financing transactions. However, since such gains and losses will be reflected as adjustments in the reconciliation of the change in net assets to cash flows from operating activities (if one is presented) under the direct method, best practices indicate that additional disclosure in a supplemental schedule or notes to the financial statements is unnecessary.

The following illustrates a portion of a statement of cash flows of a nonprofit organization that carries its investments at fair value and presents its statement of cash flows using the indirect method. Investments with a cost of $44,320 were sold for $67,420; unrealized losses of $2,500 were recorded in the statement of activities, and no other transactions occurred.

CASH FLOWS FROM OPERATING ACTIVITIES	
Change in net assets	$ 20,600
Adjustments to reconcile change in net assets to net cash provided by operating activities:	
Realized gains on sales of investments	(23,100)
Unrealized losses on investments	2,500
NET CASH PROVIDED BY OPERATING ACTIVITIES	—
CASH FLOWS FROM INVESTING ACTIVITIES	
Proceeds from sales of investments	67,420

Alternatively, nonprofit organizations may choose to aggregate realized and unrealized gains and losses on investments as a single line item in reconciling the change in net assets to net cash provided by operating activities. The adjustment could be captioned "Net realized and unrealized gains and losses on investments."

The discussions and illustration relating to realized and unrealized gains and losses on investments are appropriate whether the gain or loss is classified in the statement of activities as unrestricted, temporarily restricted, or permanently restricted (net assets without donor restrictions or net assets with donor restrictions after the adoption of ASU 2016-14). As previously noted, no distinction among the categories of net assets is required to be made in the statement of cash flows.

Noncontrolling Interests. The consolidated statement of activities presents the consolidated change in net assets followed by separate amounts of change in net assets attributable to the parent and the noncontrolling interest. Because the noncontrolling interest is not reported as an expense in the consolidated financial statements, no adjustment to reconcile the change in net assets to net cash provided by operating activities is needed for the change in net assets attributable to the noncontrolling interest. Rather, the cash flow statement begins with the consolidated change in net assets.

Split-Interest Agreements. The following adjustments related to split interest gifts are commonly reported in a statement of cash flows to reconcile the change in net assets to net cash flows from operating activities:

- To remove the effects of noncash operating revenues and expenses:
  - A change in the value of a split-interest agreement reported in the statement of activities as a debit (loss or expense) is added to the change in net assets.
  - A change in the value of a split-interest agreement reported in the statement of activities as a credit (gain or revenue) is subtracted from the change in net assets.
  - A change in a beneficial interest in a trust account reported in the statement of activities as a debit (loss or expense) is added to the change in net assets.
  - A change in a beneficial interest in a trust account reported in the statement of activities as a credit (gain or revenue) is subtracted from the change in net assets.
- To remove the effects of financing and investing activities:
  - Net gains on sales of trust investments are subtracted as a reconciling item only if the gain is reported in the statement of activities, and thus is included in the change in net assets. (Be careful not to double count these transactions if they are already included in the analysis of the investment account.) When the nonprofit organization is the trustee for the trust assets, gains on investments of split-interest unitrusts and annuity trusts are reported as increases in the liability for amounts held for the donor or another beneficiary. Therefore, net gains on sales of trust investments can be ignored for purposes of preparing the statement of cash flows if the offset is to the liability account. Only gains related to charitable gift annuities whose investments are held as the general assets of the organization are included as a reconciling item.
  - Similar to net gains, net losses on sales of trust investments are added back as a reconciling item only if the loss is reported in the statement of activities.
  - Contributions (cash, securities, or other assets) that are restricted to split-interest trust agreements are subtracted as a reconciling item. (When the organization is the trustee, the adjustment relates only to the contribution portion of the transaction, not the amount of the assets transferred.)
  - Contributions that are beneficial interests in trusts held by others are subtracted as a reconciling item.

SELF-STUDY QUIZ

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

15. Which of the following would be classified as an operating activity on the Statement of Cash Flows?

    a. Investment income (from an endowment) that is donor-restricted for long-term purposes.

    b. A payment to purchase equipment.

    c. Contributions received in a capital campaign to be used to build a new facility.

    d. Unrestricted cash donations received from contributors.

16. FASB ASC 230-10-50-2 requires disclosure of interest paid (net of amounts capitalized) regardless of whether the direct or indirect method is used. Assume ABC Organization made total interest payments in the amount of $150,000 for the fiscal year. $60,000 of the total was capitalized as a cost of constructing a building. In addition, $10,000 was capitalized into inventory. What should the cash flows from operations reflect for interest payments?

    a. $80,000.

    b. $90,000.

    c. $140,000.

    d. $150,000.

17. Which of the following is an advantage of using the indirect method for the statement of cash flows?

    a. It provides more useful information.

    b. It is easier and takes less time to prepare.

    c. Do not have to show noncash items.

    d. It is the method preferred by GAAP.

18. Canine Care, a nonprofit organization, had a balance at the beginning of the year in receivable for unconditional promises to give of $120,000. During the year CC received $540,000 in promises to give and collected $420,000 by the end of the year. During the year, $60,000 was written off as uncollectible. The balance of the allowance for uncollectible promises to give was $24,000 at the beginning of the year. An allowance for uncollectible promises to give was recorded in the amount of $75,000. What is the amount of increase in receivable for unconditional promises to give that would be reported in operating activities under the indirect method?

    a. $60,000.

    b. $120,000.

    c. $135,000.

    d. $180,000.

19. Which of the following statements regarding restricted contributions and investment income is correct?

    a. Long-term donor-restricted investment income and contributions are considered operating transactions.

    b. Only collections of contributions and investment income that are restricted for long-term purposes can be included in cash flows from financing activities when the indirect method is used.

    c. The amount that is subtracted from the change in net assets to arrive at cash flows from operating activities will be different from the amount reflected as cash flows from financing activities if contributions restricted for long-term purposes are in the form of unconditional promises to give.

20. ABC Organization, a nonprofit organization using the indirect method for the statement of cash flows, purchased a mailing list that it plans to use over the next three years. Which of the following statements is correct?

    a. The list should be expensed when purchased.

    b. The amortization expense uses cash from the organization each period as it is expensed.

    c. The amortization expense should be added back to the change in net assets to arrive at cash flows provided by operating assets.

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.)**

15. Which of the following would be classified as an operating activity on the Statement of Cash Flows? **(Page 195)**

    a. Investment income (from an endowment) that is donor-restricted for long-term purposes. [This answer is incorrect. Investment income that is donor-restricted for long-term purposes is considered a financing activity.]

    b. A payment to purchase equipment. [This answer is incorrect. Cash outlays for acquiring long-lived assets should be reported as a cash outflow from investing activities.]

    c. Contributions received in a capital campaign to be used to build a new facility. [This answer is incorrect. Receipts of contributions that have been restricted for long-term purposes by the donor are considered financing activities. Long-term purposes include constructing property.]

    d. Unrestricted cash donations received from contributors. [This answer is correct. Cash flows from operating activities include cash received from contributors. FASB ASC 230-10-20 defines cash flows from operating activities by exception: operating activities include all transactions and events that are not investing or financing activities.]

16. FASB ASC 230-10-50-2 requires disclosure of interest paid (net of amounts capitalized) regardless of whether the direct or indirect method is used. Assume ABC Organization made total interest payments in the amount of $150,000 for the fiscal year. $60,000 of the total was capitalized as a cost of constructing a building. In addition, $10,000 was capitalized into inventory. What should the cash flows from operations reflect for interest payments? **(Page 198)**

    a. $80,000. [This answer is incorrect. Total interest payments need not be reduced for interest amounts capitalized into inventory, because those amounts would be included in operating cash flows.]

    b. $90,000. [This answer is correct. FASB ASC 230-10-50-2 requires disclosure of interest paid net of amounts capitalized for the cost of property and equipment. The amount capitalized as a cost of constructing a building ($60,000) should be subtracted from total interest paid ($150,000) when calculating the interest payments to disclose. Total interest payments need not be reduced for interest amounts capitalized into inventory, because those amounts would be included in operating cash flows.]

    c. $140,000. [This answer is incorrect. FASB ASC 230-10-50-2 requires disclosure of interest paid net of amounts capitalized for the cost of property and equipment. On the other hand, amounts capitalized into inventory, would not reduce total interest payments.]

    d. $150,000. [This answer is incorrect. The amounts capitalized as a cost of constructing a building should be subtracted from the total interest payments for this disclosure. ABC Organization would not disclose interest paid of $150,000.]

17. Which of the following is an advantage of using the indirect method for the statement of cash flows? **(Page 195)**

    a. It provides more useful information. [This answer is incorrect. Proponents of the direct method, not the indirect method, believe it is preferable because it shows the actual sources and uses of cash from operating activities and, therefore, provides meaningful information.]

    b. It is easier and takes less time to prepare. [This answer is correct. The indirect method is the predominant method used in practice. It is more widely used because it is generally easier and takes less time to prepare a statement of cash flows using the indirect method.]

c. Do not have to show noncash items. [This answer is incorrect. This is an advantage of the direct method. Because the direct method explicitly shows only cash receipts and payments, no adjustments are necessary for noncash revenues and expenses such as contributions of property and depreciation.]

d. It is the method preferred by GAAP. [This answer is incorrect. GAAP encourages the use of the direct method, not the indirect method, because it shows the actual sources and uses of cash from operating activities.]

18. Canine Care, a nonprofit organization, had a balance at the beginning of the year in receivable for unconditional promises to give of $120,000. During the year CC received $540,000 in promises to give and collected $420,000 by the end of the year. During the year, $60,000 was written off as uncollectible. The balance of the allowance for uncollectible promises to give was $24,000 at the beginning of the year. An allowance for uncollectible promises to give was recorded in the amount of $75,000. What is the amount of increase in receivable for unconditional promises to give that would be reported in operating activities under the indirect method? **(Page 200)**

a. $60,000. [This answer is incorrect. The increase in receivable for unconditional promises to give is not the difference between the balances at the beginning and end of the year. The allowances for uncollectible promises and the allowance for uncollectible promises to give recorded during the year must factor into the calculation.]

b. $120,000. [This answer is correct. The increase in receivable for unconditional promises to give is equal to the difference between net receivable for unconditional promises to give at the beginning and end of the year, plus the allowance for uncollectible promises to give already identified. Net receivable for unconditional promises to give at the end of the year is $141,000. Net receivable for unconditional promises to give at the beginning of the year is $96,000. The $45,000 increase in net receivables plus the $75,000 allowance for uncollectible promises to give recorded during the year equal $120,000, the increase in receivable for unconditional promises to give.]

c. $135,000. [This answer is incorrect. The net receivable for unconditional promises to give must be used to calculate the increase. Stated another way, the beginning and ending balances for receivable for unconditional promises to give must be reduced by the allowance for uncollectible promises to give.]

d. $180,000. [This answer is incorrect. This is the receivable for unconditional promises to give at the end of the year, not the increase in receivable for unconditional promises to give.]

19. Which of the following statements regarding restricted contributions and investment income is correct? **(Page 203**)

a. Long-term donor-restricted investment income and contributions are considered operating transactions. [This answer is incorrect. Contributions and investment income that are donor-restricted for long-term purposes are considered financing transactions, not operating transactions. Contributions restricted to long-term purposes include contributions restricted to endowment, the purchase of long-lived assets, and the creation of split-interest trusts.]

b. Only collections of contributions and investment income that are restricted for long-term purposes can be included in cash flows from financing activities when the indirect method is used. [This answer is incorrect. If the direct method is used, only collections of contributions and investment income that are restricted for long-term purposes are included in cash flows from financing activities, if one is presented.]

c. The amount that is subtracted from the change in net assets to arrive at cash flows from operating activities will be different from the amount reflected as cash flows from financing activities if contributions restricted for long-term purposes are in the form of unconditional promises to give. [This answer is correct. If contributions restricted for long-term purposes are in the form of unconditional promises to give or if the organization receives current-year payments on prior-period promises to give that have long-term restrictions, the amount subtracted from the change in net assets to arrive at cash flows from operating activities will not be the same as the

amount reflected as cash flows from financing activities. This is because the amount from the statement of activities reflected as an adjustment to reconcile the change in net assets to operating cash flow could include both cash and noncash activity while, as previously stated, only the cash received as contributions and collections of promises to give that are restricted for long-term purposes is reported as a financing cash flow.]

20. ABC Organization, a nonprofit organization using the indirect method for the statement of cash flows, purchased a mailing list that is plans to use over the next three years. Which of the followings is correct? **(Page 203)**

    a. The list should be expensed when purchased. [This answer is incorrect. Intangible assets and deferred charges are classified as assets and may be periodically charged to expense over some period of time depending on the nature of the intangible asset or deferred charge.]

    b. The amortization expense uses cash from the organization each period as it is expensed. [This answer is incorrect. The amortization or impairment of intangible assets and deferred charged do not use cash.]

    c. The amortization expense should be added back to the change in net assets to arrive at cash flows provided by operating assets. [This answer is correct. When using the indirect method to present cash flows from operating activities, adjustments are necessary to arrive at net cash flows from operating activities. Any amortization expense or impairment loss recognized should be added back to the change in net assets to arrive at cash flows provided by operating activities.]

CASH FLOWS FROM INVESTING ACTIVITIES

Investing activities include the following:

- Lending money and collecting on loans.
- Acquiring and selling or disposing of most debt and equity instruments that are not cash equivalents, except certain donated debt and equity instruments.
- Acquiring and selling or disposing of productive assets that are expected to generate revenue over a long period of time.
- Acquiring and selling collection items, regardless of whether they are capitalized in the statement of financial position.
- Receiving cash from contributions donor-restricted for long-term purposes for which the restrictions have not yet been satisfied and cash is still held.

Exhibit 3-1 lists some typical examples of cash flows provided by and used in investing activities. The following paragraphs discuss how to present cash flows from investing activities in statements of cash flows.

Presentation Considerations

Netting Certain Cash Flows. While FASB ASC 230-10-45-7 through 45-9 generally require that cash receipts and payments be reported on a gross rather than a net basis, cash flows related to loans and short-term investments with original maturities of three months or less may be reported net rather than gross. In addition, best practices indicate, prior to the adoption of ASU 2016-18, that changes in cash and cash equivalents restricted for long-term purposes, properly excluded from the nonprofit organization's definition of cash and cash equivalents for purposes of the statement of cash flows, may be reported net as investing activities. However, *all* other cash receipts and payments from investing activities should be reported on a gross basis.

Noncash Investing Activities. Certain investing activities, such as acquiring assets by assuming liabilities, exchanging assets, or receiving noncash contributions of investments or equipment, are transactions that do not involve cash receipts or payments. (Exhibit 3-1 lists other typical examples of noncash investing activities.) Nevertheless, investing activities that do not involve cash are required to be reported separately so that information is provided on all investing activities.

Capital Expenditures

Purchases. Cash outlays for acquiring long-lived assets (including capitalized interest, if any) should be reported as a cash outflow from investing activities. The amount to be reported in the statement of cash flows generally should consist of (a) assets purchased for cash and (b) cash down payment for assets purchased by assuming liabilities. Payments of liabilities, including lease obligations, trade-in allowances, and other noncash aspects of the transaction should be excluded from the amounts reported as investing activities. The following illustrates how to report a typical capital expenditure, assuming the following facts:

- Increase in net assets and depreciation for the year amounted to $12,000 and $3,000, respectively.
- On January 1, the nonprofit organization purchased a new machine with a list price of $74,000.
- A used machine with an undepreciated cost of $5,000 was traded in on the purchase. The trade-in allowance on the used machine was $4,000. Thus, the loss was $1,000.
- The nonprofit organization made a down payment of $10,000 and financed the balance of the purchase with an installment loan in the amount of $60,000 to be paid in six annual installments of $10,000 plus interest at the rate of 14%.

A statement of cash flows such as the following would be presented:

CASH FLOWS FROM OPERATING ACTIVITIES	
Increase in net assets	$ 12,000
Adjustments to reconcile increase in net assets to net cash provided by operating activities:	
Depreciation	3,000
Loss on disposal of equipment	1,000
NET CASH PROVIDED BY OPERATING ACTIVITIES	16,000
CASH FLOWS USED BY INVESTING ACTIVITIES	
Purchase of equipment	(10,000)
CASH FLOWS USED BY FINANCING ACTIVITIES	
Debt reduction	(10,000)
NET DECREASE IN CASH	(4,000)
CASH AT BEGINNING OF YEAR	24,000
CASH AT END OF YEAR	$ 20,000

Investing cash flows only include advance payments, the down payment, or other amounts paid at the time productive assets are purchased or shortly before or after. Thus, in the preceding example, cash flows used by investing activities consist solely of the $10,000 cash down payment. Subsequent principal payments on the installment loan are classified as financing activities. The noncash aspects of the transaction (equipment acquired by assuming liabilities, net of the trade-in allowance) should be disclosed separately.

Sales. Proceeds from sales of long-lived assets should be shown as cash inflows from investing activities. Accordingly, if the facts in the scenario above were changed to assume that a used machine with an undepreciated cost of $5,000 was sold for $6,500 (rather than traded in on the new equipment), a statement of cash flows such as the following would be presented:

CASH FLOWS FROM OPERATING ACTIVITIES	
Increase in net assets	$ 14,500
Adjustments to reconcile increase in net assets to net cash provided by operating activities:	
Depreciation	3,000
Gain on sale of equipment	(1,500)
NET CASH PROVIDED BY OPERATING ACTIVITIES	16,000
CASH FLOWS FROM INVESTING ACTIVITIES	
Proceeds from sale of equipment	6,500
Purchase of equipment	(10,000)
NET CASH USED BY INVESTING ACTIVITIES	(3,500)
CASH FLOWS USED BY FINANCING ACTIVITIES	
Debt reduction	(10,000)

NET INCREASE IN CASH	2,500
CASH AT BEGINNING OF YEAR	24,000
CASH AT END OF YEAR	$ 26,500

Note that the difference in the net change in cash between this example and the preceding example (an increase of $2,500, compared with a decrease of $4,000) equals the cash inflow from the sale of equipment in the amount of $6,500.

Collections

Although GAAP does not require collection items meeting certain criteria to be capitalized in the statement of financial position, it does encourage capitalization, either retroactively or prospectively. (Contributions of collection items are noncash activities that are excluded from statements of cash flows and separately disclosed.) Regardless of whether a nonprofit organization has capitalized its collection, purchases and sales of collection items are considered cash flows from investing activities. Such purchases and sales should be presented in the statement of cash flows similar to the illustrations for capital expenditures under the topic Purchases.

Purchases or proceeds from sales of noncapitalized collection items and proceeds from insurance recoveries of lost or destroyed collection items are presented separately in the statement of activities. Those activities would be reflected as adjustments to the change in net assets to arrive at net cash provided by operating activities. To illustrate, assume that a nonprofit organization spent $50,000 on collection items that were not capitalized. There were no donor restrictions related to the collection items. That transaction would be presented in the statement of cash flows as follows:

CASH FLOWS FROM OPERATING ACTIVITIES	
Change in net assets	$ 8,000
Adjustments to reconcile change in net assets to net cash provided by operating activities:	
Collection items purchased	50,000
NET CASH PROVIDED BY OPERATING ACTIVITIES	58,000
CASH FLOWS FROM INVESTING ACTIVITIES	
Purchase of collection items	(50,000)

Contributions Donor-restricted for Long-term Purposes for Which Restrictions Are Not Yet Satisfied

Receipts of cash contributions and receipts from disposing of certain donated financial assets that are donor-restricted for long-term purposes are considered financing activities, not operating activities. In addition, restricted cash is excluded from cash and cash equivalents for purposes of the statement of cash flows. As a result, if a cash contribution restricted for long-term purposes (such as for the purchase of equipment) has not been spent during the period to satisfy the donor restriction, both a cash inflow and a cash outflow must be presented on the statement of cash flows. The restricted contribution received is reported as a cash inflow from *financing* activities, and a corresponding cash outflow from *investing* activities is reported to arrive at the proper change in cash and cash equivalents for the period. For example, an organization receives a cash donation for the purchase of equipment but does not purchase the equipment before the end of its fiscal year. Thus, it still holds cash restricted for the purchase of the equipment at the financial statement date, and the restricted cash is excluded from cash and cash equivalents on the statement of financial position. The organization's statement of cash flows should reflect both a cash inflow from financing activities for the receipt of the contribution (using a caption such as "Contributions restricted for purchasing property and equipment") and a corresponding cash outflow from investing activities (using a caption such as "Purchase of assets restricted to investment in property and equipment"). The corresponding cash outflow must be reported to arrive at the proper change in cash and cash equivalents for the year. If the organization had purchased the equipment during the period, however, no corresponding cash outflow would

be necessary, as the equipment purchase would already be reflected as a cash outflow from investing activities on the statement of cash flows. Also, if this situation occurs in consecutive years and a balance of restricted cash is maintained, the activity in the restricted cash account may be presented on a net basis. Note that an adjustment to reconcile the change in net assets to net cash provided or used by operating activities would also be required.

Installment Sales

Installment sales of long-lived assets are considered investing activities. Accordingly, cash receipts in the form of cash down payments and collections of principal should be classified as cash provided by investing activities. (Interest collected should be classified as cash flows from operating activities, however.) For example, a building with an undepreciated cost of $60,000 (cost $100,000; accumulated depreciation $40,000) that is sold for $70,000 with terms of sale requiring a cash down payment of $20,000 and payment of the balance in five annual installments of $10,000 plus interest at the rate of 16% would result in the following amounts at the end of the first two years (assuming no other transactions):

	20X7	20X6
Change in net assets—$8,000 interest income in 20X7 and gain on sale of $10,000 in 20X6	$ 8,000	$ 10,000
Building	—	100,000
Accumulated depreciation	—	40,000
Sales price	—	70,000
Cash down payment	—	20,000
Short-term portion of receivable	10,000	10,000
Long-term portion of receivable	30,000	40,000
Principal collected	10,000	—

The following example illustrates how the transaction would be presented in the statements of cash flows:

	20X7	20X6
CASH FLOWS FROM OPERATING ACTIVITIES		
Change in net assets	$ 8,000	$ 10,000
Adjustment to reconcile change in net assets to net cash provided by operating activities:		
Gain on sale of building	—	(10,000)
NET CASH PROVIDED BY OPERATING ACTIVITIES	8,000	—
CASH FLOWS FROM INVESTING ACTIVITIES		
Collection on installment sales	10,000	20,000

Investments

Short-term Investments versus Cash Equivalents. If a nonprofit organization has amounts that do not meet the definition of cash according to GAAP, it must decide whether to account for such amounts as cash equivalents or as other short-term investments. [Cash equivalents are defined as "short-term, highly liquid investments that are both (a) readily convertible to known amounts of cash and (b) so near to their maturity that they present insignificant risk of changes in value because of changes in interest rates." However, cash equivalents exclude short-term investments purchased with contributions that have donor-imposed restrictions limiting their use to long-term purposes.] Not all investments that meet the definition of cash equivalents are required to be treated as such for purposes of the statement of cash flows. In distinguishing between short-term investments that are classified as cash equivalents and those that are not, FASB ASC 230-10-45-6 and 230-10-50-1 (a) permit nonprofit organizations to establish a policy concerning which short-term, highly liquid investments with original maturities of three months

or less are considered cash equivalents and which are to be reported as short-term investments and (b) require nonprofit organizations to disclose the policy in their financial statements. Three illustrative disclosures follow.

- NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

  Cash Equivalents and Short-term Investments

  Cash equivalents consist primarily of repurchase agreements and commercial paper with original maturities of 90 days or less provided that those financial instruments are not held temporarily subject to donors' restrictions that the contributed resources be used to purchase property or equipment or invested as an endowment. Certificates of deposit with original maturities of more than 90 days are classified as short-term investments. Repurchase agreements and commercial paper held temporarily until property and equipment is purchased are classified as assets held for purchase of property and equipment. Repurchase agreements and commercial paper held as part of the endowment portfolio are classified as long-term investments. Cash equivalents and short-term investments are stated at cost, which approximates fair value. At December 31, 20X7 and 20X6, cash equivalents included with cash amounted to $40,900 and $31,800, respectively.

- NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

  Short-term Investments

  For purposes of the statement of cash flows, the Organization does not consider any of its investments in repurchase agreements and commercial paper to be cash equivalents, regardless of their original maturities. Those short-term investments are stated at cost, which approximates fair value. At December 31, 20X7 and 20X6, short-term investments amounted to $14,300 and $11,150, respectively.

- NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

  Cash Equivalents and Money-Market Funds

  Cash equivalents consist primarily of repurchase agreements, loan participations, and commercial paper with original maturities of 90 days or less. Money market funds, held as a portion of the Organization's endowment portfolio, are classified as short-term investments and are not considered to be cash equivalents for purposes of the statement of cash flows. Cash equivalents and money-market funds are stated at cost, which approximates fair value. At December 31, 20X7 and 20X6, cash equivalents amounted to $6,450 and $8,230, respectively.

Once a policy is established, it should be followed consistently. A change in the type of investments that are classified as cash equivalents is a change in accounting principle.

Purchases and sales of investments that are classified as cash equivalents are considered part of a nonprofit organization's cash management activities rather than part of their operating, investing, and financing activities. Thus, the net change in cash equivalents should be included in the net change in cash and cash equivalents shown in the statement of cash flows; purchases and sales of cash equivalents would not be reported separately.

Changes in cash and cash equivalents designated or restricted for long-term purposes (i.e., not currently available for use by the organization) are not a part of a nonprofit organization's cash management activities due to their nature; that is, their use is restricted by donor stipulation or board designation to purposes other than operations. Rather, changes in such cash and cash equivalents should be considered investing activities. Accordingly, best practices indicate that the net change in cash and cash equivalents designated or restricted for long-term purposes be reported as an investing activity.

Investments That Are Not Cash Equivalents. Purchases and sales of all investments that are not considered cash equivalents should be shown as investing activities in statements of cash flows. This includes proceeds from the sale of investments for nonprofit organizations that apply a spending rate to fund operations. The Audit Guide,

Paragraph 3.54, indicates that the spending rate does not affect the classification for cash flows and outflows. The following illustrates how investments that are not cash equivalents should be presented in statements of cash flows.

CASH FLOWS FROM OPERATING ACTIVITIES	
Change in net assets	$ 39,000
Adjustments to reconcile increase in net assets to net cash provided by operating activities:	
Depreciation	6,800
(Increase) decrease in:	
Unconditional promises to give	20,700
Inventories	(12,350)
Prepaid expenses	4,250
Decrease in:	
Accounts payable	(25,000)
Accrued liabilities	(12,350)
Contributions restricted for long-term investment	(5,630)
Unrealized and realized gains on investments	(14,700)
NET CASH PROVIDED BY OPERATING ACTIVITIES	720
CASH FLOWS FROM INVESTING ACTIVITIES	
Proceeds from sales of investments	19,600
Purchases of investments	(23,230)
NET CASH USED BY INVESTING ACTIVITIES	(3,630)

Interest and Dividend Income. Receipts of interest and dividends not restricted for long-term purposes should be classified as cash flows from operating activities rather than cash flows from investing activities. Interest and dividends that *are* donor restricted for long-term purposes should be classified as cash flows from financing activities. In many cases, interest and dividend income on investments held by outside custodians is automatically reinvested to principal. Such interest and dividend proceeds should be treated as "constructively received" and presented as a cash activity in the statement of cash flows. The interest or dividend income *not* restricted for long-term purposes should be reflected as a cash flow from operating activities, while the reinvestment should be reflected as an investing activity. (The interest or dividend income that is donor restricted for long-term purposes should be reflected as a cash flow from financing activities, while the reinvestment should be reflected as an investing activity.) Even though the proceeds are not physically transferred from the custodian and reinvested in separate transactions, the substance of the transaction is that cash proceeds could have been withdrawn but were instead used to increase an investment. Accordingly, presenting the transaction as a cash activity is more appropriate than presenting it as a noncash activity. If presented as a noncash activity, interest or dividend income without donor restrictions would be subtracted from the change in net assets in arriving at cash flows from operations and the reinvestment would be separately reported as a noncash investing and financing activity.

Split-Interest Agreements

The following activities related to split-interest gifts are commonly reported in a statement of cash flows as cash flows from investing activities:

- Cash distributions for operating purposes received from trusts held by others that are not perpetual trusts (an investing cash inflow).
- Purchases of investments held under split-interest agreements (an investing cash outflow).
- The sale of investments held under split-interest agreements (an investing cash inflow).

- The use of trust cash to pay distributions to beneficiaries or to the organization if trust cash is separately reported as a trust asset rather than commingled with the organization's cash (an investing cash inflow, because it is similar to a sale of trust assets).

- Uninvested cash at the inception of a split-interest agreement if trust cash is separately reported as a trust asset rather than commingled with the organization's cash (an investing cash outflow, because it is similar to a purchase of trust assets).

Making Loans

Making loans (notes and loans receivable) is an investment activity. Accordingly, the principal amount of the loan should be shown as cash used for investing activities, and principal collected on the loans should be shown as cash provided by investing activities. However, cash flows relating to loans receivable with original maturities of three months or less may be reported net. Interest collected on the loans should be shown as an operating activity. The following illustrates the operating and investing cash flows related to making loans.

CASH FLOWS FROM OPERATING ACTIVITIES	
Change in net assets	$ 31,300
Adjustment to reconcile change in net assets to net cash provided by operating activities:	
Depreciation	7,500
NET CASH PROVIDED BY OPERATING ACTIVITIES	38,800
CASH FLOWS FROM INVESTING ACTIVITIES	
Loans made	(27,700)
Collections on loans	8,500
NET CASH USED BY INVESTING ACTIVITIES	(19,200)

Mergers and Acquisitions

Purchase (Sale) of a Subsidiary. When a subsidiary is purchased or sold, statements of cash flows should report the *cash paid* to acquire the subsidiary (or cash proceeds from sale) as an investing activity. For example, if a nonprofit organization pays $90,000 to acquire an entity with working capital (other than cash) of $30,000 and net noncurrent assets of $60,000, cash flows from investing activities would be presented as follows:

CASH FLOWS FROM INVESTING ACTIVITIES	
Acquisition of ABC Company	(90,000)

The major categories and the fair values of assets obtained and liabilities assumed would be disclosed as noncash investing and financing activities. If the subsidiary has cash when it is acquired, the cash on its statement of financial position on the acquisition date is subtracted from the consideration paid. For example, if ABC Company had $12,000 cash in its account when it was acquired, the cash outflow for the acquisition of ABC Company would be $78,000 ($90,000 less $12,000).

Mergers. When two nonprofit organizations combine in a transaction or event that qualifies as a merger under FASB ASC 958-805, the merger itself should not be reported in the statement of cash flows and does not impact amounts reported as cash flows from investing activities.

CASH FLOWS FROM FINANCING ACTIVITIES

Financing activities include the following:

- Receiving resources that by donor stipulation must be used for long-term purposes.

- Borrowing money and repaying amounts borrowed, or otherwise settling the obligation.

- Obtaining and paying for other resources from creditors on long-term credit.

- Obtaining resources from owners and providing them with a return on, and a return of, their investment. (Because nonprofit organizations are typically not "owned" by any one individual or group of investors, that financing activity is not generally applicable to nonprofit organizations and is not addressed in this course.)

Exhibit 3-1 lists some typical examples of financing cash flows. The following paragraphs discuss how to present cash flows from financing activities in the statement of cash flows.

Presentation Considerations

Netting Certain Cash Flows. Cash receipts and payments are generally required to be reported on a gross rather than a net basis. However, borrowings with original maturities of three months or less may be reported on a net basis.

Noncash Financing Activities. Certain financing activities, such as obtaining a building by receiving a gift, do not involve cash receipts or payments. (Exhibit 3-1 lists other typical examples of noncash financing activities.) Financing activities that do not involve cash are required to be reported separately so that information is provided on all financing activities.

Donor-restricted Contributions for Long-term Purposes

Receipts of contributions and receipts from disposing of certain donated financial assets that donors have restricted for long-term purposes are considered financing activities. Long-term purposes include purchasing, improving, or constructing property, equipment, or any other long-lived asset and establishing or adding to a donor-restricted endowment or a split-interest trust. Only amounts that are donor-restricted for these purposes are financing cash flows. (A governing board's designations of certain contributions without donor restrictions or other resources for long-term purposes is not a financing cash flow.) Under the direct method, those types of restricted contributions are included in cash flows from financing activities. However, under the indirect method, the contributions are (a) deducted from the change in net assets to arrive at cash flows from operating activities and (b) reflected as cash inflows from financing activities. To illustrate both methods, assume that $100,000 was received to establish a perpetual endowment, $25,000 was received to acquire land, and $200,000 was received as contributions without donor restrictions. The $100,000 was invested in equity securities, and the land was acquired for the amount contributed. No other transactions occurred. The following example illustrates the direct method of presenting the statement of cash flows:

CASH FLOWS PROVIDED BY OPERATING ACTIVITIES	
Cash received from contributors	$ 200,000
CASH FLOWS FROM INVESTING ACTIVITIES	
Purchase of land	(25,000)
Purchase of investments	(100,000)
NET CASH USED BY INVESTING ACTIVITIES	(125,000)
CASH FLOWS FROM FINANCING ACTIVITIES	
Proceeds from contributions restricted for:	
Investment in perpetual endowment	100,000
Investment in land	25,000
NET CASH PROVIDED BY FINANCING ACTIVITIES	125,000

NET INCREASE IN CASH	200,000
CASH AT BEGINNING OF YEAR	—
CASH AT END OF YEAR	$ 200,000

The following example illustrates the indirect method of presenting the statement of cash flows:

CASH FLOWS FROM OPERATING ACTIVITIES	
Change in net assets	$ 325,000
Adjustment to reconcile change in net assets to net cash provided by operating activities:	
Contributions restricted for long-term purposes	(125,000)
NET CASH PROVIDED BY OPERATING ACTIVITIES	200,000
CASH FLOWS FROM INVESTING ACTIVITIES	
Purchase of land	(25,000)
Purchase of investments	(100,000)
NET CASH USED BY INVESTING ACTIVITIES	(125,000)
CASH FLOWS FROM FINANCING ACTIVITIES	
Proceeds from contributions restricted for:	
Investment in perpetual endowment	100,000
Investment in land	25,000
NET CASH PROVIDED BY FINANCING ACTIVITIES	125,000
NET INCREASE IN CASH	200,000
CASH AT BEGINNING OF YEAR	—
CASH AT END OF YEAR	$ 200,000

Had the $100,000 received to establish a perpetual endowment not been invested, but held as restricted cash instead, the caption under cash flows from investing activities would have been "Purchase of assets restricted for investment in endowment" instead of "Purchase of investments" since the $100,000 restricted cash would not have been included in the balance of "Cash at end of year," due to its restriction. If contributions are in the form of unconditional promises to give that are restricted for long-term purposes or if the organization receives current-year payments on prior-period promises to give restricted to long-term purposes, the amount subtracted from the change in net assets to derive at cash flows from operating activities will not be the same as the amount reflected as cash flows from financing activities.

Restricted Investment Income

Similar to donor-restricted contributions for long-term purposes, investment income that is donor-restricted for long-term purposes is also considered a financing activity, not an operating receipt. That situation could occur if a donor established an endowment, the income from which was required to be used to purchase property and equipment for a particular program. Another common example would be if a donor established a perpetual endowment for a particular program but required all investment income to be reinvested until the endowment reached a specified amount. When that point is reached, investment income would become unrestricted or only temporarily restricted (investment income with donor restrictions after the adoption of ASU 2016-14) and would be an operating cash flow. Again, under the direct method, the restricted investment income would be included in cash flows from financing activities. However, under the indirect method, the investment income restricted to long-term purposes must be deducted from the change in net assets to arrive at cash flows from operating activities and then

reflected as a cash flow from financing activities. To illustrate the indirect method, assume that interest and dividends of $12,000 were received and reinvested in securities in a perpetual endowment; $200,000 was received as contributions; without donor restrictions and no other transactions occurred.

CASH FLOWS FROM OPERATING ACTIVITIES	
Change in net assets	$ 212,000
Adjustment to reconcile change in net assets to net cash provided by operating activities:	
Interest and dividends donor-restricted for long-term reinvestment	(12,000)
NET CASH PROVIDED BY OPERATING ACTIVITIES	200,000
CASH FLOWS USED BY INVESTING ACTIVITIES	
Purchase of investments	(12,000)
CASH FLOWS PROVIDED BY FINANCING ACTIVITIES	
Interest and dividends donor-restricted for long-term	12,000
NET INCREASE IN CASH	200,000
CASH AT BEGINNING OF YEAR	—
CASH AT END OF YEAR	$ 200,000

Short-term and Long-term Debt

Cash receipts from both short-term and long-term borrowings should be shown as cash inflows from financing activities. The reduction of short-term and long-term obligations should be reported as a separate cash outflow from financing activities, except for cash flows related to borrowings with original maturities of three months or less, which may be reported net. To illustrate, assume that a nonprofit organization's activities related to borrowings are summarized as follows:

- Equipment was acquired in a capital lease transaction; the capital lease obligation was $84,000.
- Cash borrowed consisted of $10,000 of short-term debt payable in less than three months; $40,000 of other short-term debt; and $125,000 of long-term debt.
- Cash repaid on borrowings consisted of $8,100 on the capital lease obligation; $5,000 on short-term debt payable in less than three months; $15,000 on other short-term debt; and $12,000 on long-term debt.

Under these assumptions, the cash flows from financing activities would be presented as follows:

CASH FLOWS FROM FINANCING ACTIVITIES	
Proceeds from short-term debt	45,000
Payments of short-term debt	(15,000)
Proceeds from long-term debt	125,000
Payments of long-term debt	(20,100)
NET CASH PROVIDED BY FINANCING ACTIVITIES	134,900

Proceeds from short-term debt consist of the net cash flows from borrowings with original maturities of less than three months in the amount of $5,000 ($10,000 borrowed less $5,000 repaid) plus $40,000 from other short-term debt. Because payments on debt with original maturities of three months or less have been netted with new borrowings in this example, reduction of short-term debt consists solely of payments of other short-term debt in the amount of $15,000. Payments on long-term debt consist of $8,100 paid on capital lease obligations and $12,000

paid on other long-term debt. Note, however, that incurring the capital lease obligation does not affect cash and, thus, would be disclosed as a noncash investing and financing activity rather than as a cash inflow from financing activities.

Debt Issue Costs. FASB ASC 835-30-45-3 requires debt issue costs such as bank fees and other costs incurred in obtaining financing or refinancing to be presented as an offset to the related debt in the statement of financial position. The costs are therefore accounted for similarly to any premium or discount on the debt; that is, they are generally amortized over the term of the loan using the interest method.

FASB ASC 230-10-45-15 states that cash payments for debt issue costs should be classified as a financing activity. Accordingly, in the period the financing arrangement is reported, the amounts reflected as financing activities are the proceeds (the face amount of the debt less the bank fees and other costs incurred) and reflected as financing activities repayment of that amount (the reduction in the net liability reported in the financial statements). To illustrate, assume costs of $3,000 are incurred in obtaining a loan of $100,000. The loan is to be repaid in 36 monthly installments of $3,227, including interest at 10%. A rate of 12.11% discounts the payments to the net proceeds of $97,000 (calculated as principal less the issuance costs of $3,000). That is the effective rate. At the end of the first year, payments of $38,724 have been made. Based on the stated rate, those payments would have been allocated approximately $30,074 to principal and $8,650 to interest, and the balance outstanding would be $69,926. However, based on the effective rate, the payments have been allocated approximately $28,526 to principal and $10,198 to interest, and the balance outstanding is $68,474. Assuming those are the only transactions for the year, cash of $58,276 has been provided (that is, net the proceeds of $97,000 less the payments of $38,724). No adjustment is needed to reconcile the change in net assets with net cash provided by operating activities because interest expense is comprised of the portion of cash payments allocated to interest. A portion of the statement of cash flows would be as follows:

CASH FLOWS FROM OPERATING ACTIVITIES	
Change in net assets and net cash used in operating activities	$ (10,198)
CASH FLOWS FROM FINANCING ACTIVITIES	
Proceeds of long-term debt	100,000
Payments for debt issue costs	(3,000)
Principal payments of long-term debt	(28,526)
NET CASH PROVIDED BY FINANCING ACTIVITIES	68,474
NET INCREASE IN CASH	58,276

Life Insurance Policies. Although not particularly common, some nonprofit organizations may choose to obtain life insurance policies on key executive employees. Loans against such life insurance policies should be treated as long-term borrowings if the loans will be repaid following the guidance in the previous topic titled Short-term and Long-term Debt. Generally, however, the loans are considered to be permanent, and, in those cases, it is recommended treating them as distributions rather than loans. For example, assume that a nonprofit organization acquires an insurance policy that accumulates cash value of $9,000 over two years, borrows $2,000 against the cash value as a long-term liability in the first year (which is offset against cash value in the nonprofit organization's financial statements), and cancels the policy in the second year. If the loan were treated as a distribution, the following amounts would be reported in the statement of cash flows, assuming no other transactions:

	20X7	20X6
CASH FLOWS FROM OPERATING ACTIVITIES		
Change in net assets	$ 5,000	$ 4,000
Adjustment to reconcile change in net assets to net cash provided by operating activities:		
(Increase) decrease in cash value of life insurance	2,000	(2,000)
NET CASH PROVIDED BY OPERATING ACTIVITIES	7,000	2,000

Upon the death of an insured individual, the face amount of the policy less any outstanding loans against the cash value is distributed. An example of a statement of cash flows is presented below assuming a $250,000 policy on the life of an executive employee had accumulated cash value of $20,000 at the date of death and that outstanding loans against the cash value amounted to $10,000. Change in net assets reported in the statement amounts to income from the life insurance policy of $230,000 ($250,000 face value less $20,000 cash value previously recognized in earnings).

CASH FLOWS FROM OPERATING ACTIVITIES	
Change in net assets	$ 230,000
Adjustment to reconcile change in net assets to net cash provided by operating activities:	
Decrease in cash value of life insurance	10,000
NET CASH PROVIDED BY OPERATING ACTIVITIES	240,000

The cash provided by operating activities in the preceding example equals the net cash distribution received by the nonprofit organization and is composed of $250,000 face value of the policy less outstanding policy loans of $10,000. The payoff of the loan is not reported as a financing cash outflow because when the loan against the policy was drawn down, the amount was reported as a distribution, not a borrowing.

Derivatives that Include a Financing Element

Derivative instruments that at their inception include off-market terms and/or require up-front cash payments often contain a financial element. For derivatives that include an other-than-insignificant financing element at inception (other than the forward points in an at-the-money forward contract), all cash inflows and outflows at inception and over the term of the derivative are reported by the borrower as cash flows from financing activities.

Split-Interest Agreements

The following activities related to split-interest gifts are commonly reported in a statement of cash flows as cash flows from financing activities:

- Cash distributions from trusts held by others if required by the donor to be used for long-term purposes (a financing cash inflow).
- Cash received from the donor at the inception of a split-interest agreement (a financing cash inflow).
- Investment income on trust assets if the cash received is commingled with the organization's cash rather than being reported as a trust asset (a financing cash inflow).
- Cash distributions to beneficiaries (a financing cash outflow).
- Cash distributions to the organization that are restricted for long-term purposes if trust cash is separately reported as a trust asset rather than commingled with the organization's cash (a financing cash outflow).

NONCASH INVESTING AND FINANCING ACTIVITIES

FASB ASC 230-10-50-3 requires investing and financing activities that do not involve cash receipts and payments during the period to be excluded from the statement of cash flows and disclosed in a narrative or schedule format. Obtaining a building or investment assets by receiving a gift is an example of a type of noncash activity that may be encountered by a nonprofit organization. The following schedule illustrates how certain noncash investing and financing activities might be disclosed:

> SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES:
>
> In 20X7, the Organization received a building from a donor valued at $200,000.
>
> Contributions of art objects valued at $125,000 were received by the Organization in 20X7.
>
> A capital lease obligation of $8,500 was incurred when the Organization entered into a lease for new office equipment.

Because the disclosure of noncash investing and financing transactions is not self-balancing, it is possible to inadvertently omit a noncash transaction from the schedule. Thus, all investing and financing transactions should be carefully reviewed to ensure that all noncash transactions are reported. It is recommended that accountants use a worksheet that reconciles noncash investing and financing transactions. Although the supplemental disclosure of noncash investing and financing transactions is not self-balancing, transactions having both cash and noncash aspects (e.g., purchase of equipment in exchange for a cash down payment and an equipment loan) reconcile to the cash received or disbursed as shown within the statement of cash flows.

Format Considerations

The supplemental disclosure of noncash investing and financing transactions may be presented either in narrative form (e.g., in the notes to the financial statements) or summarized in a schedule. If the supplemental disclosure is made in a schedule, best practices indicate presenting it at the bottom of the statement of cash flows.

CASH FLOWS FROM OPERATING ACTIVITIES		
Change in net assets	$	67,100
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation		9,200
(Increase) decrease in:		
Unconditional promises to give		(47,750)
Inventories		21,850
Prepaid expenses		13,950
Increase (decrease) in:		
Accounts payable		11,200
Accrued liabilities		(14,150)
NET CASH PROVIDED BY OPERATING ACTIVITIES		61,400
CASH FLOWS USED BY INVESTING ACTIVITIES		
Purchase of equipment		(30,000)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds of long-term borrowings		25,000
Repayment of long-term borrowings		(5,000)
NET CASH PROVIDED BY FINANCING ACTIVITIES		20,000
NET INCREASE IN CASH		51,400
CASH AT BEGINNING OF YEAR		67,800
CASH AT END OF YEAR	$	119,200

SUPPLEMENTAL DISCLOSURES	
Noncash investing and financing transaction:	
Lease of equipment	
Equipment	$ 15,600
Capital lease obligation	(15,600)

Alternatively, nonprofit organizations may disclose noncash investing and financing transactions in the notes to the financial statements in a separate note. (Note also, that cash payments for interest and unrelated business income or excise taxes must be disclosed on the face of the statement or in the notes.)

Generally, all noncash investing and financing transactions should be disclosed together either in a separate schedule or in the notes to the financial statements. In other words, they recommend against disclosing only certain noncash transactions in a separate schedule and other the remaining noncash transactions in the notes.

Assets Acquired by Assuming Liabilities

Assets acquired by assuming liabilities, including purchasing a building financed with a mortgage, are noncash transactions that should be disclosed separately. These transactions may include acquiring assets through seller financing or third-party financing. Assume the following facts:

- Increase in net assets and depreciation for the year amounted to $12,000 and $3,000, respectively.
- On January 1, the nonprofit organization purchased a new machine with a list price of $74,000.
- A used machine with an undepreciated cost of $5,000 was traded in on the purchase. The trade-in allowance on the used machine was $4,000.
- The nonprofit organization made a down payment of $10,000 and financed the balance of the purchase with an installment loan in the amount of $60,000 to be paid in six annual installments of $10,000 plus interest at the rate of 14%.

The noncash aspects of the preceding transaction should be disclosed separately, for example, in a schedule of noncash investing and financing transactions as follows:

Acquisition of equipment	
Cost of equipment, net of trade-in	$ 69,000
Loss on trade-in	1,000
Equipment loan	(60,000)
Cash down payment for equipment	$ 10,000

Alternatively, the organization could disclose the noncash investing and financing activity by describing the transaction. To illustrate, assume an organization purchased a truck with a list price of $74,000 by making a cash down payment of $10,000, trading in a truck with a trade-in allowance of $4,000 (undepreciated cost of $5,000), and financing the balance of $60,000. A loss of $1,000 on trade-in was recognized. The $10,000 cash down payment should be shown as cash used by investing activities in the statement of cash flows.

The traditional form of this transaction is for the lender to send a check to the seller or for the buyer to assume directly related debt. In some situations, however, the form of the transaction is such that the buyer may actually receive the proceeds of the borrowing and then send those proceeds to the seller. The following are common examples:

- The lender deposits the proceeds of the loan into the nonprofit organization's checking account, and the nonprofit organization drafts a check to the vendor.
- The nonprofit organization draws against a pre-established line of credit to pay the vendor.

The substance of those situations is virtually the same; the nonprofit organization acquires an asset by incurring a liability. The nonprofit organization is in the same position as if the lender sent a check directly to the vendor. Accordingly, each should be reported as a noncash investing and financing activity.

Gift of Building, Investment, or Collection Asset

The gift of a building or investment asset is an example of a noncash investing and financing activity. Nonprofit organizations are often the recipients of property and equipment, securities, or collection items due to the tax advantages afforded donors on the contribution of appreciated property. Although such contributions are recognized at their fair value in the statement of activities, they do not involve the receipt of cash and are, therefore, considered noncash investing and financing transactions. If a nonprofit organization uses the indirect method of presenting cash flows from operating activities, such contributions are reported as adjustments to reconcile the change in net assets to cash flows from operating activities in the statement of cash flows. Nonprofit organizations that choose to present cash flows from operating activities using the direct method must also reconcile changes in net assets to cash flows from operating activities. Thus, the noncash contributions would also be reflected as a reconciling item. Disclosure of such contributions could be in a supplemental schedule or a note to the financial statements. The following examples illustrate notes to the financial statements disclosing such noncash investing and financing transactions:

> The Organization received 2,000 shares of ABC Company common stock with a fair value of $10,000 in 20X7. As required by the donor, investment income from the securities will be reinvested until the value of such securities and reinvested income reaches $15,000, at which time both the principal and interest may be used at the discretion of the Board of Directors.
>
> In 20X6, a donor contributed a warehouse to the Organization. Its fair value at the date of its contribution was $100,000.

Capitalization of Donated Services

Donated services should be recognized if they (a) create or enhance a nonfinancial asset; or (b) require specialized skills, are provided by persons possessing those skills, and those specialized skills would typically be purchased if not provided by donation. Services that create or enhance a nonfinancial asset are recognized as contributions at their fair value in the statement of activities and are capitalized as part of the cost of the nonfinancial asset. For example, donated architectural time and construction labor would both be capitalized as part of the cost of a nonprofit organization's new building. Because those contributions and capitalized costs do not involve the receipt or payment of cash, the authors believe they should be treated as noncash investing and financing transactions.

Contributions of services that are not capitalized, but are recognized with offsetting expenses of a similar amount, will not be reflected in the statement of cash flows. Neither the direct nor indirect method of reporting cash flows from operating activities would show those noncash contributions and related expenses.

Mergers and Acquisitions

Purchase (Sale) of a Subsidiary. When a subsidiary is purchased or sold, the cash paid to acquire the subsidiary (or cash proceeds from sale of the entity) should be shown as cash used (or provided) by investing activities. FASB ASC 230-10-50-3 only requires the fair value of assets acquired and the fair value of liabilities assumed to be disclosed as a noncash transaction. That guidance does not require the major categories of assets obtained and liabilities assumed to be disclosed.

A supplemental schedule disclosing only the required information may be presented as follows:

Fair value of assets of ABC Entity acquired	$ 167,000
Cash paid to acquire ABC Entity	(77,000)
Liabilities assumed	$ 90,000

However, a nonprofit organization may choose to disclose the major categories and the fair values of assets obtained and liabilities assumed as a noncash transaction as follows:

Acquisition of ABC Entity	
Working capital, other than cash	$ 17,000
Equipment and leasehold improvements	120,000
Intangibles and other assets	30,000
Long-term debt assumed	(90,000)
Cash paid to acquire ABC Entity	$ 77,000

When less than 100% of a subsidiary is acquired, the noncontrolling (minority) interests in the subsidiary at the date of acquisition generally are shown as follows:

Acquisition of ABC Entity	
Working capital, other than cash	$ 17,000
Equipment and leasehold improvements	120,000
Intangibles and other assets	30,000
Long-term debt assumed	(90,000)
Noncontrolling interests	(20,000)
Cash paid to acquire ABC Entity	$ 57,000

Increases in the nonprofit organization's investment in a for-profit subsidiary as a result of the subsidiary issuing additional common stock also should be disclosed, for example, in a schedule of noncash investing and financing transactions as follows:

Issuance of common stock to reduce noncontrolling interests in ABC Entity	$ 10,000

Mergers. When two nonprofit organizations combine in a transaction or event that qualifies as a merger under FASB ASC 958-805, the merger itself should not be reported in the statement of cash flows. Instead, the assets, liabilities, and net assets of the combined entities should be reflected in the beginning balances in the statement of financial position. The statement of cash flows should reflect any subsequent activity occurring through the end of the reporting period. Authoritative literature does not require disclosure of the beginning amounts resulting from the merger as noncash investing or financing transactions. However, FASB ASC 958-805-50-2 requires disclosure (for each merging organization) in the notes to the financial statements of amounts recognized in a merger for each major class of assets, liabilities, and each class of net assets as of the merger date.

Issuance of Social or Country Club Membership Shares

Social and country clubs typically have members' equity in the form of membership shares, which often may be sold, transferred, or redeemed by the club if a member decides to terminate membership. Cash receipts from issuance of membership shares should be reported as cash inflows from financing activities. However, the following transactions related to issuance of membership capital shares do not affect cash flows and, accordingly, should be disclosed as noncash investing and financing activities:

- Capital shares issued for receivables or other noncash consideration such as property and equipment.
- Capital shares issued to settle debt.

Other Noncash Investing and Financing Activities

Although authoritative literature does not specifically address how the following transactions affect the statement of cash flows, they resemble noncash investing and financing activities. However, the transactions need not be disclosed separately in a supplemental schedule or note. Because each of the four items below is needed to reconcile the change in net assets to cash flows from operating activities, the transactions usually will be

adequately disclosed on the face of the statement of cash flows (if the indirect method of presenting cash flows from operating activities is used) or in the reconciliation of changes in net assets to cash flows from operating activities (if the direct method is used and such a reconciliation is presented).

Amortization of Discount on Unconditional Promises to Give. Amortization of the discount on unconditional promises to give without donor restrictions is considered an operating activity. However, because unconditional promises to give that are donor-restricted for long-term purposes are considered financing activities, amortization of the discount on such promises to give also should be considered noncash financing transaction activity and reported separately in the statement of cash flows.

Allowance for Uncollectible Unconditional Promises to Give. Bad debt expense related to an uncollectible promise to give that is donor-restricted for long-term purposes should be considered a noncash financing activity, similar to the amortization of discount.

Unrealized Gains and Losses on Investments. Nonprofit organizations are required to carry investments in equity securities with readily determinable fair values and all investments in debt securities at their fair value on the statement of financial position. In addition, nonprofit organizations are permitted to report certain other investments at cost, fair value, or lower of cost or fair value. As a result of carrying investments at fair value, unrealized gains and losses will be recognized in the statement of activities in the period in which they occur. The net unrealized investment gain or loss should be considered a noncash investing and financing transaction.

OTHER PRESENTATION ITEMS

Presenting Gross and Net Cash Flows

Cash flows from investing and financing activities are generally required to be reported gross rather than as net amounts. The presumption is that gross cash receipts and disbursements are more relevant than net amounts. Thus, for example, cash flow statements would show the following amounts:

Investing Activities

a. Proceeds from sales of assets and cash payments for capital expenditures rather than the net change in property and equipment.

b. Proceeds from sales and maturities of securities and purchases of securities rather than the net change in those investments.

c. Loans made and collections on loans rather than the net change in notes and loans receivable.

Financing Activities

a. Proceeds from long-term borrowings and repayments of long-term obligations (including capital lease obligations) rather than the net change in long-term debt.

b. Proceeds from short-term debt and payments to settle short-term debt rather than the net change in short-term debt when the debt term exceeds three months.

While the general rule calls for reporting gross cash flows, reporting net cash flows is permitted for the following activities:

a. Cash receipts and payments from purchasing and selling cash equivalents.

b. Cash receipts and payments related to investments (other than those considered cash equivalents), loans receivable, and debt when the original maturity of the asset or liability is three months or less. (Amounts due on demand are generally considered to have maturities of three months or less.)

c. Cash receipts and payments related to agency transactions (i.e., transactions for which the organization is holding or disbursing cash on behalf of others).

Although reporting net cash flows from the preceding activities is permitted, netting is not required. Presenting gross cash flows for those activities may be preferable in some instances. For example, it may create an unnecessary recordkeeping burden to segregate cash flows from investments with a maturity of three months or less from those of investments with longer maturities assuming that the nonprofit organization's accounting policy is that all investments, regardless of their maturities, should not be considered cash equivalents.

Another example is a federated fund-raising organization that receives donor-designated cash contributions in addition to its regular campaign contributions. In that case, the organization is acting as an agent or intermediary with respect to the donor-designated cash contributions. Although netting of the cash receipts and the subsequent cash payments to the designated agency organizations is allowed, the federated fundraising organization may prefer to report gross cash flows in the operations section of the statement of cash flows.

Should cash flows from revolving lines of credit be presented on a gross or net basis? A difference of opinion exists among CPAs in practice. Some accountants have taken the position that there must be a series of 90-day notes for the cash flows to be presented net. If the borrower signs a single note with a term of more than three months for the maximum amount of the line of credit, they believe that gross amounts are required to be presented. Others, however, present all cash flows related to revolving lines of credit net. Best practices suggest that either method is acceptable.

Discontinued Operations

FASB ASC 205-20-50-5B requires an organization to disclose either of the following related to cash flows of discontinued operations. The information may be presented on the face of the financial statements as part of discontinued operations or in the notes to the financial statements:

- The total operating and investing cash flows of the discontinued operation for each period presented, or
- The depreciation, amortization, capital expenditures, and significant operating and investing noncash items of the discontinued operation.

Best practices indicate that the most simple and efficient way to comply with the cash flow disclosure requirements is to include the amount of cash flows from operating and investing activities in the note disclosure that describes discontinued operations.

An organization that chooses to report operating cash flows of discontinued operations separately should do so consistently for all periods affected, which may include periods long after sale or liquidation of the operation. Because discontinued operations of a component of an organization are segregated in the statement of activities, and assets and liabilities of the component at the statement of financial position date are disclosed, information to present cash flows from both continuing and discontinued operations generally is readily available. Assuming the disposal of a component of a nonprofit organization, the following is an example of cash flows from operating activities classified by continuing and discontinued operations.

CASH FLOWS FROM OPERATING ACTIVITIES	
Continuing operations	
Change in net assets	$ 24,000
Adjustments to reconcile change in net assets to net cash provided by continuing operations:	
Depreciation	13,000
Loss on sale of property and equipment	2,000
(Increase) decrease in:	
Receivables	11,200
Inventories	(7,700)
Prepaid expenses	2,650
Increase (decrease) in:	
Accounts payable	10,700
Accrued liabilities	7,250

NET CASH PROVIDED BY CONTINUING OPERATIONS	63,100
Discontinued operations	
Change in net assets	(20,000)
Adjustments to reconcile change in net assets to net cash used by discontinued operations:	
Depreciation	6,000
Gain on disposal of property and equipment	(3,000)
Provision for loss on disposal of other assets	12,000
(Increase) decrease in:	
Receivables	(10,050)
Inventories	6,450
Increase (decrease) in:	
Accounts payable	(7,200)
Accrued liabilities	5,800
NET CASH USED BY DISCONTINUED OPERATIONS	(10,000)
NET CASH PROVIDED BY OPERATING ACTIVITIES	53,100

Cash flows from investing activities of discontinued operations may be similarly displayed on the face of the cash flow statement by using a caption such as "Proceeds from disposal of property and equipment—discontinued operations."

Cumulative Accounting Adjustments

Most cumulative accounting adjustments are noncash items. Accordingly, under the direct method of reporting cash flows from operations, which only presents cash receipts and payments, cumulative accounting adjustments would be excluded. When the indirect method is used, however, the change in net assets should be adjusted to arrive at cash flows from operations by adding the noncash elements of expense amounts to, and subtracting the noncash elements of revenue amounts from, the change in net assets. GAAP does not specifically require cumulative accounting adjustments to be presented separately in the statement of cash flows. However, FASB ASC 230-10-45-29 states the reconciliation should include all major classes of reconciling items and meaningful categories. Best practices suggest such reconciling items be classified according to the nature of the accounting change.

For example, assume the nature of the cumulative effect of adopting a new accounting principle of $44,000 relates to unrealized gains and losses and the organization reports no other transactions that would require a reconciling adjustment in the statement of cash flows. The cash flows from operating activities, using the indirect method, would be presented as follows:

CASH FLOWS FROM OPERATING ACTIVITIES	
Change in net assets	$ 103,000
Adjustment to reconcile change in net assets to net cash provided by operating activities:	
Cumulative effect of adopting new accounting principle on net unrealized gain on investments	(44,000)
NET CASH PROVIDED BY OPERATING ACTIVITIES	59,000

However, if the organization also needs to report a reconciling item for the effect of current year unrealized gains on investments, it might chose to combine that amount with the cumulative adjustment and report the total in one caption such as "net unrealized gain on investments."

PREPARING CASH FLOW STATEMENTS

The information needed to prepare a statement of cash flows usually is obtained from comparative statements of financial position and additional information about changes in accounts in sufficient detail to identify (a) the nature of cash flows (operating, investing, or financing), (b) gross cash receipts and payments, and (c) any noncash transactions.

This section illustrates how to prepare a statement of cash flows for Habitat House, Inc. The statements of financial position, statement of activities, and statement of functional expenses for Habitat House, Inc., follow.

HABITAT HOUSE, INC.
STATEMENTS OF FINANCIAL POSITION
June 30, 20X7 and 20X6

	20X7	20X6
ASSETS		
Cash and cash equivalents	$ 29,907	$ 15,655
Short-term investments	62,378	24,833
Accounts receivable	—	1,355
Prepaid expenses	6,402	8,845
Unconditional promises to give	191,238	190,304
Long-term investments	25,932	13,282
Contribution receivable—charitable lead trust	206,800	230,000
Construction deposits	1,000	1,500
Cash restricted to purchase of property and equipment	30,000	—
Investment and promises for new men's shelter	45,893	—
Investments and promises restricted for new men's shelter Property and equipment	648,410	664,342
TOTAL ASSETS	$ 1,247,960	$ 1,150,116
LIABILITIES		
Accounts payable	$ —	$ 3,445
Accrued compensation expense	4,284	8,145
Refundable advances	2,132	—
Notes payable	79,991	85,930
TOTAL LIABILITIES	86,407	97,520
NET ASSETS		
Unrestricted		
Designated for new program development	50,000	—
Undesignated	612,559	612,499
Temporarily restricted	492,125	435,932
Permanently restricted	6,869	4,165
TOTAL NET ASSETS	1,161,553	1,052,596
TOTAL LIABILITIES AND NET ASSETS	$ 1,247,960	$ 1,150,116

HABITAT HOUSE, INC.
STATEMENT OF ACTIVITIES
Year Ended June 30, 20X7

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
REVENUES, GAINS, AND OTHER SUPPORT				
Contributions				
United Way services	$ —	$ 156,275	$ —	$ 156,275
New men's shelter	300	45,893	—	46,193
Capital campaign	1,000	3,771	—	4,771
Equipment acquisition	—	30,000	—	30,000
Endowment	—	—	2,704	2,704
Other	89,736	—	—	89,736
Federal financial assistance	43,473	—	—	43,473
Program service fees	22,417	—	—	22,417
Investment return	6,229	34	—	6,263
Change in value of split-interest agreement	—	1,800	—	1,800
Other	2,777	—	—	2,777
Net assets released from restrictions				
Expiration of time restriction—United Way services	146,465	(146,465)	—	—
Restrictions satisfied by charitable lead trust receipts	25,000	(25,000)	—	—
Restrictions satisfied by payments	10,115	(10,115)	—	—
TOTAL REVENUES, GAINS, AND OTHER SUPPORT	347,512	56,193	2,704	406,409
EXPENSES				
Program services				
Women and children	134,051	—	—	134,051
Men	94,231	—	—	94,231
Supporting services				
Management and general	55,629	—	—	55,629
Fund-raising	13,541	—	—	13,541
TOTAL EXPENSES	297,452	—	—	297,452
CHANGE IN NET ASSETS	50,060	56,193	2,704	108,957
NET ASSETS AT BEGINNING OF YEAR	612,499	435,932	4,165	1,052,596
NET ASSETS AT END OF YEAR	$ 662,559	$ 492,125	$ 6,869	$ 1,161,553

HABITAT HOUSE, INC.
STATEMENT OF FUNCTIONAL EXPENSES
Year Ended June 30, 20X7

	Program Services		Supporting Services		
	Women and Children	Men	Management and General	Fund-raising	Total
Compensation and related expenses					
Compensation					
Full-time	$ 27,530	$ 26,049	$ 27,789	$ 7,894	$ 89,262
Part-time	42,531	41,316	7,141	—	90,988
Employee benefits					
Medical	2,020	1,010	861	189	4,080
Other	94	108	254	43	499
Payroll taxes	5,354	5,200	2,926	731	14,211
	77,529	73,683	38,971	8,857	199,040
Conferences and training	215	144	502	—	861
Depreciation	20,644	—	2,534	634	23,812
Food	3,039	76	—	—	3,115
Insurance					
Property and casualty	1,295	515	—	—	1,810
Vehicles	3,785	—	—	—	3,785
Worker's compensation	—	—	1,548	387	1,935
Interest	—	—	4,038	—	4,038
Maintenance of equipment	324	—	733	—	1,057
Occupancy					
Electricity	10,964	1,715	975	243	13,897
Gas	1,081	601	105	15	1,802
Heating oil	—	2,054	—	—	2,054
Maintenance	3,449	938	371	24	4,782
Rent	—	8,388	—	—	8,388
Water and sewer	1,502	1,282	135	32	2,951
Postage	68	39	997	996	2,100
Printing	434	138	968	1,450	2,990
Specific assistance	1,012	274	—	—	1,286
Supplies					
Cleaning	3,271	2,243	—	—	5,514
Office	357	365	1,779	432	2,933
Other	971	14	303	27	1,315
Telephone	2,293	874	581	387	4,135
Transportation					
Fuel	409	208	—	—	617
Repairs and other	1,385	680	869	—	2,934
Other	24	—	220	57	301
	$ 134,051	$ 94,231	$55,629	$ 13,541	$ 297,452

Additional financial information for Habitat House, Inc., is as follows:

- The Organization financed the purchase of a new copier through a long-term note payable to Lane Bank for $5,251. Additional equipment totaling $2,629 was purchased in 20X7; none was sold.
- Short-term investments have original maturities of three months or less.
- Collections of unconditional promises to give related to restricted purposes were $17,771 for payment of notes payable, $39,273 for new men's shelter, and $2,704 for the endowment fund.
- Interest and gains on investments are not restricted to long-term purposes.
- The Organization purchased long-term investments totaling $60,837; maturities of long-term investments totaled $12,500. No gain or loss on sales of investments was realized during 20X7. Because the Organization carries its investments at fair value, unrealized gains of $3,256 were recognized in 20X7.
- A split-interest lead trust contribution of $230,000 was received in 20X6, of which $25,000 was collected in 20X7. Amortization of discount on the split-interest lead trust of $1,800 was recorded in 20X7.
- Unconditional promises to give consisted of the following:

	20X7	20X6
Unrestricted	$ —	$ 5,748
United Way services funding	154,938	135,256
Restricted to payment of notes payable	36,300	49,300
Restricted to purchase of new men's shelter	6,950	—
	$ 198,188	$ 190,304

- The Organization received a $30,000 cash contribution restricted for the purchase of equipment in 20X7. At year end, the cash had not yet been expended.

Case Study—Indirect Method

The worksheet in Exhibit 3-2, prepared using the indirect method, summarizes the changes in each financial statement caption and includes a "draft" cash flow statement section used in preparing the final statement.

Exhibit 3-2

Example Cash Flow Worksheet

A	B	C	D	E	F	G	H	I	J	K	L	M	N
HABITAT HOUSE, INC.	Year End Balances		Net Change		Account	Gross Change in Financial Statement Amounts					Draft Statement of Cash Flows[a]		
						Analysis		Expanded Account Analysis					
	Current	Prior	Increase	Ref.	Description	Amounts	Ref.	Description	Amounts	Ref.	Captions	Amounts	Ref.
	20X7	20X6	(Decrease)										
ASSETS			(C) – (B)								OPERATING ACTIVITIES:		
Short-term investments[b]	$ 62,378	$ 24,833	$ (37,545)	⑮		$			$		Change in net assets	$ 108,957	①
Accounts receivable	—	1,355	1,355		Revenues	—					Adjustments:		
					Allowance- uncollectible	—					Depreciation	23,812	②
					Collections	1,355	⑤				Amortization of discount on split-interest agreement	(1,800)	③
Prepaid expenses	6,402	8,845	2,443	⑥		—					Realized and unrealized (gain) loss on investments	(3,256)	④
Unconditional promises to give											Bad debt expense	—	
Unrestricted	—	5,748	5,748		Promises to give	—					(Increase) decrease in:		
					Allowance- uncollectible	—					Accounts receivable	1,355	⑤
					Collections	5,748	⑦				Prepaid expenses	2,443	⑥
United Way Services funding	154,938	135,256	(19,682)		Promises to give	(156,275)	⑧				Unrestrict., uncon. promises to give	5,748	⑦
					Allowance- uncollectible	—					United Way Services funding	(19,682)	⑧
					Collections	136,593	⑧	Amortization	(3,771)	⑭	Contribution receivable—charitable lead trust	25,000	⑨
Restricted to payment of notes payable	36,300	49,300	13,000		Promises to give	(4,771)		New promises	(1,000)	⑬	(Increase) decrease in:		
					Allowance- uncollectible	—					Accounts payable	(3,445)	⑩
					Collections	17,771	⑳				Accrued compensation expense	(3,861)	⑪
Restricted to new men's shelter	6,950	—	(6,950)		Promises to give	(46,193)	⑬				Refundable advances	2,132	⑫
					Allowance- uncollectible	—					Contributions restricted for LT purposes	(79,897)	⑬
					Collections	39,243	㉑				Interest restricted for LT purposes	—	
Restricted to endowment fund	—	—	—		Promises to give	(2,704)	⑬				Amortization of discount on uncon. promises	(3,771)	⑭
					Allowance- uncollectible	—					Total operating	53,735	
					Collections	2,704	㉒				INVESTING ACTIVITIES:		
Interest receivable restricted for LT purposes	—	—	—		Earned	—					Short-term investments, net	(37,545)	⑮
					Collected	—					Purchases of LT investments	(60,837)	⑯
											Maturities of LT investments	12,500	⑰
Cash restricted to purchase of property and equipment	30,000	—	(30,000)	⑬ ⑲ ㉓							Payments for P&E	(2,129)	⑱
											Purchase of assets restricted to investment in equipment	(30,000)	⑲

A	B	C	D	E	F	G	H	I	J	K	L	M	N
HABITAT HOUSE, INC.	Year End Balances		Net Change		Account	Gross Change in Financial Statement Amounts					Draft Statement of Cash Flows[a]		
	Current	Prior	Increase	Ref.		Analysis		Expanded Account Analysis					
	20X7	20X6	(Decrease)		Description	Amounts	Ref.	Description	Amounts	Ref.	Captions	Amounts	Ref.
Long-term investments	64,875	13,282	(51,593)		Purchases	(60,837)	(16)	Proceeds	12,500	(17)		—	
					Sales/maturities	12,500		(Gain) loss	—		Total investing	(118,011)	
					Unrealized gain	(3,256)	(4)						
Contribution receivable—charitable lead trust	206,800	230,000	23,200		Collected	25,000	(9)						
					Amortization	(1,800)	(3)						
Construction Deposits	1,000	1,500	500		Applied	500	(18)		—		**FINANCING ACTIVITIES:**		
Property and equipment—net	648,410	664,342	15,932		Depreciation	23,812	(2)	Cash purchase	(2,629)	(18)	Capital Campaign collections	17,771	(20)
					Purchases	(7,880)		Noncash purchase	(5,251)	(X)	Collection of contributions for men's shelter	39,243	(21)
					Disposals	—		Proceeds	—		Collection of endowment fund contributions	2,704	(22)
LIABILITIES			**(B) – (C)**					(Gain) loss	—		Cash received for equipment	30,000	(23)
Accounts payable	—	3,445	(3,445)	(10)							Payments on Lane Bank note	(876)	(24)
Accrued compensation expense	4,284	8,145	(3,861)	(11)							Payments on SHDA note	(10,314)	(25)
Refundable advances	2,132	—	2,132	(12)				Cash debt	—		Total financing	78,528	
Notes payable	79,991	85,930	(5,939)		New debt	5,251		Noncash debt	5,251	(X)	Net increase (decrease)	14,252	(26)
					Payments	(11,190)		Lane Bank	(876)	(24)	Cash BOY	15,655	
								SHDA	(10,314)	(25)	Cash EOY	$ 29,907	
NET ASSETS	1,161,553	1,052,596	108,957		Increase in net assets	108,957	(1)				**OTHER NONCASH ITEMS:**		
Cash and cash equivalents	$ 29,907	$ 15,655	$ 14,252	(26)							P&E acquired	(5,251)	(X)
											Debt issued	5,251	(X)

Notes:

[a] Notes receivable, investments, and short-term notes with maturities of 90 days or less, including demand notes, may be presented on a net change basis.

[b] When the indirect method is used, interest paid (net amounts capitalized) and unrelated business income taxes or excise taxes paid, if any, during the period should be disclosed.

* * *

The final statement of cash flows for Habitat House, Inc., using the indirect method is as follows:

CASH FLOWS FROM OPERATING ACTIVITIES		
Increase in net assets	$ 108,957	[a]
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Depreciation	23,812	[b]
Amortization of discount on split-interest agreement	(1,800)	[c]
Unrealized gains on investments	(3,256)	[d]
(Increase) decrease in operating assets:		
Accounts receivable	1,355	[e]
Prepaid expenses	2,443	[f]
Unrestricted unconditional promises to give	9,519	[e]
United Way services funding for the next fiscal year	(19,682)	[e]
Contribution receivable—charitable lead trust	25,000	[e]
Increase (decrease) in operating liabilities:		
Accounts payable	(3,445)	[f]
Accrued compensation expense	(3,861)	[f]
Refundable advances	2,132	[f]
Contributions restricted for long-term purposes:		
Contributions	(78,597)	[g]
Amortization of discount on unconditional promises to give	(3,771)	[g]
NET CASH PROVIDED BY OPERATING ACTIVITIES	58,606	
CASH FLOWS FROM INVESTING ACTIVITIES		
Short-term investments, net	(37,545)	[h]
Purchases of long-term investments	(60,837)	[i]
Proceeds from maturity of long-term investments	12,500	[j]
Payments for property and equipment	(2,129)	[k]
Purchase of assets restricted to investment in property and equipment	(30,000)	[l]
NET CASH USED BY INVESTING ACTIVITIES	(118,011)	
CASH FLOWS FROM FINANCING ACTIVITIES		
Collections of contributions restricted for long-term purposes:		
Capital Campaign	13,000	[m]
New men's shelter	38,943	[m]
Purchase of equipment	30,000	[m]
Endowment	2,704	[m]
Payments on Lane Bank note	(876)	[n]
Payments on SHDA note	(10,314)	[n]
NET CASH PROVIDED BY FINANCING ACTIVITIES	73,457	
NET INCREASE IN CASH AND CASH EQUIVALENTS	14,252	
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	15,655	
CASH AND CASH EQUIVALENTS AT END OF YEAR	$ 29,907	

SUPPLEMENTAL DISCLOSURES

Cash payments for interest totaled $248.
Noncash investing and financing transaction:

Acquisition of equipment	
Cost of equipment	$ 5,251
Equipment loan	(5,251)

Notes:

[a] Cash flows from operating activities begins with an increase in net assets of $108,957, as reported in the statement of activities.

[b] Depreciation is a noncash expense. Thus, it is added back to the increase in net assets in arriving at cash flows from operating activities. The amount should be the same as that reported in the statement of functional expenses if that statement is presented. Note that any amortization of intangible assets is also a noncash expense and would be added back as well.

[c] Amortization of discount is a noncash item. Thus, it is subtracted from the increase in net assets in arriving at cash flows from operating activities. The amount should be the same as that reported in the statement of activities.

[d] Unrealized gains on investments are noncash items and, accordingly, must be added back to the increase in net assets to arrive at cash flows from operating activities. The amount should be the same as the total net unrealized gains and losses reported in the statement of activities, regardless of the classification of the unrealized gains and losses in the statement of activities (i.e., unrestricted, temporarily restricted, or permanently restricted). Realized gains on investments, if any, would also be added back with the proceeds from such sales reported as a cash flow from investing activities. Unrealized and realized gains may be combined and reported as one line item on the statement of cash flows.

[e] The net change in unconditional promises to give and any other receivables should be adjusted for any provision for uncollectible amounts or amortization of discount that is presented separately as an adjustment to the increase in net assets. In this particular example, no provision for uncollectible accounts was recorded, but amortization of discount on the split-interest agreement of $1,800 was recorded. Therefore, except for the Contribution receivable—charitable lead trust, any change can be attributed to cash amounts and, accordingly, only the net change is reflected as an adjustment. The decrease of $23,200 in the Contribution receivable—charitable lead trust account was adjusted for the amortization resulting in a reported net change of $25,000.

[f] When cash flows from operating activities are presented using the indirect method, an increase in net assets (or change in net assets) should be adjusted for changes during the period in operating assets and liabilities to approximate actual cash receipts and payments attributed to operations. If there are no material noncash entries posted to operating assets and liabilities, the net change would be as follows:

	20X7	20X6	Net Change
Prepaid expenses	$ 6,402	$ 8,845	$ 2,443
Accounts payable	—	(3,445)	(3,445)
Accrued compensation expense	(4,284)	(8,145)	(3,861)
Refundable advances	(2,132)	—	2,132
Total	$ (14)	$ (2,745)	$ (2,731)

g Contributions restricted for long-term purposes are required to be shown as financing activities. As a result, any such contributions, whether they are cash or unconditional restricted promises to give, that are recognized in the statement of activities for the period must be deducted from the increase in net assets and then shown as a financing activity to the extent such revenue has been collected. An analysis of the activity in each restricted unconditional promises to give account should be prepared (even if it has no balance at the end of the period) to identify amounts recognized as revenue and amounts collected. It is not believed that the adjustment for restricted contributions must be broken out by cash contributions versus unconditional restricted promises to give, but believe that such information may be useful to the readers of the financial statements. It is believed, however, that the amortization of the discount related to the unconditional promises should be separately disclosed since it would be considered a noncash financing transaction.

All unconditional promises to give accounts restricted for long-term purposes should be reviewed, and any new promises to give recognized during the period should be included in the analysis of activity in the accounts. The amount of contributions restricted for long-term purposes is calculated as follows:

Promises to give during the period:	
Restricted to payment of notes payable	$ 4,771
Restricted to new men's shelter	46,193
Restricted to endowment	2,704
	53,668
Less: Amortization of discount	(3,771)
	49,897
Cash received to purchase equipment	30,000
Contributions restricted for long-term purposes	$ 79,897

Similar to contributions restricted for long-term purposes, interest and dividends that are restricted for long-term investment are also required to be shown as financing activities. Accordingly, any such interest and dividends recognized in the statement of activities for the period must be deducted from the increase in net assets and shown as a financing activity to the extent such revenue has been collected.

h The change in short-term investments with original maturities of three months or less may be shown net as an investing activity. For purposes of this example, such short-term investments are not considered cash equivalents.

i Purchases of long-term investments are shown as cash used by investing activities.

j Proceeds from the maturity or sales of long-term investments are shown as cash flows from investing activities. Although in this example no gain or loss was recognized because long-term investments were allowed to mature and were not sold, had a gain or loss been recognized on a sale, it would have been reflected as an adjustment to the increase in net assets.

k Cash payments made for property and equipment are shown as cash used by investing activities. Conversely, any proceeds realized from the sale of property and equipment would be shown as cash provided by investing activities with any related gain or loss shown as an adjustment to the increase in net assets.

l Cash contributions that are donor-restricted for long-term purposes are shown as a cash inflow from financing activities and a cash outflow from investing activities. In this example, the restricted cash was held at year end; that is, the equipment had not been purchased. Therefore, the caption, "Purchase of assets restricted to investment in property and equipment," was used.

m Collections of contributions, interest, or dividends restricted for long-term purposes are shown as financing activities. Although this example shows collections by individual restriction, it is not believed that this level of detail is necessarily required, but may be useful to the readers of the financial statements. Alternatively, collections of contributions restricted for long-term purposes could be aggregated and shown as one line item.

n Payments of notes payable are shown as cash used by financing activities. Again, such payments could be aggregated and shown as one line item if the nonprofit organization prefers.

Case Study—Direct Method

If Habitat House, Inc., prepared its statement of cash flows using the direct method, it would be presented as follows. Preparers should note that cash flows from investing activities, cash flows from financing activities, and the schedule of noncash investing and financing activities are presented the same way using either the direct or the indirect method; only cash flows from operating activities are presented differently.

CASH FLOWS FROM OPERATING ACTIVITIES	
Revenue collected:	
United Way services	$ 136,593
Other	191,855
Payments for expenses:	
Compensation and related expenses	(202,901)
Interest paid	(248)
Other	(71,564)
NET CASH PROVIDED BY OPERATING ACTIVITIES	53,735
CASH FLOWS FROM INVESTING ACTIVITIES	
Short-term investments, net	(37,545)
Purchases of long-term investments	(60,837)
Proceeds from maturity of long-term investments	12,500
Payments for property and equipment	(2,129)
Purchase of assets restricted to investment in property and equipment	(30,000)
NET CASH USED BY INVESTING ACTIVITIES	(118,011)
CASH FLOWS FROM FINANCING ACTIVITIES	
Collections of contributions restricted for long-term purposes:	
Capital Campaign	13,000
New men's shelter	38,943
Purchase of equipment	30,000
Endowment	2,704
Payments on Lane Bank note	(876)
Payments on SHDA note	(10,314)
NET CASH PROVIDED BY FINANCING ACTIVITIES	73,457
NET INCREASE IN CASH AND CASH EQUIVALENTS	14,252
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	15,655
CASH AND CASH EQUIVALENTS AT END OF YEAR	$ 29,907
RECONCILIATION OF INCREASE IN NET ASSETS TO NET CASH PROVIDED BY OPERATING ACTIVITIES	
Increase in net assets	$ 108,957
Adjustments to reconcile increase in net assets to net cash provided by operating activities:	
Depreciation	23,812
Amortization of discount on split-interest agreement	(1,800)
Unrealized gains on investments	(3,256)
(Increase) decrease in operating assets:	
Accounts receivable	1,355
Prepaid expenses	2,443

Unrestricted unconditional promises to give	9,519
United Way services funding for the next fiscal year	(19,682)
Contribution receivable—charitable lead trust	25,000
Increase (decrease) in operating liabilities:	
Accounts payable	(3,445)
Accrued compensation expense	(3,861)
Refundable advances	2,132
Contributions restricted for long-term purposes:	
Contributions	(78,597)
Amortization of discount on unconditional promises to give	(3,771)
NET CASH PROVIDED BY OPERATING ACTIVITIES	$ 58,606
SUPPLEMENTAL DISCLOSURES	
Noncash investing and financing transaction:	
Acquisition of equipment	
Cost of equipment	$ 5,251
Equipment loan	(5,251)

To calculate cash receipts and payments reported under the direct method, revenues, gains, support, and expenses presented in the statement of activities are adjusted for accrued amounts, if any, at the beginning and ending of the period and are then grouped into categories. As illustrated below, grouping may be necessary, particularly for similar support or revenue items that are recorded both as unrestricted and temporarily restricted due to time restrictions. Noncash revenues and expenses are excluded. Amounts for Habitat House, Inc., are calculated as follows:

- United Way services

Temporarily restricted contributions per statement of activities	$ 156,275
Increase in restricted unconditional promises to give—United Way Services funding for the next fiscal year	(19,682)
Cash collected	$ 136,593

- Other

Total unrestricted revenue, gains, and other support per statement of activities	$ 347,512
Less net assets released from restrictions, excluding charitable lead trust receipts	(158,343)
Temporarily restricted investment return per statement of activities	497
Less unrealized gains (noncash)	(3,256)
Less contribution of interest on SHDA loan (noncash)	(3,790)
Decrease in unrestricted unconditional promises to give	5,748
Decrease in accounts receivable	1,355
Increase in refundable advances	2,132
Cash collected	$ 191,855

- Compensation and related expenses

Total compensation and related expenses per statement of functional expenses	$ 199,040
Decrease in accrued compensation expense	3,861
Cash paid	$ 202,901

- Cash paid for interest

Total interest expense per statement of functional expenses	$ 4,038
Less interest on SHDA loan (noncash)	(3,790)
Cash paid	$ 248

- Other

Expenses, other than compensation and related expenses and interest expense, per statement of functional expenses ($297,452 − $199,040 − $4,038)	$ 94,374
Less depreciation (noncash)	(23,812)
Decrease in prepaid expenses	(2,443)
Decrease in accounts payable	3,445
Cash paid	$ 71,564

In the statement of cash flows using the direct method, cash collected or paid for interest expense and unrelated business income taxes or excise taxes should be included as separate line items. Interest collected or paid and taxes paid are computed by adjusting the revenue or expense reported on the statement of activities by the change in any accrued amounts relating to the expense. For example, the amount of taxes paid would be calculated as the amount expensed on the statement of activities plus any decrease in accrued taxes payable (or less any increase in accrued taxes payable). Cash flows related to interest or taxes would not be included in a statement of cash flows using the indirect method; they would, however, be disclosed either in a supplemental schedule or in the notes to the financial statements.

In this example, Habitat House, Inc. paid $248 for interest on a note payable to a bank in 20X7. The Organization also recorded $3,790 of noncash interest contributions and expense related to an interest-free note payable. These noncash transactions are subtracted from total revenues, gains, and other support, and other expenses, respectively, in order to determine cash collected and cash payments for interest. The Organization did not collect any interest payments, nor did it pay any taxes.

SELF-STUDY QUIZ

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

21. The Herman Foundation owns a collection of art and historical artifacts. Which of the following statements concerning the treatment of collections in the financial statements is correct?

    a. Purchases and sales of collection items are netted on the Foundation's statement of cash flows.

    b. Purchases and sales of collection items that have been capitalized are considered cash flows from investing activities.

    c. Contributions of art added to the Foundation's collection are included on the statement of cash flows.

    d. Purchases and sales of collection items that have not been capitalized are considered cash flows from operating activities.

22. The New York Night Shelter (NYNS) received $100,000 to purchase equipment for its new facility which is under construction. The equipment will not be purchased until the following fiscal year. How will the donor-restricted cash contribution be reported for purposes of the statement of cash flows?

    a. A cash inflow from financing activities and a cash outflow from investing activities.

    b. The contribution will be included in cash and cash equivalents.

    c. A cash inflow from investing activities and a cash outflow from financing activities.

    d. A cash inflow from financing activities.

23. How should debt issue costs be reflected on the statement of cash flows?

    a. Cash payments for debt issue costs are cash management activities.

    b. Cash payments for debt issue costs are operating activities.

    c. Cash payments for debt issue costs are investing activities.

    d. Cash payments for debt issue costs are financing activities.

24. Organization A purchased Entity B, as a subsidiary, for $200,000 in cash and $50,000 in assumption of liabilities. At acquisition, Entity B's assets had a fair value of $250,000. Based on this scenario, which of the following is required?

    a. The $200,000 paid to acquire Entity B would be reported in the statement of cash flows as cash used by financing activities.

    b. The $200,000 paid to acquire Entity B would be reported in the statement of cash flows as cash used by operating activities.

    c. In a supplemental schedule, report $250,000 as fair value of assets acquired and $200,000 as cash paid to acquire the company with the net shown as liabilities assumed.

    d. In a supplemental schedule, the major categories of assets obtained and liabilities assumed must be disclosed.

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. The Herman Foundation owns a collection of art and historical artifacts. Which of the following statements concerning the treatment of collections in the financial statements is correct? **(Page 216)**

    a. Purchases and sales of collection items are netted on the Foundation's statement of cash flows. [This answer is incorrect. All cash receipts and payments for purchases and sales of collection items should be reported on a gross basis. FASB ASC 230-10-45-7 through 45-9 generally require that cash receipts and payments be reported on a gross rather than a net basis. There are only a few exceptions.]

    b. Purchases and sales of collection items that have been capitalized are considered cash flows from investing activities. [This answer is correct. Purchases and sales of collection items are investing activities. This applies regardless of whether a nonprofit organization capitalized its collection.]

    c. Contributions of art added to the Foundation's collection are included on the statement of cash flows. [This answer is incorrect. When an organization receives collection items, they are considered noncash activities that are excluded from statements of cash flows. They are separately disclosed in the financial statements.]

    d. Purchases and sales of collection items that have not been capitalized are considered cash flows from operating activities. [This answer is incorrect. Purchases and sales of collection items that have not been capitalized are investing activities. Whether they are capitalized has no bearing on the type of cash flows.]

22. The New York Night Shelter (NYNS) received $100,000 to purchase equipment for its new facility which is under construction. The equipment will not be purchased until the following fiscal year. How will the donor-restricted cash contribution be reported for purposes of the statement of cash flows? **(Page 214)**

    a. A cash inflow from financing activities and a cash outflow from investing activities. [This answer is correct. NYNS still holds cash restricted for the purchase of equipment at the financial statement date. The organization's statement of cash flows should reflect both a cash inflow from financing activities for the receipt of the contribution and a corresponding cash outflow from investing activities. The corresponding cash outflow must be reported to arrive at the proper change in cash and cash equivalents for the year. If the organization had purchase the equipment during the period, however, no corresponding cash outflow would be necessary, as the equipment purchase would already be reflected as a cash outflow from investing activities on the statement of cash flows.]

    b. The contribution will be included in cash and cash equivalents. [This answer is incorrect. Restricted cash is excluded from cash and cash equivalents for purposes of the statement of cash flows. As a result, if a contribution restricted for long-term purchases has not been spent during the period to satisfy the donor restriction, both a cash inflow and a cash outflow must be presented on the statement of cash flow.]

    c. A cash inflow from investing activities and a cash outflow from financing activities. [This answer is incorrect. Both a cash inflow and a cash outflow must be presented on the statement of cash flows. However, these classifications are not correct.]

    d. A cash inflow from financing activities. [This answer is incorrect. If NYNS had purchased the equipment during the period, no corresponding cash outflow would be necessary, as the equipment purchase would already be reflected as a cash outflow from investing activities on the statement of cash flows.]

23. How should debt issue costs be reflected on the statement of cash flows? **(Page 224)**

    a. Cash payments for debt issue costs are cash management activities. [This answer is incorrect. Cash management activities include purchases and sales of investments that are classified as cash equivalents, not debt issue costs.]

    b. Cash payments for debt issue costs are operating activities. [This answer is incorrect. FASB ASC 230-10-45-15 states that cash payments for debt issue costs are reflected as a different type of activity on the statement of cash flows.]

    c. Cash payments for debt issue costs are investing activities. [This answer is incorrect. Because debt issue costs are related to a financing activity, they do not fall under investing activities.]

    d. Cash payments for debt issue costs are financing activities. [This answer is correct. Debt issue costs include bank fees and other costs incurred in obtaining financing or refinancing. These costs are accounted for as a discount on the debt according to FASB ASC 835-30-45-3. FASB ASC 230-10-45-15 states that these are reflected as financing activities on the statement of cash flows.]

24. Organization A purchased Entity B, as a subsidiary, for $200,000 in cash and $50,000 in assumption of liabilities. At acquisition, Entity B's assets had a fair value of $250,000. Based on this scenario, which of the following is required? **(Page 228)**

    a. The $200,000 paid to acquire Entity B would be reported in the statement of cash flows as cash used by financing activities. [This answer is incorrect. When a subsidiary is purchased, the cash paid to acquire the subsidiary should be shown as cash used by investing activities.]

    b. The $200,000 paid to acquire Entity B would be reported in the statement of cash flows as cash used by operating activities [This answer is incorrect. The cash paid to acquire the subsidiary should be shown as cash used by investing activities, not operating activities.]

    c. In a supplemental schedule, report $250,000 as fair value of assets acquired and $200,000 as cash paid to acquire the company with the net shown as liabilities assumed. [This answer is correct. FASB ASC 230-10-50-3 only requires the fair value of assets acquired and the fair value of liabilities assumed to be disclosed as a noncash transaction.]

    d. In a supplemental schedule, the major categories of assets obtained and liabilities assumed must be disclosed. [This answer is incorrect. FASB ASC 230-10-50-3 through 50-5 do not require the major categories of assets obtained and liabilities assumed to be disclosed.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Preparing Nonprofit Financial Statements—Course 2—Form, Style, and the Statements of Functional Expenses and Cash Flows (NFSTG182)

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.tr.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 $95 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 ($95 for email or fax; $105 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**
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     Thomson Reuters
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   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 ($95 for answer sheets sent by email or fax; $105 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 $271 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $342 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $404 (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.

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EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Preparing Nonprofit Financial Statements—Course 2—Form, Style, and the Statements of Functional Expenses and Cash Flows (NFSTG182)

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. What should be included on the title page of a nonprofit financial statement presentation?

    a. The organization's name, the title of the financial statements, and the date or period covered.

    b. The organization's name, the title of the financial statements, and the accountant or auditor's firm name.

    c. The organization's name, the title of the financial statements, and the date the report was issued.

    d. The organization's name, the account or auditor's firm name and complete address.

2. When would it be most appropriate for an accountant or auditor to include a description of the level of service performed to the title of the financial statements on the title page?

    a. When supplementary information is included and the assurance expressed is different than what is expressed on the financial statements.

    b. When compiled financial statements are presented in comparative form with unaudited financial statements.

    c. When audited financial statements are presented in comparative form with unaudited financial statements.

    d. When consolidated or combined financial statements are presented.

3. When is including a table of contents in the financial report suggested?

    a. When the financial report is long and includes supplementary information.

    b. When the financial report consists of a single financial statement.

    c. When the accompanying notes are presented with the financial statement.

    d. When the financial report includes an accountant or auditor's report.

4. Bethany, a CPA with the accounting firm of Blalock and Parsons, is preparing the auditor's report that will be included in the financial report for The James Goodwin Foundation. To whom should she address the report?

    a. To the Executive Director.

    b. To the Controller.

    c. To the foundation's lender.

    d. To the Board of Trustees.

5. Which of the following is **not** one of the typical components of a nonprofit's basic financial statements?

   a. A statement of cash flows.

   b. A statement of financial position.

   c. A statement of income and expenses.

   d. A statement of activities.

6. Which one of the following references to the notes can be used without modification on most financial statements?

   a. See notes to combined financial statements.

   b. See accompanying notes.

   c. The accompanying notes are an integral part of these financial statements.

   d. See notes to financial statements.

7. Which of the following is true regarding notes to the financial statements?

   a. Notes should be arranged in descending order by dollar amount.

   b. The notes are the responsibility of the accounting practitioner.

   c. Notes should be arranged in the same order as the amounts in the statements for which they relate.

   d. A subsequent event note would be placed first.

8. The caption "Substantially All Disclosures Required by Accounting Principles Generally Accepted in the United States of America Are Not Included" might be printed in the title of the financial statement notes for which of the following?

   a. Notes for unaudited financial statements.

   b. Notes for compiled financial statements.

   c. Notes for reviewed financial statements.

   d. Notes for audited financial statements.

9. What is generally the first note to the financial statements?

   a. Summary of significant accounting policies.

   b. Restrictions on net assets.

   c. Leasehold improvements.

   d. Investments.

10. The schedule headings for comparative schedules should be presented in which of the following way?

    a. Singular.

    b. The heading "SCHEDULE" may be used.

    c. Plural.

    d. Do not select this answer choice.

11. In a column of numbers with no total, where should the dollar sign be placed?

    a. A dollar sign should appear before the first number in the column.

    b. A dollar sign should appear before each double underlined number.

    c. A dollar sign should appear before the first number appearing a column after a double underlined number.

    d. A dollar sign should appear before each number in the column.

12. What would the caption on the comparative financial statements be if an organization had a decrease in unrestricted net assets in year 1 and an increase in unrestricted net assets in year 2?

    a. Increase in unrestricted net assets.

    b. Decrease in unrestricted net assets.

    c. Increase (decrease) in unrestricted net assets.

    d. Change in unrestricted net assets.

13. As a best practice, when should a parenthetical phrase indicating the level of rounding be added to the page heading?

    a. When rounding to the nearest dollar.

    b. When rounding to the nearest hundred dollars.

    c. When rounding in the notes.

    d. When presenting historical information.

14. Which one of the following is a natural expense classification?

    a. Rent.

    b. Accrued liabilities.

    c. Note balances.

    d. Goodwill.

15. All expenses are required to be included in a statement of functional expenses, while losses are not. According to FASB ASC 958, which of the following is an expense that would be included?

    a. Change in the value of a split-interest agreement.

    b. Cost of a fund-raising activity that is held occasionally and considered peripheral.

    c. A loss when a tornado damaged the roof of the office building.

    d. Expenses related to an ongoing and central activity.

16. Shelley is preparing a statement of functional expenses. Which of the following is correct?

    a. It should be in a single column format.

    b. It should be in matrix format.

    c. The functional classification should be down the left side of the statement.

    d. The natural classification should be listed from left to right as column headings.

17. AlignOrg is a voluntary health and welfare organization. When comparative financial statements are presented, how should the comparative statements of functional expenses be presented?

    a. AlignOrg is allowed to decide the form of presentation.

    b. Complete statements of functional expenses are required for both periods.

    c. The statement of functional expenses can present comparative totals for the prior year on the current year's statement.

    d. AlignOrg must prepare a complete presentation for both years presented on one page.

18. Expenses pertaining to more than one function are required to be allocated to the separate functions. Which allocation method described below would be considered objective and thus allowable?

    a. Allocation of rent expense based on square footage of space occupied by each program.

    b. Allocation of salaries based on location of each employee's office in the building.

    c. Allocation of property insurance based on revenue dollars of each program.

    d. Allocation of utilities based on number of employees working on each program or support service.

19. According to the guidance in FASB ASC 230-10-15-3, which organization is required to present a statement of cash flows?

    a. Organization A prepares GAAP financial statements which include a statement of financial position and a statement of activities.

    b. Organization B prepares cash basis financial statements which include a statement of financial position and a statement of activities.

    c. Organization C prepares a GAAP basis statement which includes a statement of financial position but not a statement of activities.

    d. Organization D prepares tax basis financial statements which include a statement of financial position and a statement of activities.

20. Which of the following items should be disclosed separately rather than within the body of the statement of cash flows?

    a. An installment sale.

    b. An equipment acquisition by liability assumption.

    c. A receipt of a grant.

    d. Short-term borrowings.

21. Hope for the Hungry (HH) is a nonprofit organization. If HH received cash receipts from borrowings, how would they be classified on the statement of cash flows according to GAAP?

    a. Financing activity.

    b. Operating activity.

    c. Investing activity.

    d. Noncash investing and financing transaction.

22. Which one of the following is correct regarding the format and style of a statement of cash flows?

    a. Disclosures made on the face of the statement should be repeated in the applicable section so that the reader can associate the information to the activity.

    b. GAAP requires that items appear in the operating, investing, and financing sections in the order of significance when the indirect method is used.

    c. Subtotals should be shown for each section (operating, investing, and financing) of the statement of cash flows.

    d. The operating, investing, and financing activities should each have their own page in the statement of cash flows, so as to not confuse the reader.

23. Clean Earth Organization, a nonprofit, discovers that due to a violation of restrictive covenants dating back to a prior year, a long-term liability should be reclassified to a current liability. Since the amount is material, how must this be reflected?

    a. The reclassification is disclosed in the notes to the financial statements.

    b. The reclassification will be reported in the statement of cash flows as a financing activity.

    c. The reclassification will be reported in the schedule summarizing noncash investing and financing transactions.

    d. The prior-period financial statements are restated and the reclassification is disclosed in the notes.

24. Generally, cash flows from operating activities must meet three criteria. Which of the following is **not** one of those criteria?

    a. The amount represents the cash effect of a transaction.

    b. The amount results from the organization's normal operations.

    c. The amount is derived from an activity that enters into the determination of a net increase or decrease in net assets.

    d. The amount results from donor stipulation concerning a long-term purpose.

25. Cash flows from operating activities exclude which of the following?

    a. Accruals and deferrals.

    b. Cash received from sales of goods.

    c. Cash used to solicit funds.

    d. Interest expense.

26. There are two basic formats for the statement of cash flows. Which one of the following describes an aspect of the indirect method?

    a. Begins with gross cash receipts.

    b. Begins with the change in net assets.

    c. Shows only cash receipts and payments.

    d. Does not require noncash adjustments.

27. Bethany is deciding which method to use in preparing the statement of cash flows for the Small Business Collective, a nonprofit organization. Under which of the following circumstances would it be preferable to use the indirect method over the direct method?

    a. When Bethany has the required information readily available.

    b. When the Collective receives significant resources from agency transactions.

    c. When Bethany needs the cash flows statement to receive loan approval.

    d. When Bethany does not have much time to prepare the cash flows statement.

28. There are certain adjustments related to split interest gifts that are commonly reported in a statement of cash flows to reconcile the change in net assets to net cash flows from operating activities. Which of the following adjustments would be made to eliminate the effects of noncash operating revenues and expenses?

    a. Subtract the net gains on sales of trust investments as a reconciling item only if the gain is reported in the statement of activities and add it to the changes in net assets.

    b. Change the value of a split-interest agreement reported in the statement of activities to a debit (loss or expense) and add it to the change in net assets.

    c. Subtract contributions that are beneficial interests in trusts held by others as a reconciling item.

    d. Subtract contributions that are restricted to split-interest trust agreements (securities, cash, or other assets) as a reconciling item.

29. Nonprofit organizations are required to measure unconditional promises to give that are expected to be collected in which of the following at fair value?

    a. Three months.

    b. Six months.

    c. Nine months.

    d. More than a year.

30. What is the proper treatment of the amortization of discount on donor-restricted unconditional promises to give on the statement of cash flows?

    a. When using the direct method, do not include the amortization on the statement of cash flows, do include the amortization on the reconciliation.

    b. When using the direct method, include the amortization on the statement of cash flows.

    c. When using the indirect method, deduct from the change in net assets to arrive at net cash flows from operating activities.

    d. When using the indirect method, include the amortization of the discount in cash flows from operating activities.

31. Danny Smith Foundation owns life insurance on one of its key employees, Danny Smith. The life insurance policy continues to earn cash value. Which of the following would be correct?

    a. Cash value that is allowed to accumulate provides cash and, thus, would not be subtracted from the change in net assets to arrive at cash flows from operating activities.

    b. If increases in cash value are used to reduce the payment of insurance premiums, rather than increase cash surrender value, the cash surrender value of the life insurance account is neither decreased nor increased for premium payments.

    c. If increases in cash value of the life insurance policy are allowed to accumulate, they are included in the change in net assets as a reduction of insurance expense.

    d. Nonprofit organizations often own the cash value of life insurance policies on key employees.

32. How would a nonprofit organization account for gains and losses on investments when using the indirect method of presenting the statement of cash flows?

    a. For unrealized gains and losses, the change in net assets should be adjusted for their effects by adding back unrealized losses and subtracting unrealized gains to arrive at cash flows from operating activities.

    b. For unrealized gains and losses, they are not reported in the statement of cash flows. They are disclosed as noncash investing and financing transactions.

    c. For realized gains and losses, only the gain or loss will be reflected on the statement of cash flows as a gain or loss from investing activities.

    d. Unrealized gains and losses are recognized on the statement of cash flows exactly the same as realized gains and losses.

33. Which of the following is correct about noncontrolling (minority) interests?

    a. Noncontrolling interests are not reflected in the consolidated statement of activities.

    b. Noncontrolling interests are reported as an expense in the consolidated financial statements.

    c. No adjustment is required to reconcile the change in net assets to the net cash provided by operating activities.

    d. The cash flow statement begins with the parent's change in net assets followed by the noncontrolling interest.

34. Generally, which of the following is **not** an investing activity?

    a. Receiving contributions.

    b. Purchasing revenue generating equipment.

    c. Selling collection items.

    d. Collecting on loans.

35. During the fiscal year, ABC organization purchased a new machine for $30,000. They paid 10,000 and financed the balance with an installment loan to be paid in four annual installments of $5,000 plus interest at the rate of 10%. In a separate transaction, ABC sold their used machine with an undepreciated cost of $9,000 for $10,000. What should be listed under operating activities?

    a. $1,000 gain on sale of equipment.

    b. $10,000 proceeds from sale of equipment.

    c. $10,000 down payment for purchase of equipment.

    d. $30,000 purchase of equipment.

36. BLDG organization sold its office building for $140,000. They received $40,000 as a cash down payment and required payment of the $100,000 in five annual installments of $20,000 plus interest at the rate of 16%. The building was originally purchased for $200,000, and $80,000 of depreciation had accumulated on the building. Which items would be classified as cash provided by investing activities on BLDG's statement of cash flows for the first two years of this transaction?

    a. $20,000 gain on sale of building in year one. No investing activities recorded for year two.

    b. $40,000 on collection of installment sale for year one. $20,000 on collection of installment sale for year two.

    c. $140,000 proceeds for sale of building for year one. No investing activities recorded for year two.

    d. Do not select this answer choice.

37. Where are purchases of investments that are **not** considered cash equivalents reported on the statement of cash flows?

    a. Cash management activities.

    b. Operating activities.

    c. Investing activities.

    d. Financing activities.

38. Generally, which of the following is **not** a financing activity?

    a. Obtaining and paying for other resources from creditors on long-term credit.

    b. Borrowing money and repaying amounts borrowed.

    c. Collecting on loans and lending money.

    d. Receiving donor stipulated resources for long-term purposes.

39. Which of the following financing activities may be reported on a net basis?

    a. Obtaining a building by gift.

    b. Repaying and amount borrowed.

    c. Issuing membership shares.

    d. Receipt from a one-month loan.

40. Which one of the following would be included in a schedule of supplemental disclosures for the statement of cash flows?

    a. Purchase of a building that is financed with a mortgage.

    b. Purchase of computer equipment.

    c. Decrease in accounts payable.

    d. Depreciation.

GLOSSARY

Cash: Includes not only currency on hand but demand deposits with banks or other financial institutions. Cash also includes other kinds of accounts that have the generally characteristics of demand deposits in that the customer may deposit additional funds at any time and also effectively may withdraw funds at any time without prior notice or penalty.

Cash equivalents: Short-term, highly liquid investments that are both (a) readily convertible to known amounts of cash and (b) so near to their maturity that they present insignificant risk of changes in value because of changes in interest rates.

Comparative financial statements: Presentation of financial statements in which the current amounts and the corresponding amounts for previous periods or dates also are shown.

Direct method: Begins with cash receipts and deducts cash payments for operating costs and expenses, individually listing the cash effects of each major type of revenue and expenses.

Functional expense classification: Represents the purpose for which the expense was incurred. The primary functional classifications are program services and supporting services.

Indirect method: Starts with the change in net assets and adjusts for (a) noncash items or items related to investing for financing activities, such as depreciation and net unrealized and realized gains on investments and (b) changes during the period in operating assets and liabilities, such as receivables and inventories.

Minority interest: A significant but non-controlling ownership of less than 50% of a company's voting shares by either an investor or another company.

Natural (object) expense classifications: Represents the type of expense, e.g., salaries and employee benefits, professional fees, occupancy, postage and shipping, and travel.

Program service expenses: The direct and indirect costs related to providing a nonprofit organization's programs or social services, i.e., the costs of the activities for which purpose the organization exists.

Statement of cash flows: One of the basic financial statements that is required as part of a complete set of financial statements prepared in conformity with generally accepted accounting principles. It categorizes net cash provided or used during a period as operating, investing, and financing activities, and reconciles beginning and ending cash and cash equivalents.

Statement of functional expenses: A detailed analysis of the expense portion of the statement of activities in matrix format. It shows how the natural expense classifications are allocated to significant program and supporting services.

Supporting service expense: Costs for activities not directly related to the purpose for which the organization exists. They are broadly categorized as management and general expenses, fund-raising expenses, and membership development expenses.

Types of cash flow: There are four types of cash flow on the statement of cash flows. They are: operating, investing, financing, and noncash investing and financing transactions.

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COMPANION TO PPC'S GUIDE TO PREPARING NONPROFIT FINANCIAL STATEMENTS

COURSE 3

AFFILIATED ORGANIZATIONS AND OTHER RELATED ENTITIES (NFSTG183)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course explores several topics related to nonprofit organizations and their financial reporting relationships with other entities. Lesson 1 provides general accounting guidance for assessing reporting requirements with affiliated and related entities including mergers, acquisitions, and combined financial results. Lesson 2 examines consolidated, consolidating, and combined financial statement preparation and presentation and accounting for assets using the equity method.

PUBLICATION/REVISION DATE: May 2018

RECOMMENDED FOR: Users of *PPC's Guide to Preparing Nonprofit Financial Statements*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of accounting

CPE CREDIT: 7 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 **May 31, 2019**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Accounting Guidance for Mergers, Acquisitions, and Other Financial Relationships

Completion of this lesson will enable you to:
- Recognize the different types of financial relationships for nonprofits and the accounting differences between these relationships, such as mergers and acquisitions.
- Determine when to include financial results of another entity in nonprofit financial statements.

Lesson 2—Consolidated, Consolidating, and Combined Financial Statement Presentation and Equity Method Reporting

Completion of this lesson will enable you to:
- Recognize proper methods for presenting consolidated financial statements for nonprofit organizations including appropriate disclosures.
- Identify when and how to use consolidating or combined financial statements and when to apply the equity method for transactions.

TO COMPLETE THIS LEARNING PROCESS:

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

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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: Accounting Guidance for Mergers, Acquisitions, and Other Financial Relationships

INTRODUCTION AND AUTHORITATIVE LITERATURE

Nonprofit organizations often have relationships with other nonprofit organizations. Examples include associated organizations, affiliated organizations, chapters, and branches. National nonprofit organizations may have state and local chapters with varying degrees of autonomy while local organizations may have auxiliaries with varied nonprofit activities. Those relationships with associated organizations, affiliated organizations, chapters, branches, etc. may be separate corporate entities or merely "boards" or committees, and their separate revenue and assets may be substantial or negligible. Associated organizations may be closely interlocked with (i.e., controlled by) the nonprofit organization or they may operate autonomously. Also, associated organizations may be economically interrelated; for example, one of the organizations may solicit funds on behalf of the other; may be financially dependent on the other; or may pay expenses of, or transfer resources to, the other organization. Sometimes the boards of two or more nonprofit organizations will decide to merge the organizations to expand the reach of their programs and take advantage of operational efficiencies.

Nonprofit organizations also can have financial relationships with for-profit entities. The relationships may be the result of acquiring or establishing an operating business or receiving one in a donation. For example, a for-profit entity could be established when the organization wants to make an investment or undertake an activity that generates a profit. The for-profit entity may construct and manage a real estate development like an office building that will be partly occupied by the nonprofit organization. There also may be legal or tax compliance reasons for segregating the assets and operating a separate for-profit activity, such as an assisted living facility, bookstore, travel or tour service, or daycare center.

As can been seen in these examples, transactions or events can involve a nonprofit organization in several different types of relationships with other entities. Accordingly, the accounting methods used to report those transactions and relationships vary. The accounting guidance is used to assess relationships with other entities in terms of ownership, economic interest, and control, to determine whether the organization is required (or allowed) to—

- consolidate the other entity,
- report the investment using the equity method,
- report the investment at cost or fair value, or
- disclose (but not recognize) the relationship.

FASB ASC 810-10-10-1 notes that consolidated financial statements are usually necessary for a fair presentation when a reporting entity directly or indirectly has a controlling financial interest in another entity or entities. A nonprofit organization that is a reporting entity generally has a controlling financial interest in a for-profit entity if it owns over 50% of the outstanding voting interests in the investee. GAAP provides additional guidance for evaluating control of other types of for-profit entities such as partnerships and limited liability companies (LLCs).

Similarly, a nonprofit reporting entity also owns a controlling financial interest in another nonprofit organization that issues voting shares if it holds over 50% of the organization's voting stock. However, although some nonprofit organizations issue corporate stock, others have different legal forms and do not. Also, even if an organization holds less than a majority of another nonprofit organization's voting stock, it may have control over the organization through other means. Because of these considerations, GAAP provides guidance for evaluating whether an organization can exercise so much influence over another nonprofit organization through its economic interest and control over that organization's governing body that consolidation is required (or allowed) even if it does not hold a majority voting interest.

If consolidated financial statements are not presented, the nonprofit reporting entity's interest in another entity may be required to be reported using the equity method, the cost method, or it may be possible to elect to report the

interest at fair value in the financial statements. Combined financial statements are sometimes presented when they provide a meaningful presentation of entities that are commonly controlled. Although there are no requirements in GAAP to present combined financial statements, combined financial statements might be used to present the financial position and the results of operations of entities under common control or common management. For example, if two are more entities are controlled by the same parent (sometimes referred to as brother/sister entities), a statement that combines those entities might be useful even though the parent is not included. Although parent-entity only financial statements are not in compliance with GAAP, subsidiary-only financial statements are permitted.

The equity method, consolidation, and combination do not result in the reporting entity recognizing changes in the *fair value* of its financial interest in another entity. Instead, the reporting entity recognizes its share of the activities reported by the other entity. Consolidation and the equity method differ in the level of detail in which the other entity's activities are recognized, while consolidation and combination generally recognize the other entity's activities in the same level of detail.

When another entity is consolidated, the substance is the same as if the other entity were a division of the reporting entity rather than a separate entity. Consolidated financial statements show results for the reporting entity and the other entity in each of the individual line items in the statements. When the equity method is used, the reporting entity recognizes its share of the activities reported by the other entity through a change in the carrying amount of its investment in the other entity and an offsetting increase or decrease in the change in net assets in the statement of activities. The equity method is often referred to as a one-line consolidation because the reported activities and net assets are generally the same in total as they would be in consolidated financial statements.

The notion of control prompts a number of accounting questions:

a. How should a nonprofit organization determine whether it controls another entity?

b. If the nonprofit organization has a controlling financial interest in another entity, may financial statements be issued for just that organization or just the other entity?

c. How should the nonprofit organization account for the acquisition of a controlling financial interest during the year?

d. How should the nonprofit organization account for the disposition of a controlling financial interest during the year?

e. Does a change in the controlling financial interest the nonprofit organization has in another entity affect the organization's ability to issue comparative financial statements, including the year of the change and the year before or after the change?

f. If an entity has a controlling financial interest in the nonprofit organization and another entity, must the financial results of the two entities be combined? Must the financial results of the holder of the controlling financial interest, the nonprofit organization, and the other entity be consolidated?

Learning Objectives:

Completion of this lesson will enable you to:
- Recognize the different types of financial relationships for nonprofits and the accounting differences between these relationships such as mergers and acquisitions.
- Determine when to include financial results of another entity in nonprofit financial statements.

Authoritative Literature

The generally accepted accounting principles that provide guidance for nonprofit organizations and their financial relationships with other entities consider not only the characteristics that distinguish the financial reporting requirements of nonprofit organizations from for-profit entities, but also the variety of the financial relationships to which nonprofit organizations can be a party. In some cases, that guidance builds upon GAAP for for-profit entities with

incremental guidance tailored for nonprofit organizations. Other guidance is only applicable for nonprofit organizations.

FASB ASC 958-810, *Not-for-Profit Entities—Consolidation*, provides guidance for nonprofit reporting relationships that could result in consolidation. Specifically, it provides guidance to nonprofit organizations for—

- Reporting relationships with another nonprofit organization that could result in consolidation
- Reporting relationships with a for-profit entity that is not a limited partnership or similar legal entity (incremental guidance only)
- Reporting relationships with a limited partnership or similar legal entity
- Reporting relationships with special-purpose entity (SPE) lessors
- Reporting a noncontrolling interest in an acquiree

The guidance in FASB ASC 958-810 also provides implementation guidance for reporting relationships between nonprofit organizations and for-profit entities. That guidance points to the reporting guidance in other locations of the Codification that may be applicable based on the characteristics of the organization and its interest in the other entity. In summary, the guidance is organized as follows—

- FASB ASC 810-10, *Consolidation—Overall*, relates to consolidation of a controlling financial interest in a for-profit entity usually through direct or indirect ownership of a majority voting interest.
- FASB ASC 323-10, *Investments—Equity Method and Joint Ventures—Overall*, relates to using the equity method to report a noncontrolling interest in a for-profit entity.
- FASB ASC 958-320, *Not-for-Profit Entities—Investments—Debt and Equity Securities*, relates to reporting a noncontrolling interest in a for-profit entity when there is a readily determinable fair value for the interest.
- FASB ASC 958-325, *Not-for-Profit Entities—Investments—Other*, relates to reporting a noncontrolling interest in a for-profit entity at cost or fair value if there is not a readily determinable fair value for the interest.

The general guidance that is found in FASB ASC 810-10, describes how to consolidate financial results, deconsolidate financial interests, and combine the financial results of another entity. Although FASB ASC 810-10 includes guidance for consolidating Variable Interest Entities (VIEs), nonprofit organizations are specifically exempted from the VIE subsections of FASB ASC 810-10 by FASB ASC 810-10-15-17.

FASB ASC 958-20, *Not-for-Profit Entities—Financially Interrelated Entities*, describes certain relationships between financially interrelated nonprofit organizations. According to the literature, two organizations are financially interrelated when one of them has the ability to influence the financial and operating decisions of the other and one of them has an ongoing economic interest in the net assets of the other.

FASB ASC 958-805, *Not-for-Profit Entities—Business Combinations*, provides guidance on nonprofit business combinations. A transaction or event that involves combining one or more nonprofit organizations, businesses, or activities should be evaluated to determine whether it is a merger or an acquisition according to the guidance.

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. 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. This course presents guidance for the presentation of the statement of position both before and after the adoption of ASU 2016-14.

Terminology

The Reporting Entity. Conceptually, the reporting entity is the entity or entities whose financial results are reported in the financial statements. In consolidated financial statements, the reporting entity is the group of entities whose

financial results are consolidated. FASB ASC 260-10-20 refers to that group as the *consolidated group*, which it defines as the "parent and all its subsidiaries." This course also refers to that group as the consolidated group. Similarly, in combined financial statements, from a conceptual standpoint, the reporting entity is the group of entities whose financial results are combined. Although not addressed in the Codification, this course refers to that group as the *combined group*. If the financial statements are not consolidated or combined, the reporting entity is a single entity.

Intra-entity. Best practices indicate that the notion of the consolidated group being the reporting entity in consolidated financial statements is the reason the FASB uses the term *intra-entity* in the Codification. The prefix *intra* conveys the notion of transactions within the consolidated group. Further, the Codification's general use of *entity* is designed to clarify that the accounting guidance in the Codification generally applies to any form of legal entity, including nonprofit organizations.

Subsidiary. The term *subsidiary* as used in this course means an entity that meets the criteria to be included in a reporting entity's consolidated financial statements.

Noncontrolling Interest. FASB ASC 220-10-20 defines *noncontrolling interest* as—

> the portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a minority interest.

While use of the term *minority interest* is not prohibited, the term *noncontrolling interest* may be preferable.

MERGERS OF NONPROFIT ORGANIZATIONS

Introduction

When a nonprofit organization is involved in a transaction or other event in which it combines with one or more other nonprofit organizations or activities, the definitions below should be used to determine whether the transaction is either a merger or an acquisition as defined in GAAP. FASB ASC 958-805, *Not-for-Profit Entities—Business Combinations*, provides guidance for distinguishing between a merger and an acquisition.

GAAP states that only combination transactions that involve two or more nonprofit organizations can potentially qualify as a merger. A *merger* is accounted for using the *carryover method* of accounting. Under the carryover method, a new organization is created by combining the assets, liabilities, and net assets of the merged organizations. If a combination of two or more organizations is not a merger, it is by default an *acquisition* and is accounted for using the *acquisition method*. The acquisition method is also *required* to be used for all business combinations involving nonprofit organizations and for-profit entities. Under the acquisition method, the acquirer recognizes and measures at fair value the identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree as of the acquisition date.

This section discusses the guidance for (a) classifying a transaction as a merger or an acquisition, and (b) accounting for and reporting a transaction that meets the definition of a merger. The guidance for business combinations discussed in this section and later in this course does not apply to:

- A combination between entities under common control.
- The acquisition of an asset or group of assets that does not constitute either a business or a nonprofit activity.
- The formation of a joint venture.
- A transaction in which an organization obtains control of another financially related nonprofit organization but does not consolidate that organization because consolidation is either not permitted, or is permitted but not required.

Distinguishing Between a Merger and an Acquisition

FASB ASC 958-805-25-1 states that a transaction or event involving a nonprofit organization should be evaluated to determine whether it is a merger or acquisition based the following definitions:

- A *merger* of nonprofit organizations is a transaction or event in which the governing bodies of two or more nonprofit organizations cede control of those entities to create a new nonprofit organization.
- An *acquisition* by a nonprofit organization is a transaction or other event in which the organization obtains control of one or more nonprofit organizations or activities, or one or more for-profit businesses and recognizes their assets and liabilities in its financial statements.

A determination of whether the governing bodies of the combining nonprofit organizations have ceded control to a new entity, and thus consummated a merger, should be based on the preponderance of the evidence. This requires assessing the—

a. Process leading to the combination.

b. Participants to the combination.

c. Combined entity.

FASB ASC 958-805-55-1 states that to qualify as a new nonprofit organization, the new entity must have a newly formed governing body. Although it is not necessary that the new organization be a new legal entity, the governing bodies of the combining organizations cannot retain shared control of the new organization in a merger. Generally, in a merger neither party dominates, or is capable of dominating, the process leading to the formation of the new organization. In an acquisition, however, the acquirer often dominates the process, sometimes dictating the terms and timing of the transaction.

According to the guidance at FASB ASC 958-805-55-5, the characteristics of the participants that may help distinguish a merger from an acquisition are their: (a) governance and related control powers, and (b) financial capacity. Although an assessment of these characteristics may be helpful, they are not themselves determinative of whether the transaction is a merger or acquisition. FASB ASC 958-805-55-1 states the sole determinative criterion of a merger is ceding of control by the combining organizations. Features of governance and control powers that may indicate the combination is an acquisition rather than a merger include:

- One organization's ability to appoint significantly more of the governing board members for the new entity,
- One organization's ability to retain significantly more key senior officers, or
- One organization's ability to retain substantially unchanged its bylaws, operating policies, and practices.

When considering financial capacity, the relative financial strength and size of the combining organizations may allow one of the organizations to dominate the process, thereby indicating the transaction is an acquisition.

The new organization formed in a merger generally has a perpetual life and assumes all of the assets and liabilities of the participating organizations without a transfer of cash or other assets to those organizations, their owners, members, sponsors, or designated beneficiaries. The organizations in the merger cease to exist as autonomous entities and do not hold financial interests in the new organization.

A merger of nonprofit organizations should be accounted for using the carryover method. The carryover method is similar in many respects to the pooling of interests method allowed by previous accounting literature, although its applicability is more limited.

If a transaction or event that combines nonprofit organizations is not a merger or another type of transaction (such as formation of a joint venture), it is an acquisition and should be accounted for using the acquisition method. The acquisition method is similar to the purchase method allowed by previous accounting literature.

The Carryover Method

The carryover method requires combining the assets and liabilities that would be recognized in the separate financial statements of the merging nonprofit organizations as of the merger date, adjusted as necessary, as described in the following paragraphs.

Recognizing and Measuring Assets and Liabilities in a Merger. A merger is easier to recognize in financial statements than an acquisition because it does not entail identifying all of the assets acquired and liabilities assumed and determining their fair values. FASB ASC 958-805-25-6 states the new nonprofit organization formed as a result of a merger should recognize and measure the assets and liabilities from the separate financial statements, prepared in accordance with GAAP, of the merging organizations as of the merger date. If the financial statements of the merging organizations are not prepared in accordance with GAAP, they should be adjusted to reflect GAAP before the assets and liabilities are recognized by the new organization.

Generally, the classifications or designations of assets and liabilities should be carried forward from the previous financial statements after the adjustments to apply GAAP, if any, have been made. FASB ASC 958-805-25-9 states that in the following two situations, however, classifications and designations can be changed:

- If the merger causes a contract to be modified in a way that changes its previous classification, the new organization should classify the related asset or liability on the basis of its own operating or accounting policies, the contract terms, economic conditions, and other relevant factors that exist on the merger date.
- If the merging organizations have different accounting policies, the new organization should make adjustments to reflect a consistent accounting method.

Also, the effects of intra-entity transactions should be eliminated as of the merger date.

In some cases, GAAP allows nonprofit organizations to adopt accounting policies from among a selection of acceptable alternatives, principles, or methods. For example, prior to the effective date of ASU 2016-14, an organization may imply time restrictions on the use of contributed long-lived assets when donors do not place stipulations about how long the assets must be used. Additionally, organizations may classify donor-restricted contributions as unrestricted (without donor restrictions after the adoption of ASU 2016-14) if the restrictions are met in the same reporting period in which the contributions were received. The new organization created by a merger should make the adjustments that are required to report assets and liabilities based on consistent accounting policies in its financial statements; such adjustments are not recorded by the predecessor organizations that were merged.

However, the carryover method does not allow "fresh-start" accounting in which an entity is allowed to elect or reverse accounting methods or options restricted to the initial acquisition or recognition of an item. For example, FASB ASC 825-10 allows an entity, at specified election dates, to elect the fair value option for measuring eligible financial assets and liabilities. The carryover method does not allow the merged organization to override the fair value option previously adopted for an asset or liability by one of the merging entities. The carryover method also does not allow the new organization to adopt the fair value option for financial assets or liabilities measured on other bases since a merger is not one of the allowed election dates for adopting the fair value option specified in the literature.

Financial Statement Presentation and Disclosure

The assets, liabilities, and net assets of the merging organizations are combined to present the initial statement of financial position of the new organization. According to FASB ASC 958-805-45-2, the following accounting changes, if required, should be reflected in the opening balances of the new organization:

- Adjustments by the predecessor organizations to present their financial statements in accordance with GAAP.
- Adjustments to apply consistent accounting policies.
- Adjustments to eliminate intra-entity balances.

The merger itself should not be reflected in the statement of activities or the statement of cash flows. The activities, cash flows and initial reporting period for a new organization formed in a merger begin on the date of the merger. Accordingly, the initial statements of activities and cash flows should report the merged organization's activity from the merger date through the end of the reporting period.

The new nonprofit organization created by a merger should disclose information that enables users of the financial statements to evaluate the nature and financial effect of the merger that resulted in its formation. In meeting this objective, the following should be disclosed:

a. Name and description of each merging organization.

b. Merger date.

c. Primary reasons for the merger.

d. For each organization in the merger—

   (1) Amounts recognized for each major class of assets, liabilities, and each class of net assets as of the merger date.

   (2) Nature and amounts of significant assets or liabilities for which GAAP does not require recognition in the financial statements (for example, conditional promises to give, collections, conditional promises payable), if applicable.

e. Nature and amount of significant adjustments to conform the accounting policies of the merging entities or eliminate intra-entity balances.

f. Additional information necessary to evaluate the nature and financial effect of the merger.

ACQUISITIONS BY NONPROFIT ORGANIZATIONS

Introduction

FASB ASC 958-805, *Not-for-Profit Entities—Business Combinations* requires that transactions or other events that involve combining two or more nonprofit organizations or nonprofit activities be evaluated to determine whether the transaction is a merger or an acquisition. If the transaction or event is not a merger, it is by default an *acquisition* and is accounted for using the acquisition method. The acquisition method is also required to be used for combinations that involve nonprofit organizations and for-profit entities.

This section discusses the acquisition method described in FASB ASC 805, *Business Combinations*, as it applies to nonprofit organizations. FASB ASC 958-805 provides incremental guidance for application of FASB ASC 805 by nonprofit organizations.

The Acquisition Method

FASB ASC 958-805-20 states that an *acquisition* by a nonprofit organization is a transaction or other event in which a nonprofit organization acquirer obtains control of one or more nonprofit activities or businesses and initially recognizes their assets and liabilities in its financial statements. The assets acquired and liabilities assumed must constitute a business or a nonprofit activity. FASB ASC 958-805-20 provides the following definitions:

- A *business* is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants.

- A *nonprofit activity* is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing benefits, other than goods or services at a profit or profit equivalent,

as a fulfillment of an entity's purpose or mission (for example, goods or services to beneficiaries, customers, or members).

If the assets acquired and liabilities assumed do not constitute a business or a nonprofit activity, the transaction should be accounted for as an asset acquisition. See the discussion later in this course.

According to FASB ASC 805-10-05-4 and 958-805-25-13, the acquisition method requires the following:

a. Identifying the acquirer.

b. Determining the acquisition date.

c. Recognizing and measuring:

   (1) Identifiable assets acquired, liabilities assumed, and noncontrolling interests.

   (2) Goodwill or the contribution received.

d. Determining what is part of the acquisition transaction.

Definition of a Business after the Effective Date of ASU 2017-01. In January 2017, the FASB issued ASU 2017-01, *Business Combinations (Topic 805): Clarifying the Definition of a Business.* The ASU retains the definition of a nonprofit activity and the definition of a business but adds additional clarification to assist entities in determining whether a transaction should be accounted for as an acquisition or disposition of (a) an asset or (b) a business or nonprofit activity. For nonprofit organizations, the ASU is effective for annual periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019.

At a minimum, FASB ASC 805-10-55-5 indicates a business or a nonprofit activity must have two elements, an input and a substantive process, which generally contribute to the creation of an output. Those elements are defined as follows:

- *Inputs.* Economic resources that create or can contribute to the creation of outputs from the application of one or more processes.

- *Processes.* Systems, standards, protocols, conventions, or rules that are applied to inputs to create or provide the ability to contribute to the creation of an output.

- *Outputs.* Goods or services provided to customers, investment income, and other revenues that result from the application of processes to inputs.

FASB ASC 805-10-55-5A clarifies that if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset, or a group of similar identifiable assets, the set of assets is not deemed to be a business or a nonprofit activity.

Identifying the Acquirer. Under the acquisition method, one of the combining organizations should be identified as the acquirer. The acquirer is the entity that obtains control of the acquiree. To determine the acquirer, a nonprofit organization uses the guidance in FASB ASC 958-805-25-15. Nonprofit organizations use the guidance on consolidation of nonprofit organizations in FASB ASC 958-810 to determine whether they have control over another business or nonprofit activity. If the potential acquiree is a nonprofit entity or activity, *control* is the direct or indirect ability to determine the direction of management and policies through ownership, contract, or otherwise. That definition of control is discussed later in this course. If the potential acquiree is a for-profit business, control has the meaning of controlling financial interest in FASB ASC 810. As an informal guideline, if a nonprofit organization is required to begin consolidating another business or nonprofit activity, it is the acquirer of that business or nonprofit activity. If the guidance does not clearly identify the acquirer, consideration should be given to the factors that are

usually characteristics of a nonprofit acquirer, as described in FASB ASC 958-805-25-15, 25-16, and 958-805-55-42 through 55-46. The following are among the factors from that guidance:

a. The entity that transfers the cash or other assets or incurs the liabilities in the acquisition.

b. The entity whose relative size is significantly larger than the other entity or entities (measured by assets, revenues, or change in net assets).

c. The combined entity may retain the legal name and mission of the entity that is the acquirer.

d. The entity that can select or dominate the process of selecting the management team of the combined entity.

e. The entity whose governing body can select or dominate the process of selecting the governing body of the combined entity. This power could be granted in the new entity's governing documents, the acquisition agreement, or by other means. Consideration should also be given to whether the ability to dominate the process of selecting the governing body of the new entity exists through other means.

Determining the Acquisition Date. The acquisition date is the date on which the acquirer obtains control of the acquiree. Typically, this is the closing date, but it might be earlier or later, for example, the date the acquirer becomes the sole corporate member of another entity or if a written agreement specifies that control transfers on an earlier date.

Recognizing Identifiable Assets Acquired, Liabilities Assumed, and Noncontrolling Interests. The acquirer should recognize the identifiable assets acquired, liabilities assumed, and noncontrolling interests in the acquiree at the acquisition date, separate from the recognition of goodwill. However, certain exceptions to the general recognition guidance are provided as described later in this section.

The assets acquired and liabilities assumed should be classified or designated as necessary to apply GAAP for subsequent accounting. Generally, classification of assets and liabilities should be based on contract terms, economic conditions, the acquirer's operating or accounting policies, and other relevant factors that exist on the acquisition date. However, lease classification and classification of insurance contracts (as insurance or reinsurance contracts or deposit contracts) should be based on terms at the inception of the contract unless the contracts are modified in a manner that would change their classifications.

Recognition Conditions. FASB ASC 805-20-25-2 and 25-3 state assets acquired and liabilities assumed should be recognized if they meet the following conditions:

a. The assets and liabilities meet the definitions of assets and liabilities in Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*, which indicates that *assets* are probable future economic benefits obtained or controlled by a particular entity due to past transactions or events. *Liabilities*, on the other hand, are probable future sacrifices of economic benefits that arise from present obligations to transfer assets or provide services to other entities in the future due to past transactions or events. The phrase "due to past transactions or events" is significant in those definitions. For example, an acquirer may expect to incur costs to terminate the employment of an acquiree's employees. Because the acquirer is not obligated to pay these costs until a plan of termination is developed and communicated to those employees, the acquirer does not recognize those costs as part of applying the acquisition method. Instead, the acquirer recognizes those costs in its post-acquisition financial statements in accordance with FASB ASC 420.

b. The assets and liabilities must be part of what the acquirer and acquiree exchanged or contributed in the acquisition transaction and did not result from separate transactions. An identifiable asset or liability also qualifies for recognition if it is part of what was contributed in an acquisition that includes an inherent contribution.

In some cases, the acquirer may recognize assets and liabilities that were not previously recognized in the financial statements of the acquiree. For example, intangible assets such as most donor lists, patented technology,

customer relationships, or brand names might be recognized by the acquirer even though they were internally developed by the acquiree and charged to expense.

Measuring Identifiable Assets Acquired, Liabilities Assumed, and Noncontrolling Interests. Most identifiable assets acquired, liabilities assumed, and noncontrolling interests in a business combination should be measured at fair value as of the acquisition date. FASB ASC 805-10-20 defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." Fair value should generally be measured following the fair value measurement guidance in FASB ASC 820.

FASB ASC 805-20-30 provides additional measurement guidance as follows:

- Fair value should be determined based on an asset's highest and best use even if the acquirer does not intend to use the asset that way.
- A separate valuation allowance should not be recognized as a result of uncertainty about future cash flows. For example, the acquirer should not recognize a separate valuation allowance on acquired receivables and loans for estimated cash flows that are considered to be uncollectible at the acquisition date. Those considerations are included in the fair value measurement.
- Assets subject to an operating lease in which the acquiree is the lessor should be measured separately from the lease contract.
- If an active market exists, the acquisition-date fair value of a noncontrolling interest can be determined based on market prices for the equity shares not held by the acquirer. If an active market does not exist, other valuation techniques should be used. If the acquiree is a for-profit entity, the per-share fair values of the acquirer's interest in the acquiree and the noncontrolling interest might be different as a result of a control premium or a discount for lack of control.

The initial measurements are the same whether the acquirer retains the acquiree as a subsidiary or liquidates the entity. If the acquiree is retained as a subsidiary, the amounts measured become the initial carrying amounts in the consolidated financial statements. If the acquiree is liquidated into the acquirer, the initial measurements become the carrying amounts of the acquired assets, liabilities, and noncontrolling financial interest. Similarly, the valuations are the same whether the acquiree holds an equity interest in the other entity or it acquires all, or substantially all, of its assets.

Recognition and Measurement Exceptions. There are limited exceptions to the general principal for recognizing and measuring assets acquired and liabilities assumed in a business combination at fair value. Certain assets and liabilities should be either (a) recognized by applying conditions other than those mentioned previously or (b) measured at an amount other than acquisition-date fair value. The following paragraphs discuss some of the exceptions described in FASB ASC 805-20-25-16 through 25-28, FASB ASC 805-20-30-11 through 30-23, and FASB ASC 958-805-25-21 through 25-26.

Donor Relationships. The acquirer should not recognize the acquiree's donor relationships as an intangible asset separately from goodwill. (The acquiree's donor list, however, could meet the conditions for recognition described earlier.)

Collections. An acquirer that capitalizes its collections also should recognize the acquiree's collection items and measure them at fair value on the acquisition date in accordance with the general measurement principle discussed earlier. An acquirer that has a policy of not capitalizing collection items should not capitalize collection items in an acquisition. Those collection items should be treated as follows:

- The cost of collection items that are purchased in the acquisition should be recognized as a decrease in the appropriate class of net assets in the acquirer's statement of activities. The cost should also be reflected as a cash outflow for investing activities in the acquirer's statement of cash flows.
- Collection items that are contributed as part of the acquisition should not be recognized, either as an asset or as contribution revenue.

Accordingly, the acquirer will need to determine if the acquired collection items were purchased or contributed in the acquisition. Further, if purchased, the cost attributable to those items must be determined. Such a

determination is made based on the facts and circumstances of the acquisition transaction. FASB ASC 958-805-55-49 through 55-54 provide additional guidance in making that determination.

Conditional Promises to Give. The acquiring organization should not recognize a conditional promise to give to the acquiree unless the conditions upon which the promise depends are substantially met as of the acquisition date. Assets that were transferred to the acquiree in connection with a conditional promise to give should be recorded as a refundable advance unless the donor conditions are met as of the acquisition date.

Contingencies. The acquirer should recognize the acquiree's recorded assets or liabilities arising from contingencies as follows:

- The acquirer should recognize an asset or a liability arising from a contingency on the acquisition date if the fair value can reasonably be determined during the measurement period.
- The acquirer should recognize an asset or liability arising from a contingency even if the acquisition-date fair value cannot be determined during the measurement period if—

  a. information available before the measurement period expires indicates that it is probable that an asset existed or a liability had been incurred at the acquisition date, and

  b. the amount of the asset or liability can be reasonably estimated.

  The guidance in FASB ASC 450-20 should be applied in evaluating whether these conditions have been met.

- The acquirer should not recognize an asset or a liability arising from a contingency on the acquisition date if the fair value cannot be determined within the measurement period and it is not possible to estimate its amount.

Contingent consideration arrangements are discussed later in this lesson.

Income Taxes. An in-depth discussion of recognizing and measuring deferred tax assets or liabilities that arise from assets acquired and liabilities assumed in an acquisition is beyond the scope of this course; however, more information is available in *PPC's Guide to Preparing Nonprofit Financial Statements*. In addition, the potential tax effects of temporary differences, carry forwards, and any income tax uncertainties of the acquiree that exist or arise as a result of the acquisition should be addressed. Specifically, a deferred tax asset or liability should be recognized at the acquisition date based on the acquired entity's taxable or deductible temporary differences (except for certain nondeductible items) or operating loss or tax credit carry forwards. The acquirer should also assess the need for a deferred tax valuation allowance at the acquisition date. For many acquisitions of a nonprofit organization by another nonprofit organization, there will likely be no income tax related recognition or measurement issues.

Employee Benefits. Liabilities (or assets, where applicable) related to an acquiree's employee benefit arrangements should be recognized and measured following applicable GAAP for those plans.

For an acquiree that sponsors a single-employer defined benefit pension or other postretirement benefit plan, the acquirer should recognize an asset or a liability for the funded status of the plan as part of the acquisition. The acquirer should exclude the effects of expected plan amendments, terminations, or curtailments that it has no obligation to make as of the acquisition date when determining the funded status. The assumed benefit obligation should reflect all other necessary changes in assumptions based on the assessment of relevant future events. For an acquiree that participates in a multiemployer plan where it is probable as of the acquisition date that the acquirer will withdraw from that plan, the acquirer should recognize a contingent liability.

Indemnification Assets. In some transactions, the seller may contractually indemnify the acquirer for contingencies or uncertainties related to specific assets or liabilities. An indemnification asset should be recognized at the same time as the indemnified item and measured on the same basis as the indemnified item. For example:

- If the indemnified asset or liability is recognized at the acquisition date and measured at fair value, the indemnification asset also should be recognized at the acquisition date and measured at fair value.

- If the indemnified asset or liability is recognized and measured following other GAAP, the indemnification asset should be recognized and measured consistently.

- If the indemnified asset or liability arises from a contingency that is not recognized on the acquisition date based on the guidance discussed earlier, the indemnification asset also should not be recognized.

A valuation allowance may be recorded for uncollectible amounts.

Other Exceptions. Other exceptions to the general measurement principle discussed above are as follows:

- *Reacquired rights.* Reacquired rights (for example, when the acquirer reacquires the right to use its trade name under a franchise agreement or its technology under a licensing agreement) should be measured based on their remaining contract terms regardless of whether market participants would consider potential contractual renewals in determining fair value.

- *Assets held for sale.* An acquired long-lived asset (or disposal group) classified as held for sale at the acquisition date should be measured at fair value less cost to sell.

Goodwill Acquired or a Contribution Received. FASB ASC 958-805-25 and 958-805-30 provide specific guidance relating to goodwill acquired or a contribution received when the acquirer in a business combination is a nonprofit organization.

Recognizing and Measuring Goodwill. How goodwill is recognized in an acquisition by a nonprofit organization depends on whether the operations of the acquiree as part of the combined organization are expected to be *predominantly supported* by contributions and returns on investments after the acquisition. According to FASB ASC 958-805-25-29, the operations of the acquire as part of the combined organization are predominantly supported by contributions and returns on investments if the amount of contribution revenue and investment return is significantly more than the total amount of revenue from all other sources. All qualitative and quantitative factors, including contributions that are precluded or not required to be recognized (such as certain contributed services, collection items, and conditional promises to give) should be considered when determining the predominant source of support of the acquiree's operations.

Goodwill on the acquisition date is measured as the excess of item a over item b as follows:

a. The aggregate of the (1) fair value of the consideration transferred, (2) fair value of any noncontrolling interest in the acquiree, and (3) acquisition-date fair value of any previously held equity interest in the acquiree, if the acquisition is achieved in stages.

b. Net amount of identifiable assets acquired and liabilities assumed as of the acquisition date measured as discussed earlier in this course.

If contributions and returns on investments are expected to be significantly more than the total of all other sources of revenues after the acquisition date, the goodwill measured in accordance with the guidance above is immediately written off as of the acquisition date as a separate charge in the statement of activities. If instead the operations of the acquiree are not expected to be predominantly supported by contributions and returns on investments, the nonprofit acquirer should recognize the goodwill as of the acquisition date as an asset. Such recorded goodwill, as with other intangible assets with indefinite useful lives, is not amortized but is tested for impairment.

In some acquisition transactions, no consideration is transferred, there are no noncontrolling interests, and the acquisition is not achieved in stages. In those transactions, goodwill or the separate charge in the statement of activities is determined as the excess of the liabilities assumed over the assets acquired.

Recognizing and Measuring the Inherent Contribution. If the net amount of identifiable assets acquired and liabilities assumed exceeds the consideration transferred and fair values of noncontrolling interests and previously-held equity interests, the acquirer should recognize the excess as a separate credit (an inherent contribution) in the statement of activities as of the acquisition date. If no consideration is transferred, there are no noncontrolling interests, and the acquisition is not achieved in stages, the separate credit in the statement of activities is

determined as the excess of the assets acquired over the liabilities assumed. Best practices indicate that acquisitions that result in a contribution being recorded will often be ones in which the acquiree has a significant amount of property and equipment or intangible assets that are reported at fair value under the acquisition method.

Acquisitions Achieved in Stages

An acquirer may already own an equity interest in the acquiree before it obtains control on the acquisition date. Those transactions are referred to as acquisitions achieved in stages or as step acquisitions. FASB ASC 805-10-25-10 states that in a step acquisition, the acquirer remeasures the previously-held interest in the acquiree at its acquisition-date fair value and recognizes a gain or loss in the statement of activities. Generally, it is rare for a nonprofit organization to acquire financial interests in entities in stages. Considerations for retroactively adjusting the carrying value of an investment are discussed in Chapter 33 of *PPC's Guide to Nonprofit GAAP*.

Consideration Transferred in an Acquisition

The guidance at FASB ASC 805-30-30-7 states that consideration transferred in an acquisition is measured at fair value and represents the sum of the acquisition-date fair values of the following:

- Assets transferred by the acquirer.
- Liabilities incurred by the acquirer to the former owners of the acquiree.

Examples of consideration include cash, other assets, a business or nonprofit activity of the acquirer, and contingent consideration.

Assets transferred by the acquirer to an unrelated third party as a required part of the acquisition are included in the consideration transferred and measured at fair value unless the acquirer retains control over those assets. If the transferred assets will remain in the combined entity after the acquisition (for example, because they are transferred to the acquiree rather than to its former owners), no gain or loss should be recognized and the assets or liabilities comprising the consideration transferred should be measured at their carrying amounts immediately before the acquisition date.

Contingent Consideration. Contingent consideration represents the acquirer's obligation to transfer additional assets or equity interests to former owners of the acquiree as part of the exchange for control if specified future events occur or conditions are met. In some cases, the acquirer has the right to the return of previously transferred consideration if specified conditions are met. FASB ASC 805-30-25-5 through 25-7 provide guidance for contingent consideration in an acquisition by a nonprofit organization. It states that consideration transferred in an acquisition includes the acquisition date fair value of any contingent consideration. A right to the return of previously transferred consideration should be classified as an asset. An obligation to pay contingent consideration should be classified as a liability.

Measurement Period for an Acquisition

It is not unusual for the final accounting for an acquisition to be incomplete at the end of the reporting period in which the acquisition occurs. In that case, the acquirer should report provisional amounts in its financial statements for items for which the accounting is incomplete. FASB ASC 805-10-25-13 through 25-19 provide guidance for how provisional amounts recognized for an acquisition can be adjusted during the measurement period. The measurement period ends when the acquirer obtains the necessary information about facts and circumstances that existed at the acquisition date or otherwise learns that additional information is not forthcoming. In any event, the measurement period cannot exceed one year from the acquisition date.After the measurement period ends, the only prior-period adjustment that can be made is the correction of an error.

The measurement period allows the acquirer time to gather information that will allow identification and measurement of the following as of the acquisition date:

a. Identifiable assets acquired, liabilities assumed, and noncontrolling interests.

b. Consideration transferred.

c. For acquisitions achieved in stages, the equity interest in the acquiree previously held by the acquirer.

d. Goodwill or the contribution received.

Provisional amounts recognized at the acquisition date should be adjusted for new information about facts and circumstances that existed at the acquisition date that would have affected the measurement as of that date. The acquirer can also recognize additional assets and liabilities during the measurement period if new information indicates that they existed at the acquisition date. After the measurement period ends, the only prior-period adjustment that can be made is the correction of an error.

Adjustments to provisional amounts during the measurement period are offset by increases or decreases in goodwill or by a direct charge or credit to the statement of activities if goodwill was not recognized. During the measurement period, the financial statements should be revised as necessary, including recognizing the full effect of any resulting changes in depreciation, amortization, or other income if the accounting had been complete at the acquisition date. After the measurement period ends, the only prior-period adjustment that can be made is the correction of an error.

Determining What Is Part of the Acquisition Transaction

FASB ASC 805-10-25-20 states that transactions that are separate from the acquisition should not be accounted for as part of the acquisition. Thus, the acquirer should identify any items that are not part of the exchange for the acquiree. Separate transactions should be accounted for following other applicable GAAP. Transactions primarily for the benefit of the acquirer or the combined entity rather than the acquiree (or its former owners), or transactions entered into by or on behalf of the acquirer, are likely to be separate transactions.

Acquisition-related Costs. The guidance at FASB ASC 805-10-25-23 defines acquisition-related costs as those costs incurred by the acquirer to effect an acquisition. Generally, those costs are expenses of the acquirer in the period the costs are incurred and the services received. However, the costs to issue debt securities should be recognized.

According to FASB ASC 805-10-25-23, acquisition-related costs include—

- Finder's fees.
- Advisory, legal, accounting, valuation, and other professional or consulting fees.
- General administrative costs.
- Costs of maintaining an internal acquisitions department.
- Costs to register and issue debt securities.

Accounting Subsequent to the Acquisition

The fair value measurements under FASB ASC 805-20 and 958-805 are only the initial amounts recorded for the assets, liabilities, and noncontrolling financial interest in a business combination. Going forward, those carrying amounts are generally subject to other measurement guidance within GAAP. For example, the reporting entity should initially record an identifiable intangible asset acquired in a business combination at its fair value at the date of the acquisition. After the acquisition, the asset should be accounted for following the guidance in FASB ASC 350-30. Accordingly, subsequent unrealized appreciation in the fair value of the asset should not be recognized, and subsequent unrealized depreciation in its fair value should be recognized only if the requirements for recognizing an impairment loss are met.

GAAP provides specific guidance for subsequent accounting as follows—

a. Reacquired rights, as described at FASB ASC 805-20-35-2.

b. Contingencies recognized at the acquisition date, as described at FASB ASC 805-20-35-3.

c. Indemnification assets, as described at FASB ASC 805-20-35-4.

d. Contingent consideration, including contingent consideration arrangements assumed by the acquirer, as described at FASB ASC 805-30-35-1 and 35-1A.

Reacquired Rights. A reacquired right recognized as an intangible asset should be amortized over the remaining contract period related to the right. If the acquirer subsequently sells the reacquired right to a third party, the carrying amount of the intangible asset should be included when determining the gain or loss on sale.

Contingencies Recognized at the Acquisition Date. The acquirer should develop a systematic and rational basis for the subsequent accounting for acquisition assets and liabilities arising from contingencies as of the acquisition date.

Indemnification Assets. An indemnification asset should be subsequently measured on the same basis as the indemnified asset or liability (subject to any contractual limitations on its amount). Indemnification assets that are not subsequently measured at fair value should be assessed for collectibility. Indemnification assets should only be derecognized when the acquirer collects, sells, or loses the right to them.

Contingent Consideration. Contingent consideration classified as an asset or liability should be measured at fair value at each reporting date until resolved. The changes in fair value are recognized in the statement of activities.

Financial Statement Presentation and Disclosure

The acquirer should report the activities related to an acquisition of another entity in the period in which the acquisition occurs. If the acquirer will recognize a separate charge in the statement of activities for the amount that would otherwise be recorded as goodwill, the separate line item may be described as the "excess of consideration paid over net assets acquired in acquisition of ABC Organization," or "excess of liabilities assumed over assets acquired in acquisition of ABC Organization."

The acquirer should recognize the separate credit in the statement of activities for the amount of the contribution inherent in the acquisition as the "excess of assets acquired over liabilities assumed in the donation of ABC Organization," "contribution received in donation of ABC Organization," or the "excess of fair value of net assets acquired over consideration paid in acquisition of ABC Organization," depending on the circumstances.

The contribution may increase any class of net assets or a combination of classifications. In determining the classification of the increase in net assets, the acquirer should consider donor-imposed restrictions on the net assets of the acquiree before the acquisition, even if those restrictions are met in the same reporting period. The policy of reporting donor-restricted contributions in the class of net assets without donor restrictions if the restrictions are met in the same reporting period that is otherwise allowed under GAAP cannot be applied by the acquirer.

If the acquirer transfers assets as consideration in an acquisition, the acquirer should assess whether the transfer satisfies donor-imposed restrictions or otherwise results in a change in the classification of net assets. If the transfer satisfies a donor-imposed restriction on the acquirer's net assets, the expiration of the restriction may be reported separately or combined with other similar expirations of donor-imposed restrictions in the statement of activities. If the transfer otherwise results in a change in net asset classification, it should be reported separately from both other reclassifications of net assets and other expirations of donor-imposed restrictions.

FASB ASC 958-805-45-8 through 45-10 provide the following two examples of how the transfer of assets as consideration in an acquisition could affect the classification of net assets in the statement of activities:

- An acquirer may transfer consideration that would satisfy an existing donor restriction for the acquisition of capital assets, works of art, or other long-lived assets. If the acquiree has such qualifying property, the acquirer may report the expiration of the donor-imposed restriction on net assets separately or combined with other similar expirations of donor-imposed restrictions during the period the acquisition occurs.

- An acquirer may transfer consideration from net assets without donor restrictions and acquire assets with donor-imposed restrictions from the acquiree. The acquirer should report this reclassification of net assets separately from any other reclassifications in the statement of activities.

The net cash flows (cash paid as consideration less cash acquired from the acquiree) should be reported as a cash flow from investing activities in the acquirer's statement of cash flows. Noncash activity related to the acquisition, such as noncash contributions received or noncash consideration transferred should be disclosed.

Transactions between Entities That Are Not Mergers or Acquisitions

Entities under Common Control. Some transactions or events in which nonprofit organizations, nonprofit activities, and businesses are combined do not meet the definition of a merger or an acquisition as defined in GAAP because they involve entities that are under the common control of a parent entity. Examples of transactions between entities under common control that could involve nonprofit organizations include the following: (Others are described in FASB ASC 805-50-15-6.)

- An organization forms a new entity and transfers some or all of its net assets to that entity.
- A new organization is formed by combining two or more nonprofit organizations that are effectively controlled by the same board members. The organizations transfer their net assets to the new organization, dissolve the former organizations, and appoint the same board members to the newly combined organization.
- A wholly owned subsidiary is liquidated and its net assets are transferred to the parent. (This is a change in legal organization but not in the reporting entity.)
- A parent transfers its controlling interest in several partially owned subsidiaries to a new wholly owned subsidiary. (This is a change in legal organization but not in the reporting entity.)

In a transfer of assets that involves entities under common control, the organization receiving the net assets or equity interests should recognize the assets and liabilities transferred at their carrying amounts in the transferring entity's accounts at the date of transfer. However, if the carrying amounts vary from the parent's historical cost (for example, because pushdown accounting was not applied) the receiving organization should record the amounts at the parent's historical costs.

If the transaction between entities under common control results in a change in the reporting organization, the following guidance applies:

a. If the receiving nonprofit organization and the transferring entity have different accounting policies, the carrying amounts of the assets and liabilities transferred can be adjusted to the basis of accounting used by the receiving organization, if the change is preferable. The accounting change should be applied retrospectively and financial statements for prior periods should be adjusted following the guidance for a change in accounting principle.

b. The receiving nonprofit organization should report changes in net assets for the period in which the transaction occurs as if it had occurred at the beginning of the period. The effects of intra-entity transactions on current assets, current liabilities, and on revenue and support for all periods presented and on net assets at the beginning of the periods presented should be eliminated, if possible.

c. The receiving nonprofit organization should present the statement of financial position and other financial information as of the beginning of the period as though the assets and liabilities had been transferred at that date. Comparative financial statements should be retrospectively adjusted. Adjusted financial statements should indicate that previously separate entities are combined. However, prior comparative information should only be adjusted for periods when the entities were under common control.

Acquisition of Assets. Nonprofit organizations sometimes purchase a group of assets that would not be considered a business or nonprofit activity under the definition provided earlier in this lesson. This is sometimes referred to as purchasing a *basket of assets*. Typically, the organization is purchasing assets that it will use in its own activities and is not looking to purchase systems or any other features of a going concern. For example, an

organization may acquire part of the inventory and equipment owned by another organization. However, those assets on their own do not constitute an integrated set of activities sufficient to provide benefits to clients.

Even though this type of acquisition is not a business combination, FASB ASC 805-50-30-1 through 30-3 provide guidance on accounting for the acquisition. Under that guidance, assets are recognized at their cost, which generally includes the transaction costs of the acquisition.

To illustrate, assume that the nonprofit organization acquires part of the inventories and equipment of another entity and that consideration for the acquisition consists of assuming the financing related to the inventories acquired and paying cash of $400. The $800 principal outstanding under the financing approximates the fair value of the bank note. The following entry illustrates how the nonprofit organization would recognize the purchase:

Assets acquired (Identify specific assets)	$ 1,200	
Cash		$ 400
Bank note		800

The $1,200 debit to the assets acquired is the total of the $800 fair value of the financing assumed and the $400 cash payment.

The $1,200 debit to assets should be allocated to the specific assets acquired according to their relative fair values. Neither goodwill nor gain should be recognized through the allocation. To illustrate, assume that the inventories have a fair value of $800 and the equipment has a fair value of $200.

a. The total fair value of the assets is $1,000, of which $800 (or 80%) is from the inventories and $200 (or 20%) is from the equipment.

b. The $1,200 debit to assets would be allocated $960 (or 80%) to inventories and $240 (or 20%) to equipment.

FASB ASC 805-50-35-1 states that the basis used for measuring the assets when they were acquired has no effect on the subsequent accounting for them. Therefore, on subsequent measurement dates, the nonprofit organization should consider whether the carrying amounts of the assets exceed their fair values and whether an impairment loss should be recognized.

SELF-STUDY QUIZ

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

1. Pete's Pet Food Bank, a nonprofit organization, has a noncontrolling interest in a for-profit entity that manufactures pet food. Pete's Pet Food Bank uses the equity method to report the noncontrolling interest. Which guidance would be the most applicable for Pete's Pet Food Bank?

    a. FASB ASC 323-10.

    b. FASB ASC 810-10.

    c. FASB ASC 958-320.

    d. FASB ASC 958-325.

2. Which of the following statements is most accurate regarding FASB ASC 958-805?

    a. This guidance describes financially interrelated relationships between nonprofits.

    b. The guidance exempts nonprofit organizations from the VIE subsections of FASB ASC 810-10.

    c. It presents business combination guidance for nonprofits.

    d. This guidance describes how to report a noncontrolling interest using the equity method.

3. Which of the following accounting characteristics is correct for a nonprofit merger?

    a. According to GAAP, all combinations of three or more nonprofits can qualify as a merger.

    b. The carryover method of accounting is used for merger transactions.

    c. A merger is accounted for using the acquisition method of accounting.

    d. The acquired identifiable assets are recognized and measured at fair value as of the acquisition date.

4. Nonprofit A and Nonprofit Z are negotiating a business combination. Which of the following must happen for the transaction to be considered a merger rather than an acquisition?

    a. The resulting organization must have a newly formed governing body.

    b. The resulting organization must be a new legal entity.

    c. Nonprofit A must recognize the assets and liabilities of Nonprofit Z in its financial statements.

    d. Nonprofit A must dictate the terms and timing of the transaction.

5. Which of the below statements is accurate for recognition and measurement of assets and liabilities during a merger?

    a. Mergers are more difficult to recognize in financial statements.

    b. Classifications of assets cannot be changed during a merger.

    c. The carryover method allows "fresh-start" accounting during a merger.

    d. Intra-entity transactions should be eliminated.

6. Which of the following is **not** required by FASB ASC 805-10-05-4 and 958-805-25-13 for the acquisition method?

   a. Establish a newly formed governing body.

   b. Identifying the acquirer.

   c. Establishing the acquisition date.

   d. Determining what is part of the transaction.

7. Which of the following is most accurate regarding accounting guidance after an acquisition?

   a. Measurements made for recording assets and liabilities in a business combination under FASB ASC 805-20 are final.

   b. FASB ASC 805-30-35-1 describes specific subsequent accounting guidance for indemnification assets.

   c. If classified as an asset, contingent consideration should be measured at fair value.

   d. Indemnification assets should always be derecognized during the acquisition.

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. Pete's Pet Food Bank, a nonprofit organization, has a noncontrolling interest in a for-profit entity that manufactures pet food. Pete's Pet Food Bank uses the equity method to report the noncontrolling interest. Which guidance would be the most applicable for Pete's Pet Food Bank? **(Page 271)**

   a. FASB ASC 323-10. [This answer is correct. FASB ASC 323-10, *Investments—Equity Method and Joint Ventures—Overall,* relates to using the equity method to report a noncontrolling interest in a for-profit entity.]

   b. FASB ASC 810-10. [This answer is incorrect. FASB ASC 810-10, *Consolidation—Overall,* is guidance relating to consolidation of a controlling interest in a for-profit entity usually through direct or indirect ownership of a majority interest.]

   c. FASB ASC 958-320. [This answer is incorrect. This guidance relates to reporting a noncontrolling interest in a for-profit when there is a readily determinable fair value for the interest.]

   d. FASB ASC 958-325. [This answer is incorrect. FASB ASC 958-325, *Not-for-Profit Entities—Investments—Other,* is guidance which relates to reporting a non-controlling interest in a for-profit entity at cost or fair value if there is not a readily determinable fair value for the interest.]

2. Which of the following statements is most accurate regarding FASB ASC 958-805? **(Page 271)**

   a. This guidance describes financially interrelated relationships between nonprofits. [This answer is incorrect. The guidance that describes certain relationships between financially interrelated nonprofit organizations is FASB ASC 958-20.]

   b. The guidance exempts nonprofit organizations from the VIE subsections of FASB ASC 810-10. [This answer is incorrect. Nonprofit organizations are specifically exempted from the VIE subsections of FASB ASC 810-10 by FASB ASC 810-15-17.]

   c. It presents business combination guidance for nonprofits. [This answer is correct. FASB ASC 958-805, *Not-for-Profit Entities—Business Combinations,* provides guidance on nonprofit business combinations. A transaction or event that involves combining one or more nonprofit organizations, businesses, or activities should be evaluated to determine whether it is a merger or acquisition according to this guidance.]

   d. This guidance describes how to report a noncontrolling interest using the equity method. [This answer is incorrect. FASB ASC 323-10, *Investments—Equity Method and Joint Ventures—Overall,* is the guidance that relates to using the equity method to report a noncontrolling interest in a for-profit entity.]

3. Which of the following accounting characteristics is correct for a nonprofit merger? **(Page 272)**

   a. According to GAAP, all combinations of three or more nonprofits can qualify as a merger. [This answer is incorrect. GAAP states that only combination transactions that involve two or more nonprofit organizations can potentially qualify as a merger.]

   b. The carryover method of accounting is used for merger transactions. [This answer is correct. Mergers are accounted for using the carryover method of accounting. Under the carryover method, a new organization is created by combining assets, liabilities, and net assets of the merged organizations.]

c. A merger is accounted for using the acquisition method of accounting. [This answer is incorrect. A combination of two or more organizations that is *not* a merger is an acquisition by default and uses the acquisition accounting method. Mergers use a different accounting method.]

d. The acquired identifiable assets are recognized and measured at fair value as of the acquisition date. [This answer is incorrect. Under the acquisition method, the acquirer recognizes and measures at fair value the identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree as of the acquisition date. This is not true for a merger because a different accounting method should be used.]

4. Nonprofit A and Nonprofit Z are negotiating a business combination. Which of the following must happen for the transaction to be considered a merger rather than an acquisition? **(Page 273)**

a. The resulting organization must have a newly formed governing body. [This answer is correct. FASB ASC 958-805-55-1 states that to qualify as a new nonprofit organization and, thus, a merger, the new entity must have a newly formed governing body.]

b. The resulting organization must be a new legal entity. [This answer is incorrect. It is not necessary that the new organization be a new legal entity, but the governing bodies of the combining organization cannot retain shared control of the new organization in a merger.]

c. Nonprofit A must recognize the assets and liabilities of Nonprofit Z in its financial statements. [This answer is incorrect. If Nonprofit A obtains control of Nonprofit Z and recognizes Nonprofit Z's assets and liabilities in its financial statements, the transaction would be considered an acquisition rather than a merger.]

d. Nonprofit A must dictate the terms and timing of the transaction. [This answer is incorrect. In an acquisition, the acquirer often dominates the process, sometimes dictating the terms and timing of the transaction. Generally, in a merger, neither party dominates or is capable of dominating the formation process.]

5. Which of the below statements is accurate for recognition and measurement of assets and liabilities during a merger? **(Page 274)**

a. Mergers are more difficult to recognize in financial statements. [This answer is incorrect. A merger is easier to recognize in financial statements then an acquisition because it does not entail identifying all the assets acquired and liabilities assumed and determining their fair values.]

b. Classifications of assets cannot be changed during a merger. [This answer is incorrect. Generally, the classifications or designations of assets and liabilities should be carried forward from previous financial statements, but FASB ASC 958-805-25-9 allows for exceptions in certain situations.]

c. The carryover method allows "fresh-start" accounting during a merger. [This answer is incorrect. The carryover method does not allow "fresh-start" accounting in which an entity is allowed to elect or reverse accounting methods or options restricted to the initial acquisition or recognition of an item. For example, the merged organization cannot override a fair value option previously adopted by one of the merging entities.]

d. Intra-entity transactions should be eliminated. [This answer is correct. During a merger, the effects of intra-entity transactions should be eliminated as of the merger date.]

6. Which of the following is **not** required by FASB ASC 805-10-05-4 and 958-805-25-13 for the acquisition method? **(Page 273)**

a. Establish a newly formed governing body. [This answer is correct. Establishing a new governing body is a requirement for a merger, not an acquisition. Therefore, it would not be required for the acquisition method of accounting.]

b. Identifying the acquirer. [This answer is incorrect. Under the acquisition method, one of the combining organizations should be identified as the acquirer. The acquirer is the entity that obtains control of the acquiree. This is one of the requirements of using the acquisition method of accounting.]

c. Establishing the acquisition date. [This answer is incorrect. Determining the acquisition date is one of the requirements of this method. It is the date on which the acquirer obtains control of the acquiree.]

d. Determining what is part of the transaction. [This answer is incorrect. Determining what is part of the acquisition transaction is required for the acquisition method. Transactions that are separate from the acquisition should not be accounted for as part of the acquisition and, therefore, the acquirer should identify any items that are not part of the exchange for the acquiree.]

7. Which of the following is most accurate regarding accounting guidance after an acquisition? **(Page 283)**

a. Measurements made for recording assets and liabilities in a business combination under FASB ASC 805-20 are final. [This answer is incorrect. The fair value measurements under FASB ASC 805-20 and 958-805 are only the initial amounts recorded for assets, liabilities, and noncontrolling financial interest in a business combination. Going forward, those carrying amounts are generally subject to other measurement guidance within GAAP.]

b. FASB ASC 805-30-35-1 describes specific subsequent accounting guidance for indemnification assets. [This answer is incorrect. FASB ASC 805-30-35-1 and 35-1A describe specific guidance for subsequent accounting on contingent consideration, including contingent consideration arrangement assumed by the acquirer.]

c. If classified as an asset, contingent consideration should be measured at fair value. [This answer is correct. As described at FASB ASC 805-30-35-1, contingent consideration classified as an asset or liability should be measured at fair value at each reporting date until resolved. The changes in fair value are recognized in the statement of activities.]

d. Indemnification assets should always be derecognized during the acquisition. [This answer is incorrect. An indemnification asset should be subsequently measured on the same basis as the indemnified asset or liability. Such assets should only be derecognized when the acquirer collects, sells, or loses the right to them.]

ASSESSING WHEN TO INCLUDE THE FINANCIAL RESULTS OF ANOTHER ENTITY IN THE FINANCIAL STATEMENTS

This section looks at the aspects of *financial interest*, *economic interest*, and *control* in relationships between a nonprofit organization and another entity. A nonprofit organization generally should present consolidated financial statements as its primary financial statements when it has a controlling financial interest in either a for-profit or nonprofit entity, or it has both an economic interest in and control over another nonprofit organization. The section also discusses the guidance that applies when an organization has an interest in another entity and consolidated financial statements are not required.

Distinguishing Interests in Related Entities from Investments

The appropriate accounting and reporting for ownership interests in other entities depends, in part, upon the purpose for which the interest is held. If the objective is to work with the other entity to (a) provide goods or services that accomplish the purpose or mission for which the nonprofit owner organization exists or (b) serve the nonprofit owner organization's administrative purposes, this lesson provides guidance.

It is assumed that the guidance in this course will apply to all interests in other nonprofit organizations because those interests typically cannot provide current income, capital appreciation, or both to an entity that "invests" in it.

Distinguishing Interests in For-profit Entities from Interests in Nonprofit Organizations

The guidance used to report an interest in another entity depends upon an assessment of whether the other entity is a for-profit entity or a nonprofit organization. A nonprofit organization that has an interest in another entity should use the definition of a nonprofit organization from the FASB ASC glossary to determine whether that other entity is also a nonprofit organization. The Audit Guide, Paragraph 3.60, points out that an entity that has a nonprofit corporation or a nonprofit membership corporation structure often will meet the definition of a nonprofit organization.

Paragraph 3.60 of the Audit Guide also states that an entity with a noncorporate structure (such as a partnership, limited liability partnership, or similar entity) often will not meet the definition of a nonprofit organization either (a) because of the existence of ownership interests, (b) because the entity provides lower costs or other economic benefits directly and proportionally to its owners, members, or participants, or (c) both.

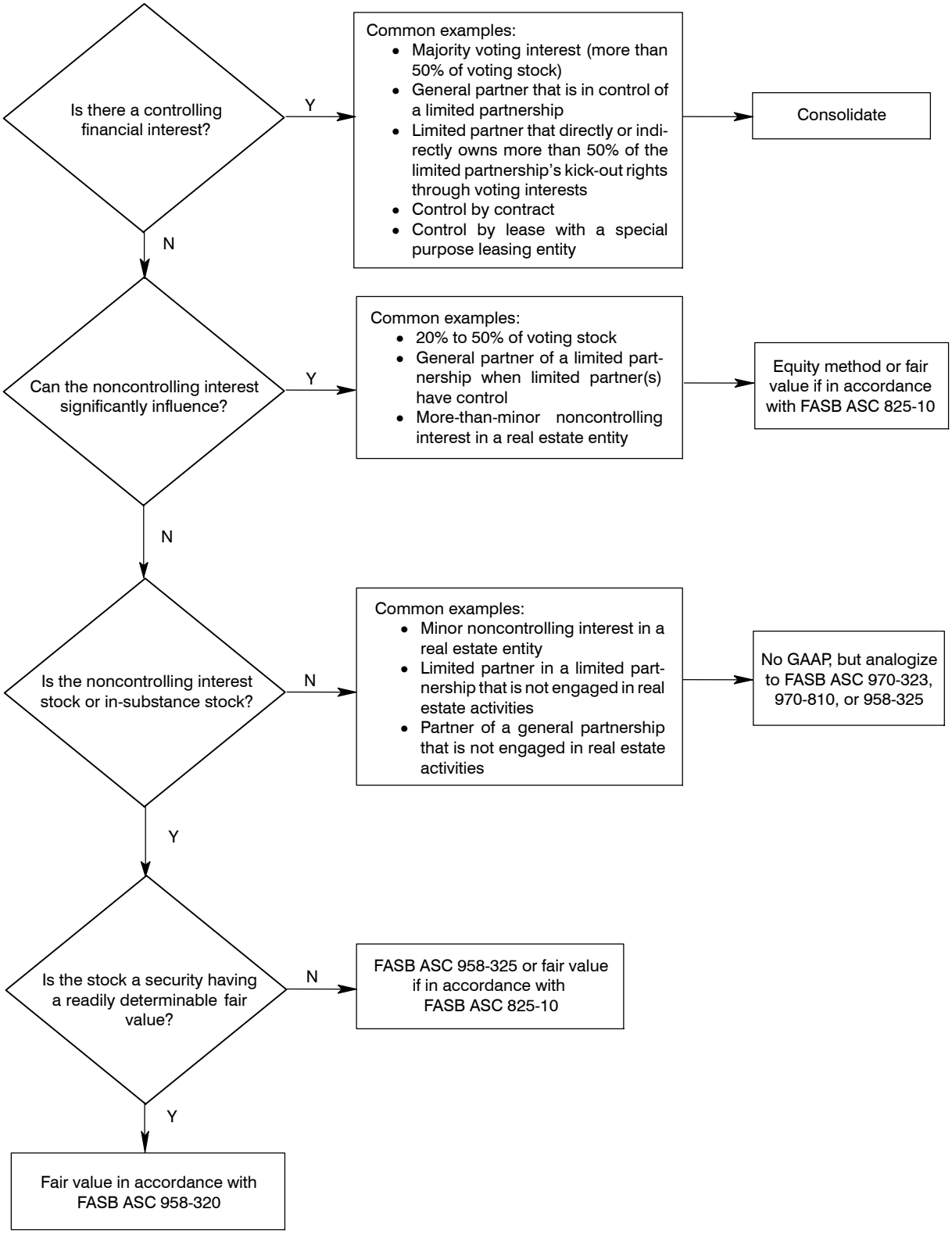
The discussion below provides further guidance if the other entity is a for-profit entity. The discussion later in this course provides further guidance if the other entity is a nonprofit organization.

Ownership Interests in For-profit Entities

How a nonprofit organization reports its ownership interest in a for-profit entity depends primarily on the amount of control the nonprofit organization has over the for-profit entity's operating and financial policies, as shown in Exhibit 1-1. The highest level of control is referred to as a *controlling financial interest*. A nonprofit organization with a controlling financial interest is generally required to consolidate the for-profit entity. The ability to significantly influence the operating and financial policies of the for-profit entity, without the ability to control it, requires the use of the equity method of accounting. If the nonprofit organization is unable to significantly influence the operating and financial policies of the for-profit entity, the ownership interest is reported as an investment.

Exhibit 1-1

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



Notes:

[a] This flowchart only summarizes the guidance for reporting interests in for-profit entities by nonprofit organizations in accordance with FASB ASC 958-810-15-4 and Chapter 3 of the Audit Guide. Exhibit 1-2 presents the most common types of interests in for-profit entities, cites the authoritative guidance, and references the applicable discussion within this course.

[b] In February 2015, the FASB issued ASU 2015-02, *Consolidation (Topic 810): Amendments to the Consolidation Analysis*, and in January 2017, the FASB issued 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*. Together, the ASUs improve the guidance for consolidating certain legal entities—primarily limited partnerships and similar legal entities. ASU 2015-02 and ASU 2017-02 are both effective for fiscal years beginning after December 15, 2016.

* * *

The following paragraphs discuss how the appropriate reporting method is determined. Exhibit 1-2 helps to locate discussion of the accounting treatment for nonprofit organization ownership interests in for-profit entities within the authoritative standards.

Exhibit 1-2

Relationships with For-profit Entities

Type of For-profit Entity	Able to use Fair Value Option[a] for Financial Instruments?	GAAP if the Fair Value Option does not apply
Corporation. The organization owns a majority of the investee's outstanding common voting stock.	No	FASB ASC 810-10
Corporation. The organization owns 50% or less of the common voting stock and can exercise significant influence over the investee's operations and financial policies.	Yes	FASB ASC 323-10
Corporation. The organization owns 50% or less, does not control, and cannot exercise significant influence. Stock is a security that has a readily determinable fair value.	Not applicable	FASB ASC 958-320
Corporation. The organization owns 50% or less, does not control, and cannot exercise significant influence. Stock does not have readily determinable fair value.	Yes	FASB ASC 958-325-35
General partnership. The organization is a partner in a partnership engaged in real estate activities.	Yes	FASB ASC 958-810-15-4 dd
General partnership. The organization is a partner in a partnership engaged in activities other than real estate activities.	Yes	Generally analogize to FASB ASC 970-810
Limited partnership or similar entity. The organization is a general partner of a limited partnership or similar entity.[b]	Yes, but only if not required to consolidate	FASB ASC 958-810-25

Type of For-profit Entity	Able to use Fair Value Option[a] for Financial Instruments?	GAAP if the Fair Value Option does not apply
Limited partnership or similar entity. The organization is a limited partner that holds more than 50% of the kickout rights via voting interests.	Yes, but only if not required to consolidate	Use FASB ASC 958-810-25 to determine if required to consolidate. If not required to consolidate, generally analogize to FASB ASC 970-323.
Limited partnership or similar entity. The organization is a limited partner of a limited partnership or similar entity engaged in real estate activities. Interest is more than minor but limited partner does not hold more than 50% of the kick-out rights via voting interests.[b]	Yes	FASB ASC 970-323 and FASB ASC 958-810-15-4(d)
Limited partnership. The organization is a limited partner of a limited partnership or similar entity engaged in real estate activities.[b] Interest is minor and limited partner does not hold more than 50% of the kick-out rights via voting interests.	Yes	FASB ASC 958-325-35
Limited partnership. The organization is a limited partner of a limited partnership or similar entity engaged in real estate activities. Interest is more than 50% but limited partner does not hold more than 50% of the kick-out rights via voting interests.	Yes, but only if not required to consolidate	Generally analogize to FASB ASC 970-323 and FASB ASC 970-810
Limited partnership. The organization is a limited partner of a limited partnership or similar entity engaged in activities other than real estate activities. Interest is more than 50% of the kick-out rights, held through voting interests.	Yes	Generally analogize to FASB ASC 970-323
Lease with a special-purpose leasing entity.	No	FASB ASC 958-810
Contractual management relationship with another entity.	No	FASB ASC 810-10

Notes:

[a] Refers to the fair value option subsections of FASB ASC 825-10.

[b] The applicable guidance is found in FASB ASC 810-20 for periods before the amendments in ASU 2015-02 and ASU 2017-02 are effective.

* * *

Controlling Financial Interest. The basic criterion for determining if a for-profit entity should be consolidated into a nonprofit organization's financial statements is whether the organization directly or indirectly owns a controlling financial interest in the for-profit entity.

Corporation. A controlling financial interest is most clearly evidenced by ownership of a majority voting interest. Therefore, as a general rule, if the nonprofit organization owns, directly or indirectly, more than 50% of the outstanding voting shares of the for-profit entity, the nonprofit organization should consolidate the for-profit entity. However, the power to control also may exist with a lesser percentage of ownership; for example, by contract, lease, agreement with other shareholders, or by court decree.

In some circumstances, control does not rest with the majority owner. A majority-owned subsidiary should not be consolidated if control does not rest with the majority owner. For example, the majority owner does not have control when the subsidiary is in legal reorganization or bankruptcy, or if it operates under foreign exchange restrictions, controls, or other governmental imposed uncertainties so severe they cast significant doubt on the parent's ability to control the subsidiary.

The majority owner also does not have control if the noncontrolling shareholders have certain approval or veto rights that restrict the majority shareholder's powers to control the investee's operations or assets. FASB ASC 810-10-25-10 states the assessment of whether the rights of a noncontrolling shareholder (or shareholders) should overcome the presumption of consolidation by the majority shareholder is a matter of judgment that depends on the facts and circumstances. The primary consideration is whether the noncontrolling rights, individually or in the aggregate, give the noncontrolling shareholder(s) the ability to effectively participate in making significant decisions that would be expected to be made in the ordinary course of business.

FASB ASC 810-10-25-5 describes effective participation as the ability to block significant decisions proposed by the investor with the majority voting interest. If the nonprofit organization that is the majority shareholder cannot cause the for-profit entity to take a significant action in the ordinary course of business because that action can be vetoed by the noncontrolling shareholder(s), the nonprofit organization does not have a controlling financial interest. Another way of saying this is that if the majority shareholder must have the agreement of the noncontrolling shareholder(s) to take actions on matters normally expected to be addressed in directing and carrying out the entity's business, the noncontrolling shareholder(s)' ability to block those actions means that the majority shareholder should not consolidate the entity. FASB ASC 810-10-25-9 through 25-13 provides examples of the types of rights and factors to consider when evaluating whether noncontrolling shareholders can prevent the majority shareholder from having a controlling financial interest.

The assessment of whether the rights of noncontrolling shareholders prevent the nonprofit organization from having control should be made at the time the organization obtains the majority voting interest. Also, the nonprofit organization's control of the for-profit entity should be reassessed if there is a significant change to the noncontrolling shareholders' rights or to the use of those rights.

General Partner in a Limited Partnership or Similar Entity. A limited partnership has two types of partners. General partners are similar to the partners of a general partnership. They have management control, rights to use partnership property and share in profits in predefined proportions, and joint and several liability for the debts of the partnership. 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. Therefore, the general partner of a limited partnership generally should consolidate the limited partnership. If the limited partnership has multiple general partners an analysis of relevant facts and circumstances is used to determine which general partner, if any, within the group controls and should consolidate the limited partnership. If certain general partners are entities under common control, they should be considered a single general partner for purposes of determining control.

If the limited partners possess one or both of the following rights, the presumption that the general partner controls, and should consolidate, the limited partnership is overcome:

a. The substantive ability to liquidate the limited partnership or remove the general partners without cause (also known as kick-out rights).

b. Substantive participating rights.

FASB ASC 958-810-25 provides guidance to evaluate the existence of such rights. The organization uses the guidance in FASB ASC 958-810-25-19 and 25-20 to determine if there are kick-out rights. *Kick-out rights* are rights that may underlie the limited partners' ability to liquidate the limited partnership or otherwise remove the general partners without cause. Substantive kick-out rights must have both of the following two characteristics:

- They can be exercised by a single limited partner or a vote of a simple majority (or a lower percentage) of the limited partners' voting interests held by parties other than the general partner(s), entities under common control with the general partner(s), and other parties acting on behalf of the general partner(s). A kick-out right that requires a vote in excess of a simple majority may still be substantive in certain circumstances.

- There are no significant barriers to the exercise of their kick-out rights by the limited partners if they choose to do so.

Participating rights are rights that allow the limited partners of the limited partnership to block or participate in certain significant financial and operating decisions that are made in the ordinary course of business. Participating rights do not require the limited partners to have the ability to initiate actions. Substantive participating rights include, but are not limited to—

- The right to select, terminate, and set the compensation of management that is responsible for implementing the limited partnership's policies and procedures.

- In the ordinary course of business, the right to establish operating and capital decisions of the limited partnership (including budgets).

FASB ASC 958-810-25-27 provides guidance about factors to consider when determining whether the participating rights held by limited partners are substantive participating rights.

Participating rights are different from protective rights. *Protective rights* do not allow the limited partners, in the ordinary course of business, to participate in significant financial and operating decisions. Instead, the rights allow the limited partners to protect their investments by blocking certain transactions or events that occur outside of the normal course of business. Allowing limited partners to block amendments to the limited partnership agreement, the issuance or repurchase of limited partnership interests, or the liquidation of the limited partnership initiated by the general partners are examples of protective rights.

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

For fiscal years beginning before December 15, 2016, FASB ASC 810-20 provides the guidance for general partners of limited partnerships. That guidance also has the presumption of control of a limited partnership by a nonprofit organization that is the general partner and similar guidance for assessing whether if the rights of the limited partners overcome the presumption of control by the general partner.

Limited Partner of a Limited Partnership or Similar Entity. For fiscal years beginning after December 15, 2016, 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,* provides guidance for assessing whether a limited partner owns a controlling financial interest. A limited partner can only have a controlling financial interest if the rights of the limited partners overcome the presumption of control by the general partner.

In general, if a nonprofit organization that is a limited partner directly or indirectly owns more than 50% of a limited partnership's kick-out rights through voting interests, that limited partner has a controlling financial interest in the limited partnership and must consolidate the limited partnership unless it has an accounting policy of reporting other investments at fair value. If the organization has adopted that accounting policy, the guidance in FASB ASC 958-325-35 is applied rather than the general requirement to consolidate. The limited partner cannot elect the fair value option in FASB ASC 825-10 if it is required to consolidate.

However, if other limited partners (referred to as the noncontrolling limited partners) have substantive participating rights, the limited partner that owns a majority of the kick-out rights through voting interests does not have a controlling financial interest.

A nonprofit organization's control of a limited partnership is assessed when it first becomes a partner and then reassessed each time financial statements are prepared.

Special transition guidance applies when entities are required to be consolidated or deconsolidated upon the initial application of ASU 2015-02. That guidance is provided at FASB ASC 810-10-65-7. Additionally, there is special transition guidance in FASB ASC 958-810-65-2 if a nonprofit organization has already adopted the amendments in ASU 2015-02, *Consolidation (Topic 810): Amendments to the Consolidation Analysis,* when ASU 2017-02 becomes effective.

Control by Contract. According to FASB ASC 810-10-15-19, an entity may control another entity by establishing a contractual management arrangement. Accordingly, a nonprofit organization can control a for-profit entity by contract if the contract meets the requirements in FASB ASC 810-10-15-22 as follows:

- The contract is for a term that is either the entire remaining legal life of the for-profit entity or for a period of 10 years or more.
- The contract cannot be terminated by the for-profit entity except in the case of gross negligence, fraud, or other illegal acts by nonprofit organization, or bankruptcy of the nonprofit organization.
- The nonprofit organization has exclusive authority over all decision making related to the ongoing, major, or central operations of the for-profit entity. This must include exclusive decision-making authority over the scope and pricing of services, negotiation and execution of contracts, establishment and approval of operating and capital budgets, and issuance of debt (if debt financing is an ongoing, major, or central source of financing).
- The nonprofit organization has the ability to establish and implement guidelines for the selection, hiring, firing, and compensation of key employees.
- The nonprofit organization has a financial interest in the for-profit entity that (a) can be sold or transferred, and (b) gives it the right to receive income (both as ongoing fees and as proceeds from the sale of its interest in the for-profit entity) in an amount that fluctuates based on the performance of the operations of the for-profit entity and the change in the fair value thereof.

The information necessary to evaluate the above terms and conditions may or may not be documented in the contractual agreements that underlie the relationship between the nonprofit organization and the for-profit entity. If the information is documented in those agreements, then that documentation should be used to evaluate whether the requirements are met regardless of whether the respective parties are currently behaving in accordance with the documented provisions. If some of the information is not documented, then facts and circumstances of the relationship should be evaluated to determine whether the requirements are met. FASB ASC 810-10-25-63 through 25-79 provide further guidance on *term*, *control*, and *financial interest*.

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

a. Substantially all of the activities of the SPE involve assets leased solely to the organization.

b. The expected substantive residual risks and substantially all of the residual rewards of the leased assets and underlying debt reside with the organization through the lease agreement; a residual value guarantee; a guarantee of the SPE's debt; or an option that allows the organization 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.)

FASB ASC 958-810-25-10 states that if the SPE was created for both the construction and subsequent lease of an asset, and the conditions described above 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. FASB ASC 958-840 provides incremental guidance for nonprofit organizations with leases involving SPE lessors.

Significant Influence. If the nonprofit organization does not control the for-profit entity (and thus is not required to consolidate it), the next level of ownership to consider is whether it has the ability to exercise significant influence over the operating and financial policies of the for-profit entity. If the nonprofit organization has that ability, it is generally required to use the equity method to account for its interest in the for-profit entity. Alternatively, when it acquires its ownership interest in the for-profit entity, the organization can elect to report that interest at fair value under the fair value option.

FASB ASC 323-10-15-6 states that the ability to exercise significant influence over operating and financial policies of another entity may be indicated in several ways, including the following:

- Representation on the board of directors.
- Participation in policy-making processes.
- Significant intra-entity transactions.
- Sharing of managerial personnel.
- Technological dependency.
- Extent of ownership by the nonprofit organization in relation to the concentration of other shareholdings. However, substantial or majority ownership of the voting stock by another investor does not necessarily preclude the nonprofit organization's ability to exercise significant influence.

There is a presumption that an investor owning 20% or more of the voting stock of an investee can exercise significant influence over the entity. GAAP notes that determination of whether there is significant influence requires an evaluation of all facts and circumstances. FASB ASC 323-10-15-10 states the following circumstances may indicate that an organization does not have significant influence, even if it owns 20% or more of a for-profit entity's voting stock:

- The entity files a lawsuit or complaint against the organization.
- The organization and entity execute an agreement restricting the organization's rights as a shareholder.
- Majority ownership of the entity is concentrated among a small group of shareholders who operate the entity without regard to the views of the organization.
- The organization seeks more financial information than is available to the entity's other shareholders and is unable to obtain that information.
- The organization tries and fails to obtain representation on the entity's board of directors.

Situations such as those described above are not conclusive indications of a lack of significant influence. All of the attendant facts and circumstances must be evaluated.

Corporation. There is a presumption, according to FASB ASC 323, that the holder (investor) of 20% to 50% of the voting stock of a corporation has the ability to exercise significant influence over that corporation; accordingly, absent *predominant evidence to the contrary*, it should account for the investment using the equity method.

Holding 20% or more of voting stock does not create an absolute requirement to use the equity method for an investment. The 20% benchmark is usually a reasonable presumption for significant influence over a public company. However, ownership of considerably more than 20% of a nonpublic company may be necessary, as a practical matter, to exercise significant influence.

When determining whether the nonprofit organization's holdings are sufficient for it to have the ability to exercise significant influence over the for-profit entity (including a corporate joint venture), the nonprofit organization should consider not only its holdings of common stock but also holdings of in-substance common stock. An interest in an entity is considered to be in-substance common stock if all of the following characteristics are substantially similar to an interest in the entity's common stock:

- Subordination features. If an investment has a substantive liquidation preference over the entity's common stock, the investment is not substantially similar to common stock.

- Risks and rewards of ownership. If an investment is not expected to participate in earnings, losses, and appreciation and depreciation in value in a manner that is substantially similar to common stock, the investment is not substantially similar to common stock.

- Obligation to transfer value. If the investee is expected to transfer substantive value to the investor (such as a mandatory redemption provision) and the common shareholders do not participate in a similar manner, the investment is not substantially similar to common stock.

If any of these characteristics indicate that the investment is not substantially similar to common stock, the interest is not considered in-substance common stock and would be excluded from the evaluation for using the equity method. If a determination about whether the interest is substantially similar to common stock cannot be reached using only the preceding criteria, the organization should determine if future changes in the interest's fair value are expected to be very correlated with changes in the common stock's fair value. If a high correlation is not expected, the interest is not considered to be in-substance common stock.

General Partner in a Limited Partnership or Similar Entity. If the nonprofit organization is the general partner of a limited partnership or similar entity, the nonprofit organization often is required to consolidate the limited partnership. However, if the limited partners have substantive kick-out rights or substantive participating rights, or if a limited partner(s) owns a controlling financial interest, the organization that is the general partner reports its noncontrolling interest in the limited partnership as follows:

- At fair value if it elected to do so at the time the organization acquired the partnership interest.

- If the organization did not make that election, the organization reports the partnership interest using the equity method in accordance with FASB ASC 958-810-25-15.

- If the limited partnership is engaged in real estate activities, the organization applies the guidance discussed below.

More-than-minor Interest in a Real Estate Entity. This course refers to interests in for-profit real estate partnerships (whether general or limited), for-profit real estate LLCs, real estate joint ventures, and similar for-profit real estate entities as *interests in real estate entities*. The guidance for real estate entities is organized in terms of controlling interests, noncontrolling interests that are more than minor, and minor interests. The following paragraphs discuss noncontrolling interests that are more than minor. FASB ASC 958-810-15-4(d) states that a nonprofit organization with a more than minor interest in a for-profit real estate entity should report its interest in the real estate entity as follows if the interest is a noncontrolling interest:

- At fair value if it elected to do so at the time the organization acquired its interest in the real estate entity.

- Using the equity method in accordance with the guidance in FASB ASC 970-323, if the organization did not make a fair value election.

Paragraph 3.93 of the Audit Guide suggests that even though a nonprofit organization is not a registrant, it might analogize to the Securities and Exchange Commission (SEC) guidance in FASB ASC 323-30-S99-1, which states that practice generally has viewed investments of more than 3% to 5% to be more than minor.

To determine whether the nonprofit organization's interest in the real estate entity is a noncontrolling interest, the organization applies the following guidance to determine if its interest is controlling, and if it is not, the organization's interest is noncontrolling:

- If the for-profit real estate entity is a general partnership, the organization's interest is controlling if it (a) owns over 50% of the partnership voting interests, (b) owns over 50% of the financial interests in profits, or losses, or (c) controls by contract, lease, or an agreement with the other partners. However, if the other partners have substantive participating rights, the organization may not control the real estate entity.

- If the for-profit real estate entity is a limited partnership or a similar legal entity and the organization is the general partner, the organization's interest is controlling if the presumption of control is not overcome by the limited partners' rights.

- If the for-profit real estate entity is a limited partnership or a similar legal entity and the organization is a limited partner, the organization's interest is controlling if it controls through voting interests more than 50% of the limited partnership's kick-out rights, and the other limited partners do not have substantive participating rights.

- If the for-profit real estate entity is a limited liability company that maintains a specific ownership account for each investor (similar to a partnership capital account structure), apply the guidance for a for-profit real estate entity that is a limited partnership to determine whether the interest is controlling (FASB ASC 323-30-35-3).

- If the for-profit real estate entity is a limited liability company that is similar to a corporation (that is, it does not maintain a specific ownership account for each investor), the organization's interest is controlling if it owns more than 50% of the outstanding voting shares or controls by contract (FASB ASC 810-10-25-2 through 25-14 and FASB ASC 323-10).

Other Relationships with For-profit Entities

If a nonprofit organization's ownership interest in a for-profit entity is not sufficient to give it a controlling financial interest or significant influence in the operating and financial policies, the accounting depends on the form of the financial interest. If the organization's noncontrolling interest in the for-profit entity is in the form of stock or in-substance stock the following guidance applies:

- If the stock is in the form of a security that has a readily determinable fair value, the organization reports its interest in the for-profit entity at fair value in accordance with FASB ASC 958-320.

- If the stock does not have a readily determinable fair value or is in-substance stock, the organization uses the guidance for other investments in FASB ASC 958-325.

If the organization's noncontrolling interest is not in the form of stock or in-substance stock, and the organization is not required to consolidate or use the equity method, GAAP often does not have specific guidance for reporting the interest in the other entity. In many cases, an organization may analogize to guidance that applies to other entities.

General Partnerships. A general partnership is one in which partners share, often equally in both responsibility and liability (as contrasted to a limited partnership, in which limited partners have limited liability). Usually, the objective is to work with the other partner(s) either to (a) provide goods or services that accomplish the purpose or mission for which the nonprofit organization exists or (b) serve the nonprofit organization's administrative purposes and the guidance discussed in the following paragraphs applies. In the less likely case that the nonprofit organization became a partner in a general partnership for investment reasons (that is, to realize current income, capital appreciation, or both), it should use the guidance in *PPC's Guide to Preparing Nonprofit Financial Statements.*

If the nonprofit organization becomes a partner to serve the purpose or mission for which the organization exists or the organization's administrative purposes, the interest in the partnership is reported as follows:

- At fair value if the nonprofit organization elected to report the partnership interest at fair value at the time the organization became a partner.

- If the organization did not make that election and the partnership is engaged in activities other than real estate activities, Paragraph 3.98 of the Audit Guide states that organizations typically analogize to the guidance in FASB ASC 970-810. A general partnership that is directly or indirectly controlled by an organization is, in substance, a subsidiary of the organization, and the controlling investor should account for its investment under the principles of accounting applicable to investments in subsidiaries. For example, inter- entity profits and losses on assets remaining within the group should be eliminated. If control of the for-profit entity is divided equally among the partners, the nonprofit organization's interest will be a noncontrolling interest and it will report the partnership interest using the equity method. However, if control of the general partnership rests with the nonprofit organization, it will consolidate the general partnership.

- If the partnership is engaged in real estate activities, the organization applies the guidance discussed below.

If analogizing to FASB ASC 970-810-25-1, a nonprofit organization controls, and would consolidate a general partnership if the nonprofit organization:

- Directly or indirectly owns over 50% of the partnership voting interests;

- Directly or indirectly owns over 50% of the financial interests in profits, or losses; or

- Controls by contract, lease, or an agreement with the other partners.

However, FASB ASC 970-810-25-2 explains that an organization meeting one of those criteria may not control the general partnership if one or more of the other partners have rights that permit those other partners to effectively participate in certain significant financial and operating decisions that are made in the ordinary course of business (referred to as substantive participating rights). The determination of whether the rights of the other partners are substantive participating rights should be evaluated in accordance with the guidance for substantive participating rights in FASB ASC 958-810-25-21 through 25-29. If the other partners have substantive participating rights, the presumption of control is overcome.

Real Estate Entities. The guidance for real estate entities is organized in terms of controlling interests, noncontrolling interests that are more than minor, and minor interests. Noncontrolling interests that are more than minor were discussed previously. The following paragraphs discuss controlling interests and minor interests.

A nonprofit organization applies the guidance discussed earlier to determine whether its real estate interest is a controlling interest. If the interest in the real estate entity is a controlling interest, the appropriate accounting depends upon the type of legal entity used to conduct the real estate activities, as follows:

- If the for-profit real estate entity is a general partnership, the Audit Guide, in Paragraph 3.98, states that the organization might consolidate by analogy to the guidance in FASB ASC 970-810, but it is not required to do so.

- If the for-profit real estate entity is a limited partnership, the organization is required to consolidate by FASB ASC 958-810-25-13 (general partners) or FASB ASC 958-810-25-16 (controlling limited partner).

- If the for-profit real estate entity is a limited liability corporation that maintains a specific ownership account for each investor (similar to a partnership capital account structure), the organization is required to consolidate by FASB ASC 958-810-25-13 (managing member) or FASB ASC 958-810-25-16 (nonmanaging member).

- If the for-profit real estate entity is a limited liability corporation that is similar to a corporation (that is, it has governing provisions that are the functional equivalent of a regular corporation), the organization is required to consolidate by FASB ASC 810-10-25-1.

If the organization's interest is so minor that, as a limited partner, it has virtually no influence over partnership operating and financial policies, the organization is, in substance, in the same position with respect to the investment as an investor that owns a minor common stock interest in a corporation. Accordingly, accounting for the

investment using the guidance in FASB ASC 958-325 may be appropriate unless the organization elected to report that interest at fair value at the time it acquired its interest.

Limited Partner in a Limited Partnership or Similar Entity. The limited partners in a limited partnership usually have no management authority and are only liable on debts incurred by the partnership to the extent of their investment. The limited partners receive a return on their investment, the nature and extent of which is usually defined in the partnership agreement.

However, if a general partner of a limited partnership or similar entity does not have a controlling financial interest, one of the limited partners may be in control. An organization that is a limited partner applies the guidance discussed earlier to determine whether it has a controlling financial interest and must consolidate the limited partnership or similar entity. (FASB ASC 958-810-25-11 states that a similar legal entity is an entity, such as a limited liability company (LLC), that has governing provisions that are the functional equivalent of a limited partnership. In those entities, a managing member is the functional equivalent of a general partner, and a nonmanaging member is the functional equivalent of a limited partner. An LLC that maintains a specific ownership account for each investor, similar to a partnership capital account structure, typically is the functional equivalent of a limited partnership. Throughout these paragraphs, any reference to a limited partnership includes limited partnerships and similar legal entities.)

If the nonprofit organization is a limited partner of a limited partnership and does not hold a controlling financial interest, the interest in the limited partnership is reported as follows:

- At fair value if it elected to do so at the time the organization acquired the limited partnership interest.
- If the organization did not make that election, Paragraph 3.86 of the Audit Guide states that organizations typically analogize to the guidance in FASB ASC 970-323 and report the partnership interest using the equity method.
- If the limited partnership is engaged in real estate activities, the organization applies the guidance discussed earlier in this lesson.

Limited Liability Companies. For purposes of determining the appropriate accounting, FASB ASC 958-810-25-11 states that any reference to a limited partnership in the guidance discussing the potential consolidation of such entities includes limited partnerships and *similar legal entities* that have governing provisions that are the functional equivalent of a limited partnership. An LLC that has a managing member that is the functional equivalent of a general partner and nonmanaging members that are the functional equivalent of limited partners is given as an example of a legal entity that is similar to a limited partnership. This course recommends an investment in an LLC should be viewed as similar to an investment in a limited partnership if the LLC maintains a specific ownership account for each investor—similar to a partnership capital account structure. Otherwise, an investment in an LLC should be accounted for as a corporation.

Programmatic Investments. As discussed in the nonauthoritative guidance in Paragraph 8.04 of the Audit Guide, a *programmatic investment* is an investment that meets both of the following criteria:

a. Its primary purpose is to further the charitable objectives of the organization.

b. The production of income or the appreciation of the asset is not a significant purpose (that is, an investor seeking a market return would not enter into the investment).

By definition, programmatic investments that are equity instruments are interests in entities that serve the purpose or mission for which the nonprofit organization exists or the organization's administrative purposes. Thus, when determining whether to consolidate, use the equity method, or other accounting, the nonprofit organization follows the guidance in this section. Programmatic equity interests typically are in for-profit entities and, therefore, generally would not have a contribution element at origination.

In some cases, the agreement for the equity interest will contain additional rights or privileges, such as the organization's right to obtain future services from the for-profit entity at reduced rates. In those cases, those

additional rights and privileges should be accounted for in accordance with relevant GAAP and the consideration specified in the agreement is allocated between the equity interest and those additional rights and privileges.

Because programmatic equity investments are often made to newly created entities or entities in economic distress, the investee may experience losses rather than net income. If the investment is accounted for using the equity method, the share of losses of an investee equals or exceeds the carrying amount of a programmatic investment; that is, the losses have reduced the carrying amount of the equity-method investment to zero. FASB ASC 323-10-35-19 through 35-30 provide guidance in those circumstances. The nonprofit organization ordinarily should discontinue applying the equity method if the investment (and net advances) is reduced to zero; however, if the investee will return to profitable operations imminently, the nonprofit investor should recognize the additional losses. If the investee subsequently reports net income (or an increase in net assets), the nonprofit organization should resume applying the equity method only after its share of that net income (or increase in net assets) equals the share of net losses not recognized while the equity method was suspended.

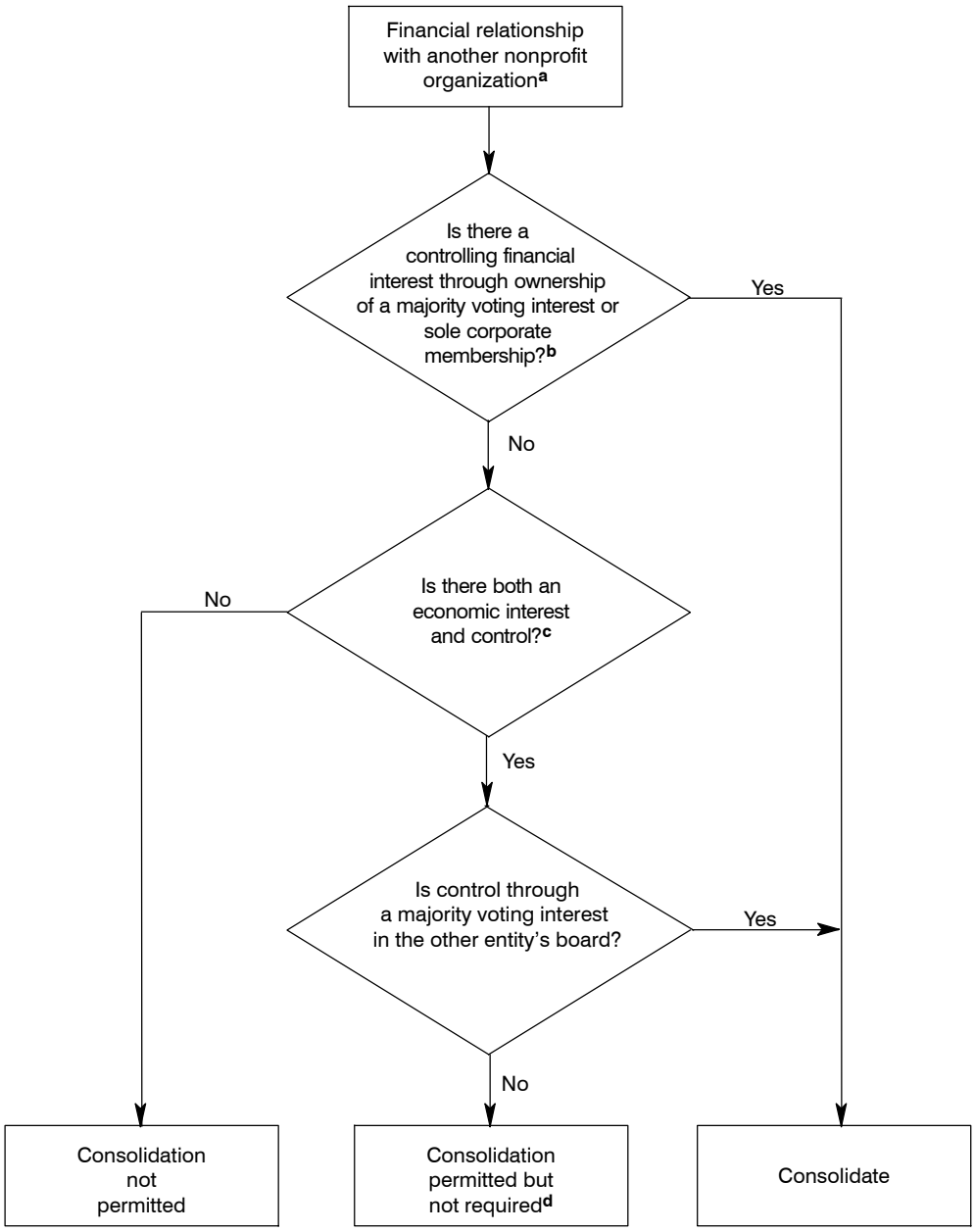
Timely identification of impairment is a consideration for any interest that is reported using the equity method. Impairment of equity method investments is discussed later in this course.

Economically Related Nonprofit Organizations

A nonprofit organization may be required to consolidate a related but separate nonprofit organization, depending on the nature of the relationship. Ownership of a nonprofit organization may occur in different ways due to the various legal forms that nonprofit organizations may take. For example, nonprofit organizations can be organized as corporations that issue stock or ownership certificates, membership corporations issuing membership certificates, joint ventures, or partnerships. The ownership interest can either be direct or indirect (e.g., if an existing subsidiary organization owns all or part of the controlling interest). In determining how to report a financial relationship with another nonprofit organization, an organization should evaluate whether it has a controlling financial interest or an economic interest and control. Exhibit 1-3 presents a flowchart that summarizes the reporting guidance when a nonprofit organization has a financial relationship with another nonprofit organization.

Exhibit 1-3

Accounting for Financial Relationships with Other Nonprofit Organizations



Notes:

[a] If the organization has a lease with a special purpose entity (SPE), it should consolidate the SPE if the conditions described previously exist.

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

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

[d] If consolidated financial statements are not presented, the disclosures described below should be made.

* * *

Controlling Financial Interest. Generally, a nonprofit organization must consolidate a nonprofit entity in which it has either a direct or indirect *controlling financial interest*. Ownership of a majority voting interest (i.e., ownership of more than 50% of the outstanding voting shares of the other organization) is the usual condition for a controlling financial interest. A sole corporate membership is also a controlling financial interest. 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 organization is in legal reorganization or bankruptcy).

FASB ASC 958-810-25-2A notes that the existence of requirements that a supermajority of the board of directors vote 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.

Control and Economic Interest. Even if a reporting nonprofit organization does not have a *controlling financial interest*, it must still consolidate the related nonprofit organization if the reporting organization—

- controls the related nonprofit organization through a majority voting interest in the board of the related organization by means other than ownership or sole corporate membership, *and*

- has an economic interest in the related organization.

GAAP prohibits consolidation, however, if control does not rest with the holder of the majority voting interest.

As indicated in FASB ASC 958-810-25-3, 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 voting interest in the related organization's board, without the ability to require that the majority of the members of a fully constituted board be appointed by the organization, does not meet the criteria of control.

A nonprofit organization may exercise control over a related but separate nonprofit organization other than by a majority voting interest or sole corporate membership by various means including, but not limited to, the following:

- *Ownership.* The related organization has more than one class of stock, resulting in a majority ownership interest but not a majority *voting* interest.

- *Charter or Bylaws.* The charter (articles of incorporation) limits or bylaws limit the activities of the related entity to those that are beneficial to the reporting organization. For example, the charter states that the related entity is created solely to benefit the reporting entity and that all of the assets of the related entity are for the use of the reporting organization.

- *Oversight Relationship.* In exchange for the use of a national name or participation in the activities of a national organization, the related entity agrees to conditions (such as financial relationships or accreditation processes) established by the reporting organization.

- *Contract.* A contract or agreement may give control to the reporting organization.

FASB ASC 958-810-20 notes an economic interest exists when one organization (a) holds or uses significant resources for another organization to directly or indirectly produce income for or provide services to it, or (b) is responsible for the other organization's liabilities. For example, if the related organization solicits funds in the name of the reporting organization or if the reporting organization provides funds for the related organization, an economic interest is present. An economic interest also exists if one organization has a right to (or responsibility for) another organization's operating results, or if it is entitled to the other organization's net assets (or responsible for any deficit) upon dissolution.

Questions have been raised about whether political action committees (PACs) sponsored by nonprofit organizations should be consolidated. Some organizations form PACs to perform political activities the organizations do not want to perform or are precluded from performing without threatening their tax-exempt status.

If a PAC's mission is to further the interests of the organization, PAC resources are used for the purposes of the organization, and the governing board of the PAC is appointed by the board of the organization, nonauthoritative guidance at Q&A 6140.10 of the AICPA Technical Questions and Answers clarifies that GAAP requires the organization to consolidate the PAC. Consolidation is required in that situation because both control (through a majority voting interest in the PAC board) and an economic interest are present.

A national organization may receive funds from and control local chapters through contract or affiliation agreements but not control the local chapters' board of directors. If the nonprofit organization has an economic interest in and exercises control over a related nonprofit entity without a majority ownership, sole corporate membership, or majority voting interest, it may, but is not required to, consolidate the related nonprofit entity. However, FASB ASC 958-810-25-4 indicates, 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, and

b. Consolidation would be meaningful.

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, the nonprofit organization's financial statements must include the following disclosures:

- Identification of the related nonprofit organization and the nature of the relationship.
- A summary of the related nonprofit entity's financial information, including total assets, liabilities, net assets, revenue, and expenses.
- The related nonprofit entity's resources that are held for the benefit of (or under the control of) the nonprofit organization. (FASB ASC 958-20 requires that certain arrangements in which an organization agrees to raise or hold contributions for a financially interrelated entity be reported using a method similar to the equity method of accounting.)
- Related party disclosures required by FASB ASC 850-10-50.

If consolidated financial statements are presented, they should disclose any external restrictions on distributions from the related nonprofit entity to the reporting organization and any resulting unavailability of the net assets of the related nonprofit organization for use by the reporting nonprofit organization.

Control or Economic Interest, but Not Both. If either control or an economic interest exists, but not both, the financial statements of the other nonprofit organization should not be consolidated. Instead, the reporting nonprofit organization should provide the disclosures required by FASB ASC 850-10-50. Paragraph 3.108 of the Audit Guide states organizations that previously presented consolidated financial statements prior to December 1994 under SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, may continue to present those statements even though the presentation otherwise would not be allowed under FASB ASC 958-810.

Commonly Controlled Entities

FASB ASC 810-10-55-1B points out that combined financial statements for entities that are under common control or common management are meaningful in some circumstances.

SELF-STUDY QUIZ

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

8. Under which of the following scenarios would a nonprofit organization be required to present consolidated financial statements with a for-profit entity?

    a. The nonprofit organization holds 40% of the voting stock in the for-profit entity.

    b. The nonprofit organization is a general partner in control of a for-profit limited partnership.

    c. The nonprofit organization is a general partner of a for-profit partnership controlled by the limited partners.

    d. The nonprofit organization has ownership interest but cannot significantly influence or control the for-profit entity.

9. Which of the following correctly describes limited partner kick-out rights?

    a. Rights allowing the limited partners to block or participate in certain major decisions made in the normal course of business.

    b. Rights that do not allow the limited partners to participate in major decisions during the ordinary course of business.

    c. Rights that might underlie the limited partner's capacity to liquidate the limited partnership with no cause.

    d. Rights obtained when the acquirer reacquires the ability to use its technology under a licensing agreement.

10. Per FASB ASC 810-10-15-19, one entity may control another entity by establishing a contractual management arrangement. Which of the following must the contract contain for a nonprofit organization to contractually control a for-profit entity?

    a. The contract allows the nonprofit organization exclusive authority over all decisions related to operations of the for-profit entity.

    b. The contract term between the two entities must be for three years or more.

    c. The contract must contain a clause allowing termination by the for-profit entity if the nonprofit organization replaces any board members.

    d. The contract disallows the nonprofit organization from selling its financial interest in the for-profit entity.

11. Which of the following nonprofit organizations may not have significant influence over a for-profit entity even if it owns 20% of the for-profit entity's voting stock?

    a. Nonprofit A has access to financial information that other shareholders cannot obtain.

    b. Nonprofit B has representation on the for-profit entity's current board of directors.

    c. Nonprofit C executes an agreement with the for-profit entity restricting the organization's rights as a shareholder.

12. In which of the cases below would a nonprofit organization report its interest in a for-profit entity at fair value using guidance in FASB ASC 958-320?

    a. The organization owns stock in the form of a security that has a readily determinable fair value.

    b. The organization owns in-substance stock in a for-profit entity.

    c. The organization's noncontrolling interest is not in stock or in-substance stock, and it is not required to consolidate or use the equity method.

    d. The organization has a noncontrolling interest in a real estate entity that is more than minor.

13. Which of the following financial relationships between two nonprofit organizations requires consolidation?

    a. National organizations accept funds from local chapters but do not control the local chapters' board of directors.

    b. A PAC is controlled by the sponsoring nonprofit organization and economic interest is present.

    c. A reporting nonprofit organization does not have control through a majority voting interest in the board.

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. Under which of the following scenarios would a nonprofit organization be required to present consolidated financial statements with a for-profit entity? **(Page 293)**

    a. The nonprofit organization holds 40% of the voting stock in the for-profit entity. [This answer is incorrect. How a nonprofit organization reports ownership interest depends primarily on the amount of control it has over the for-profit entity. In the case of 40% stock ownership, the organization would have significant influence over the for-profit entity, but would not have a controlling financial interest. This would require the use of the equity method of accounting, not consolidation.]

    b. The nonprofit organization is a general partner in control of a for-profit limited partnership. [This answer is correct. A nonprofit organization with a controlling financial interest in either a for-profit or nonprofit entity is generally required to present consolidated financial statements. Acting as a controlling general partner would signify a controlling financial interest in the for-profit entity.]

    c. The nonprofit organization is a general partner of a for-profit partnership controlled by the limited partners. [This answer is incorrect. The organization would only have significant influence over the operating and financial policies of the for-profit entity in this case. Since the organization does not have the ability to control the partnership, the equity method of accounting is required rather than consolidation.]

    d. The nonprofit organization has ownership interest but cannot significantly influence or control the for-profit entity. [This answer is incorrect. If the nonprofit organization is unable to significantly influence or control the operating and financial policies of the for-profit entity, the ownership interest is reported as an investment rather than a consolidation.]

9. Which of the following correctly describes limited partner kick-out rights? **(Page 297)**

    a. Rights allowing the limited partners to block or participate in certain major decisions made in the normal course of business. [This answer is incorrect. Rights that allow the limited partners of the limited partnership to block or participate in certain significant financial and operating decisions that are made in the ordinary course of business are known at participating rights, not kick-out rights.]

    b. Rights that do not allow the limited partners to participate in major decisions during the ordinary course of business. [This answer is incorrect. This describes protective rights, which are rights that do not allow the limited partners, in the ordinary course of business, to participate in significant financial and operating decisions.]

    c. Rights that might underlie the limited partner's capacity to liquidate the limited partnership with no cause. [This answer is correct. Kick-out rights are rights that may underlie the limited partner's ability to liquidate the limited partnership or otherwise remove the general partners without cause. Organizations use the guidance in FASB 955-810-25-16 and 25-20 to determine if there are kick-out rights.]

    d. Rights obtained when the acquirer reacquires the ability to use its technology under a licensing agreement. [This answer is incorrect. This describes reacquired rights. Another example is when the acquirer reacquires the right to use its trade name under a franchise agreement. GAAP provides specific guidance on subsequent accounting for reacquired rights in FASB ASC 805-20-32-2.]

10. Per FASB ASC 810-10-15-19, one entity may control another entity by establishing a contractual management arrangement. Which of the following must the contract contain for a nonprofit organization to contractually control a for-profit entity? **(Page 298)**

    a. The contract allows the nonprofit organization exclusive authority over all decisions related to operations of the for-profit entity. [This answer is correct. The nonprofit organization must have exclusive authority over all decision making related to the ongoing, major, or central operations of the for-profit entity. This would include authority over such things as scope and pricing of services and contract negotiation.]

    b. The contract term between the two entities must be for three years or more. [This answer is incorrect. The contract must be written for a term that is either the entire remaining legal life of the for-profit entity or for a period of 10 years or more.]

    c. The contract must contain a clause allowing termination by the for-profit entity if the nonprofit organization replaces any board members. [This answer is incorrect. The contract cannot be terminated by the for-profit entity except in the case of gross negligence, fraud, or other illegal acts by the nonprofit organization, or bankruptcy of the organization.]

    d. The contract disallows the nonprofit organization from selling its financial interest in the for-profit entity. [This answer is incorrect. The contract must allow the nonprofit organization to have a financial interest in the for-profit entity that (a) can be sold or transferred and (b) gives it the right to receive income in an amount that fluctuates based on performance.]

11. Which of the following nonprofit organizations may not have significant influence over a for-profit entity even if it owns 20% of the for-profit entity's voting stock? **(Page 299)**

    a. Nonprofit A has access to financial information that other shareholders cannot obtain. [This answer is incorrect. According to FASB ASC 323-10-15-10, if the organization seeks more financial information than is available to the entity's other shareholders and is unable to obtain that information, then the organization may not have significant influence. Since Nonprofit A was able to obtain additional information, it does not fall under this presumption.]

    b. Nonprofit B has representation on the for-profit entity's current board of directors. [This answer is incorrect. Per FASB ASC 323-10-15-10, if the nonprofit organization tries and fails to obtain representation on the for-profit entity's board of directors, it may not have significant influence.]

    c. Nonprofit C executes an agreement with the for-profit entity restricting the organization's rights as a shareholder. [This answer is correct. If the organization and entity execute an agreement restricting the organization's rights as a shareholder, the organization may not have significant influence per FASB ASC 323-10-15-10.]

12. In which of the cases below would a nonprofit organization report its interest in a for-profit entity at fair value using guidance in FASB ASC 958-320? **(Page 301)**

    a. The organization owns stock in the form of a security that has a readily determinable fair value. [This answer is correct. If a nonprofit organization's ownership interest in a for-profit entity is not sufficient to give it a controlling interest or significant influence, the accounting will depend on the form of financial interest. If the interest is in stock that is in the form of a security that has readily determinable fair value, then FASB ASC 958-320 would apply and the interest is reported at fair value.]

    b. The organization owns in-substance stock in a for-profit entity. [This answer is incorrect. If the stock owned by the nonprofit organization does not have a readily determinable fair value or is in-substance stock, the organization uses the guidance for other investments contained in FASB ASC 958-325 rather than FASB ASC 958-320.]

c. The organization's noncontrolling interest is not in stock or in-substance stock, and it is not required to consolidate or use the equity method. [This answer is incorrect. If the noncontrolling interest is not in stock or in-substance stock and neither consolidation nor the equity method is required, GAAP often does not have specific guidance for reporting the interest in the other entity. In many cases, an organization may analogize to guidance that applies to other entities. Therefore, it would not follow the guidance in FASB ASC 958-320.]

d. The organization has a noncontrolling interest in a real estate entity that is more than minor. [This answer is incorrect. FASB ASC 958-810-15-4(d) contains the guidance for nonprofit organizations with a more then minor interest in a for-profit real estate entity that is noncontrolling. In some cases, it will be recorded at fair value, in other cases it is reported using the equity method.]

13. Which of the following financial relationships between two nonprofit organizations requires consolidation? **(Page 306)**

a. National organizations accept funds from local chapters but do not control the local chapters' board of directors. [This answer is incorrect. If the nonprofit organization has an economic interest in and exercises control over a related nonprofit entity (such as the local chapter) without a majority ownership, sole corporate membership, or majority voting interest, it is not required to consolidate the related organization. However, consolidation may be allowed under these circumstances and, in some cases, be encouraged.]

b. A PAC is controlled by the sponsoring nonprofit organization and economic interest is present. [This answer is correct. Some nonprofit organizations form PACs to perform political activities. If the PAC's mission is to further the interest of the organization, PAC resources are used for the purpose of the organization, and the governing board of the PAC is appointed by the organization, then GAAP requires consolidation.]

c. A reporting nonprofit organization does not have control through a majority voting interest in the board. [This answer is incorrect. GAAP prohibits consolidation if control does not rest with the holder of the majority voting interest. To have this control, 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. Simply having majority voting interest does not meet the criteria of control.]

Lesson 2: Consolidated, Consolidating, and Combined Financial Statement Presentation and Equity Method Reporting

INTRODUCTION

This lesson explores when and how a nonprofit organization needs to present consolidated, consolidating, or combined financial statements depending on the relationship with the partner entity. Typically, consolidated financial statements are necessary for a fair presentation when the reporting entity has a controlling interest in the other entity. This lesson takes an in-depth look at the presentation of several consolidated financial statements and discusses when consolidating or combined statements may be more appropriate. If consolidated or combined statements are not presented, the nonprofit may be required to report using the equity method, cost method, or elect to report the interest at fair value in the financial statements. These types of financial relationships will also be discussed.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize proper methods for presenting consolidated financial statements for nonprofit organizations including appropriate disclosures.
- Identify when and how to use consolidating or combined financial statements and when to apply the equity method for transactions.

GENERAL CONSIDERATIONS IN PRESENTING CONSOLIDATED FINANCIAL STATEMENTS

Consolidated financial statements present financial position and results of activities of a parent and all its subsidiaries as if the consolidated group were a single economic entity. Consolidated financial statements are usually necessary to make a fair presentation of financial results when an organization directly or indirectly has a controlling financial interest in another entity.

FASB ASC 810-10-20 defines *parent* and *subsidiary* as follows:

a. A *parent* is "an entity that has a controlling financial interest in one or more subsidiaries."

b. A *subsidiary* is "an entity, including an unincorporated entity such as a partnership or trust, in which another entity, known as its parent, holds a controlling financial interest."

The terminology recognizes that the parent and subsidiary may be any form of legal entity, including nonprofit organizations.

The headings of consolidated financial statements typically name the parent and refer to the subsidiaries collectively as follows:

ABC Organization and Subsidiaries, *or*

ABC Organization and Consolidated Subsidiaries.

The consolidation policy is required to be disclosed in the notes to the financial statements. Thus, it is also appropriate to just name the parent.

Best practices indicate the financial statement titles should include the word *consolidated* and prefer placing the word *consolidated* in front of the name of the statement—for example, *consolidated statement of financial position*.

That presentation is illustrated at FASB ASC 810-10-55-4G through 55-4L. However, it is also appropriate to place the word *consolidated* prior to the results presented—for example, *statement of consolidated financial position*.

Nonprofit organizations typically present comparative financial statements for the current and prior year. The acquisition or disposition of a controlling financial interest may result in financial statements that present consolidated financial results for one of the years but not the other year. The authoritative accounting literature does not preclude presenting consolidated financial results in comparison with financial results for years that consolidation was not required. However, an organization may decide that consolidated financial results for one year are not comparable with results for another year that are not consolidated. It could issue single-year financial statements for the year the controlling financial interest was acquired (or disposed of) and return to comparative presentations when both years are presented on a comparable basis.

Special Considerations in Consolidating a Nonprofit Organization

Organizations should consider any implications to net asset classifications when the net assets of two or more nonprofit organizations are combined into a single set of financial statements. The Audit Guide, beginning at Paragraph 3.103, indicates that net asset classifications in consolidated financial statements should be applied from the reporting entity's perspective, rather than from the perspective of the separate entities. As a result, the classifications may be different in the consolidated financial statements than in the separate parent or subsidiary financial statements. For example, donor restrictions placed on contributions to a subsidiary that are no more restrictive than the general mission of the subsidiary organization are reported as unrestricted contributions (contributions without donor restrictions after the adoption of ASU 2016-14) in the subsidiary's financial statements. When consolidated, however, the restrictions are more restrictive than the general mission of the reporting entity as a whole and thus require classification as restricted net assets (net assets with donor restrictions after the adoption of ASU 2016-14). Although less likely, Paragraph 3.105 of the Audit Guide explains that the reverse situation could also occur. For example, donor restrictions placed on contributions to a subsidiary are more restrictive than the general mission of the subsidiary organization and are thus reported as temporarily restricted net assets. However, the donor restrictions are no more restrictive than the general mission of the reporting entity when consolidated and therefore are reported as unrestricted net assets (net assets without donor restrictions after the adoption of ASU 2016-14) in the consolidated financial statements.

Organizations should consider any unique disclosures required in financial statements that consolidate a subsidiary nonprofit organization. For example, FASB ASC 958-810-50-1 indicates that any third-party restrictions placed on distributions from a subsidiary to a parent organization should be disclosed as well as any net assets that are unavailable to the parent as a result of the restrictions.

Special Considerations in Consolidating a For-profit Entity

Flexibility is required in determining how the financial results of a for-profit subsidiary are consolidated with a nonprofit organization parent. For example, an organization that consolidates a for-profit retailing subsidiary may choose to include the activities of the for-profit subsidiary in a separate section of the statement of activities after a caption such as "retailing activities." Those activities could be included after the nonprofit organization's revenues and expenses from unrestricted net assets (net assets without donor restrictions after the adoption of ASU 2016-14) but before the caption "change in unrestricted net assets." (change in net assets without donor restrictions after the adoption of ASU 2016-14) The preparer should primarily be concerned with providing financial statements that are meaningful and understandable.

FASB ASC 810-10-25-15 and the Audit Guide at Paragraph 3.102 indicate that industry-specific GAAP requirements that apply to a subsidiary should be retained in the consolidated financial statements of the nonprofit organization. An organization's for-profit subsidiary that has interests in other for-profit entities would also need to consider the guidance in FASB ASC 810, including VIE guidance, when evaluating whether those interests require consolidation.

Nonauthoritative guidance at Q&A 6140.26 of the AICPA Technical Questions and Answers provides guidance about whether a nonprofit organization's for-profit subsidiary is permitted to adopt an accounting alternative in the nonprofit organization's consolidated financial statements when adoption of the accounting alternative by nonprofit organizations is not allowed. The guidance indicates that a for-profit subsidiary that would otherwise qualify as a

private company may not elect to amortize goodwill in the consolidated financial statements. The AICPA Q&A clarifies that the definition of *private company* in the FASB ASC glossary is referring to the *reporting entity*. Because the reporting entity is a nonprofit organization, the private company accounting alternative may not be adopted in the consolidated financial statements of the nonprofit organization. The guidance clarifies, however, that the for-profit entity may adopt the accounting policy election allowed by Accounting Alternative Subsections of FASB ASC 350-20 in its *stand-alone* financial statements. This methodology generally would apply to all accounting alternatives provided to private companies that are not available to nonprofit organizations.

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

Consolidating and Eliminating Entries

If consolidated financial statements are prepared, all transactions and balances between the entities whose financial results are consolidated should be eliminated. For example, if consolidated financial statements are presented for Organization A and its for-profit subsidiary Company B, an account receivable recognized by Organization A would be eliminated if it arose from transactions with Company B. The related account payable to Organization A recognized by Company B also would be eliminated in preparing the consolidated financial statements. The eliminating entry would be as follows:

Account payable to Organization A	15,000	
Account receivable from Company B		15,000

The receivable is a valid asset from the standpoint of Organization A as a separate entity, but is not an asset from the standpoint of the consolidated financial statements because the consolidated group cannot owe itself.

Consolidating or eliminating entries are made only for the purpose of preparing consolidated financial statements. They are not recorded in the accounting systems of the entities being consolidated.

Elimination of the Investment Account

If the nonprofit parent organization has an ownership interest in the subsidiary, the carrying amount of the parent's investment in the subsidiary must be eliminated. Usually, the elimination of the investment account is done in two steps. The first step is to eliminate the carrying amount of the investment as of the beginning of the period by offsetting the investment against the stockholders' equity accounts of the subsidiary as of the beginning of the period. The second step is to eliminate the effects of any entries recorded during the period that affected the carrying amount of the investment.

For example, assume that on January 1, 20X7, Parent Organization paid $140,000 for 80% of the outstanding common stock of the for-profit Sub Company. On that date, Sub Company had identifiable assets with a carrying amount and fair value of $150,000, no liabilities, paid-in capital of $100,000 and retained earnings of $50,000. The fair value of the noncontrolling interest was $35,000, yielding a total fair value of Sub Company of $175,000 (140,000 + 35,000). The $25,000 excess of the $175,000 fair value of Sub Company over the $150,000 fair value of the identifiable assets of Sub Company was considered to be goodwill. Assume further that during 20X7, Sub Company reported earnings of $30,000 and declared and paid dividends of $10,000 and that Parent Organization recorded its share of Sub Company's undistributed earnings for 20X7 using the equity method. The eliminating entries would be as follows:

a. Paid-in capital—Sub Company	100,000	
Retained earnings—Sub Company	50,000	
Goodwill	25,000	
Investment in Sub Company		140,000
Noncontrolling interest in Sub Company		35,000
To eliminate the beginning investment account balance.		

b. Equity in earnings of Sub Company (80% × $30,000)	24,000	
Investment in Sub Company		24,000
To eliminate Sub Company's earnings recorded by the Parent Organization under the equity method.		
c. Retained earnings—Sub Company	6,000	
Noncontrolling interest in Sub Company (20% × $30,000)		6,000
To recognize the noncontrolling interest share of Sub Company's earnings.		
d. Investment in Sub Company (80% × $10,000)	8,000	
Noncontrolling interest in Sub Company (20% × $10,000)	2,000	
Retained earnings—Sub Company		10,000
To eliminate Sub Company dividends.		

The following illustrates the effects of the preceding transactions on consolidated financial position:

	PARENT ORGANIZATION	SUB COMPANY		ELIMINATIONS	CONSOLIDATED
ASSETS					
Investments					
Initial	$ 140,000	$ —	(a)	$ (140,000)	$ —
Earnings	24,000	—	(b)	(24,000)	—
Dividends	(8,000)	—	(d)	8,000	—
Goodwill	—	—	(a)	25,000	25,000
Other	8,000	170,000		—	178,000
	$ 164,000	$ 170,000		$ (131,000)	$ 203,000
EQUITY					
Parent Organization					
Unrestricted net assets (Net assets without donor restrictions after the adoption of ASU 2016-14)					
Beginning	$ 140,000	$ —		$ —	$ 140,000
Equity in Sub Company earnings	24,000	—	(b)	(24,000)	—
Sub Company					
Paid-in capital	—	100,000	(a)	(100,000)	—
Retained earnings					
Beginning	—	50,000	(a)	(50,000)	—

Net income	—	30,000	(c)	(6,000)	24,000
Dividends	—	(10,000)	(d)	10,000	—
Noncontrolling interest					
Beginning balance	—	—	(a)	35,000	35,000
Net income	—	—	(c)	6,000	6,000
Dividends	—	—	(d)	(2,000)	(2,000)
	$ 164,000	$ 170,000		$ (131,000)	$ 203,000

As a practical matter, unless *consolidating* financial statements will be issued, there is no need for an organization to record its share of the activities or earnings of subsidiaries. Instead, many nonprofit organizations that have a controlling financial interest in another entity account for their interest internally using the cost method. For those organizations, there is no need to make an elimination entry for unrealized earnings in preparing the consolidated financial statements. In the preceding example, if the cost method had been used to record the investment, the following eliminating entries would have been made:

a.	Paid-in capital—Sub Company	100,000	
	Retained earnings—Sub Company	50,000	
	Goodwill	25,000	
	Investment in Sub Company		140,000
	Noncontrolling interest in Sub Company		35,000
	To eliminate the beginning investment account balance.		
b.	Dividend income	8,000	
	Noncontrolling interest in Sub Company earnings	2,000	
	Retained earnings—Sub Company		10,000
	To eliminate Sub Company's dividends.		
c.	Noncontrolling interest in Sub Company earnings	6,000	
	Noncontrolling interest in Sub Company		6,000
	To recognize the noncontrolling interest share of Sub Company's earnings.		

The following illustrates the statement of financial position effects when the parent organization uses the cost method to record its investment in Sub Company:

	PARENT ORGANIZATION	SUB COMPANY		ELIMINATIONS	CONSOLIDATED
ASSETS					
Investments					
Initial	$ 140,000	$ —	(a)	$ (140,000)	$ —
Earnings	—	—		—	—
Dividends	—	—		—	—
Goodwill	—	—	(a)	25,000	25,000
Other	8,000	170,000		—	178,000
	$ 148,000	$ 170,000		$ (115,000)	$ 203,000

EQUITY					
Parent Organization					
Unrestricted net assets (Net assets without donor restrictions after the adoption of ASU 2016-14)					
Beginning	$ 140,000	$ —		$ —	$ 140,000
Dividend income	8,000	—	(b)	(8,000)	—
Equity in Sub Company earnings	—	—		—	—
Sub Company					
Paid-in capital	—	100,000	(a)	(100,000)	—
Retained earnings					
Beginning	—	50,000	(a)	(50,000)	—
Net income	—	30,000	(c)	(6,000)	24,000
Dividends	—	(10,000)	(b)	10,000	—
Noncontrolling interest					
Beginning balance	—	—	(a)	35,000	35,000
Net income	—	—	(c)	6,000	6,000
Dividends	—	—	(b)	(2,000)	(2,000)
	$ 148,000	$ 170,000		$ (115,000)	$ 203,000

Note the amounts in the consolidated column are the same as those in the illustration above.

The Effects of Preexisting Relationships

When an organization initially consolidates another entity, FASB ASC 810-10-45-4 requires it to include the activities of the entity in its financial statements beginning on the date the subsidiary qualifies for consolidation. Thus, intra-entity transactions and balances from the date the organization determines the investee qualifies for consolidation through the end of the reporting period should be eliminated. However, transactions between the organization and the subsidiary entity prior to the date the interest or relationship met the criteria for consolidation should not be eliminated.

FASB ASC 805-10-25-20 and 25-21 provide guidance on how the parent should account for the effects of a financial relationship with another entity prior to the date it is acquired in a business combination. Whether the relationship should be considered part of the consideration for the purchase depends on the facts and circumstances. For example, if the acquiring entity agreed to make payments to the selling equity holders as compensation for services after the acquisition and the agreement would terminate if they terminate their employment, that agreement would likely not be considered a part of the consideration for the purchase. However, if the payments would continue even if they terminated their employment, the agreement would likely be considered part of the consideration for the purchase.

Elimination of Intra-entity Balances and Transactions That Do Not Include Profit or Loss

All intra-entity balances and transactions should be eliminated even if they do not include profit or loss, such as interest-free transfers of funds between affiliates and intra-entity sales with no markup. Although those transactions have no effect on the change in net assets of the consolidated group, financial relationships, such as the gross profit percentage and the current ratio, would be misstated if they were not eliminated.

Examples of intra-entity balances and transactions that typically do not include profit or loss are as follows:

Accounts receivable—Accounts payable
Promises to give—Grant payable
Notes receivable—Notes payable
Advances to subsidiary (parent)—Advances from subsidiary (parent)

Interest income—Interest expense
Rent income—Rent expense
Management fees—Management services

Noncontrolling Interests

Consolidated financial statements present the financial results of the reporting entity and the entities it controls. If a nonprofit organization is the sole investor of all the entities in the consolidated group, all of the consolidated net assets are allocated to that reporting entity. For example, if a for-profit subsidiary has 10,000 shares of common stock outstanding and all 10,000 shares are held by the nonprofit parent, 100% of the subsidiary's equity would be considered to be owned by the parent organization and the consolidated statement of financial position would include all of the subsidiary's equity.

However, if the reporting entity is not the sole investor and some of the consolidated net assets is owned by other investors, consolidated net assets must be allocated between the reporting entity and those other equity investors. To illustrate, assume that—

- A reporting entity, ABC Organization, owns 80% of DEF Company,
- XYZ Company owns 20%, and
- Unrestricted net assets (Net assets without donor restrictions after the adoption of ASU 2016-14) total $60,000, consisting of $40,000 from ABC Organization and $20,000 from DEF Company.

Because ABC Organization owns 80% of the equity of DEF Company—

- ABC Company would be allocated $16,000 of the net assets of DEF Company ($20,000 net assets × 80%) and
- XYZ Company would be allocated the $4,000 remainder ($20,000 net assets–$16,000 allocated to ABC Organization).

Therefore, the consolidated unrestricted net assets (Net assets without donor restrictions after the adoption of ASU 2016-14) of $60,000 would be allocated—

- $56,000 to ABC Organization, consisting of the ABC Organization net assets of $40,000 and the $16,000 net assets of DEF Company allocated to ABC Organization, and
- $4,000 to XYZ Company, consisting solely of the $4,000 net assets of DEF Company allocated to it.

ABC Organization has the controlling interest in the consolidated entity, and the equity investors of XYZ Company have the noncontrolling interest.

The existence of a noncontrolling interest does not affect the amount of intra-entity balances and transactions that should be eliminated in consolidation. That is, the entire balance of an intra-entity receivable/payable should be eliminated, not just the portion related to the controlling interest.

FASB ASC 958-810-25-6 provides guidance when a nonprofit organization presents consolidated financial statements that include a nonprofit subsidiary that is consolidated because the parent has both an economic interest and control. When control is obtained by a majority *voting* interest (in contrast to a majority *ownership* interest) in another nonprofit organization, the consolidated financial statements should *not* reflect a noncontrolling interest for the portion of the board that the parent organization does not control. The remaining voting interests do not represent ownership interests; because of its economic interest the parent organization has the only ownership interest in the subsidiary.

In most cases the income from a for-profit subsidiary will not be subject to donor restrictions. However, the income from the subsidiary could be restricted in some cases. For example, a for-profit subsidiary could have been

donated to a nonprofit organization with the stipulation that the net income from the subsidiary be used for a specific purpose each year. In that case, the noncontrolling interest and the parent organization's equity in the net income of the subsidiary should be shown as a component of the appropriate class of net assets to reflect the donor restriction.

The following illustrates presentation of the noncontrolling interest as a component of unrestricted net assets before the effective date of ASU 2016-14:

LONG-TERM DEBT		75,000
	TOTAL LIABILITIES	205,000
NET ASSETS		
Unrestricted		
Controlling interests		500,000
Noncontrolling interest		60,000
		560,000
Temporarily restricted		70,000
Permanently restricted		130,000
	TOTAL NET ASSETS	760,000
	TOTAL LIABILITIES AND NET ASSETS	$ 965,000

The following illustrates presentation of the noncontrolling interest as a component of net assets without donor restrictions after the effective date of ASU 2016-14. The ASU is 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.

LONG-TERM DEBT		75,000
	TOTAL LIABILITIES	205,000
NET ASSETS		
Without donor restrictions		
Controlling interests		500,000
Noncontrolling interest		60,000
		560,000
With donor restrictions		200,000
	TOTAL NET ASSETS	760,000
	TOTAL LIABILITIES AND NET ASSETS	$ 965,000

Preparers should consider whether disclosure of the percentage ownership held by the noncontrolling interest and the name of the subsidiary is necessary in certain situations for adequate disclosure. Noncontrolling interests in multiple subsidiaries may be aggregated.

Nonprofit organizations should apply the guidance in FASB ASC 810-10 regarding the attribution of subsidiary losses to the noncontrolling interest. FASB ASC 810-10-45-20 and 45-21 state that when losses exceed the amount of equity attributable to the parent or the noncontrolling interest, the losses should continue to be attributed to those interests even if it results in a deficit balance for the noncontrolling interest.

Fiscal Years of Parent and Subsidiary Differ

According to FASB ASC 810-10-15-11, a subsidiary should not be excluded from consolidation just because its fiscal year differs from that of its parent. FASB ASC 810-10-45-12 states that, for consolidation purposes, the subsidiary ordinarily can prepare statements for a period that corresponds with or closely approaches the parent's fiscal period. However, that guidance permits consolidation using the subsidiary's financial statements for its fiscal period if the parent's and subsidiary's fiscal years differ by no more than "about three months." When entities with

different fiscal years are consolidated, "recognition should be given by disclosure or otherwise to the effect of intervening events that materially affect the financial position or results of operations." (Following the guidance in FASB ASC 810-10-45-13, a change in the policy of the use of different year-ends should be reported as a change in accounting principle.) GAAP provides little additional guidance about the unique accounting and presentation issues that may arise in preparing consolidated financial statements of entities having different fiscal years. The following paragraphs discuss how to apply this guidance to some consolidation issues.

Classification of Nonaffiliated Loan Payable. Questions about appropriate classification of receivables and payables may arise when a subsidiary with a fiscal year different from that of the parent organization has a payable or receivable to an entity that is not part of the consolidated group. For example, assume that a subsidiary's September 30, 20X6, statement of financial position reflects noncurrent debt to a bank due November 30, 20X7. When the subsidiary is consolidated with its parent organization that has a December 31, 20X6, year end, some accountants consider the loan to be a current liability with respect to a classified consolidated statement of financial position. The primary objective in accounting for intervening transactions should be to fairly present the consolidated financial statements. Thus, they recommend that the date of the consolidated statement of financial position generally should determine whether payables or receivables of a subsidiary should be classified as current or noncurrent. To do otherwise could result in consolidated financial statements that were materially misstated. Accordingly, in the preceding example, the subsidiary's debt would be reclassified as current since it is due within 12 months of the date of the consolidated statement of financial position.

If a classified statement of financial position is not prepared, the classification of the debt will not be as important. However, the maturity date should be considered when sequencing the liability in a sequenced statement of financial position or for disclosure in the notes to the financial statements if another format is used.

Elimination of Intra-entity Transactions. When a parent and its subsidiaries have different fiscal years, intra-entity transactions may occur during the period between their respective year ends. For example, assume that consolidated financial statements are prepared for Parent Organization, which has a December 31 year end, and Sub Company, which has an October 31 year end. If Parent Organization advances funds to Sub Company between November 1 and December 31, Parent Organization's financial statements will reflect a receivable from Sub Company; however, Sub Company's financial statements will not reflect a corresponding payable to Parent Organization. It is logical that intervening transactions should be accounted for in a manner that fairly presents the consolidated financial statements. Because the difference in the intra-entity account arose from a transaction after the subsidiary's year-end, the transfer could be recorded on the subsidiary's consolidating trial balance. If there were other intra-entity transactions during that period, they also should be recorded so that the intra-entity accounts agree and can be eliminated in consolidation. As a practical matter, however, if the difference between the intra-entity accounts is not material, they could be offset, with the difference included with other assets or other liabilities

Although best practices indicate that the accounting described in the preceding paragraphs is preferable because the consolidated financial statements include all transactions that have occurred as of the consolidated year end, FASB ASC 810-10-45-12 also permits intervening transactions to be disclosed in the consolidated financial statements rather than recognized through consolidating adjustments.

CONSOLIDATED STATEMENT OF ACTIVITIES

Eliminating Intra-entity Transactions

When one member of the consolidated group sells an asset to another member of the consolidated group at an amount that differs from the asset's carrying amount, the selling entity appropriately recognizes a gain or loss on the sale of the asset. However, the intra-entity profit or loss must be eliminated when consolidated financial statements are prepared. Intra-entity profit or loss is not considered to be realized until the asset is sold to an entity that is not a member of the consolidated group.

All intra-entity profit or loss should be eliminated regardless of whether the selling entity is the parent, a wholly owned subsidiary, or a partially owned subsidiary. FASB ASC 810-10-45-18 states that intra-entity profit or loss that is eliminated may (but is not required to) be allocated between the parent and noncontrolling interests. In practice, many nonprofit organizations may not make such an allocation.

Intra-entity Profit in Inventory

To illustrate elimination of intra-entity profit in inventory when there are noncontrolling interests, assume (a) that in 20X6, Sub B, a 90%-owned subsidiary, sold merchandise costing $10,000 to Sub A, an 80%-owned subsidiary, for $15,000; (b) that all of the merchandise remained in the inventory of the purchasing subsidiary at the end of 20X6; and (c) that all of the merchandise was sold to a party that is not part of the consolidated group during 20X7 for $18,000. (To simplify the illustration, there are no intra-entity receivables or payables, opening 20X6 assets are matched by liabilities rather than equity, and the parent uses the cost method to account for its investment.)

In 20X6, the following eliminating entry would be made:

Sales	15,000	
Inventory		5,000
Cost of sales		10,000

Since there were no sales outside of the consolidated entity, there would be no entry to record the noncontrolling interests in the transaction.

The following illustrates the effects of the 20X6 transaction:

	PARENT ORGANIZATION	SUB A	SUB B	ELIMINATIONS	CONSOLIDATED
ASSETS					
Cash	$ —	$ —	$ 15,000	$ —	$ 15,000
Inventory	—	15,000	—	(5,000)	10,000
	$ —	$ 15,000	$ 15,000	$ (5,000)	$ 25,000
LIABILITIES	$ —	$ 15,000	$ 10,000	$ —	$ 25,000
NET ASSETS OR EQUITY					
Unallocated	—	—	5,000	$ (5,000)	—
Controlling interest	—	—	—	—	—
Noncontrolling interests	—	—	—	—	—
	$ —	$ 15,000	$ 15,000	$ (5,000)	$ 25,000
EARNINGS					
Sales	$ —	$ —	$ 15,000	$ (15,000)	$ —
Cost	—	—	(10,000)	10,000	—
Consolidated change in net assets	—	—	5,000	(5,000)	—
Noncontrolling interests	—	—	—	—	—
Controlling interest	$ —	$ —	$ 5,000	$ (5,000)	$ —

In 20X7, when the merchandise is sold to an entity that is not a member of the consolidated group for $18,000, the following eliminating entries would be made:

a. Opening retained earnings	5,000	
Cost of sales		5,000
To eliminate the intra-entity portion of cost of sales.		
b. Noncontrolling interests in earnings	1,100	
Noncontrolling interests in equity		1,100
To record noncontrolling interests in earnings.		

c. Current retained earnings	6,900	
Net assets—controlling interest		6,900

To allocate retained earnings of controlling interest.

Note that all of the $8,000 profit on the sale is recognized in 20X7, as illustrated in the following paragraph, even though $5,000 of it arose in 20X6 through an intra-entity sale. Also note that, as the computation in the following paragraph illustrates, the noncontrolling interests are allocated their proportionate share of the total profit. Accordingly, if the parent (instead of Subsidiary B) had sold the inventory to Subsidiary A in 20X6, all of the $5,000 intra-entity profit would have been allocated to the controlling interest in 20X7, and the noncontrolling interests in Subsidiary A would have been allocated $600 of the $3,000 profit from the 20X7 sale to the entity that is not a member of the consolidated group.

The following illustrates the effects of the 20X7 transaction and computation of the noncontrolling interests in earnings:

	PARENT ORGANIZATION	SUB A	SUB B		ELIMINATIONS	CONSOLIDATED
ASSETS						
Cash	$ —	$ 18,000	$ 15,000		$ —	$ 33,000
Inventory	—	—	—		—	—
	$ —	$ 18,000	$ 15,000		$ —	$ 33,000
LIABILITIES	$ —	$ 15,000	$ 10,000		$ —	$ 25,000
NET ASSETS OR EQUITY						
Unallocated	—	3,000	5,000	(a)	(5,000)	—
Controlling interest	—	—	—	(c)	6,900	6,900 [a]
Noncontrolling interests	—	—	—	(b)	1,100	1,100 [b]
	$ —	$ 18,000	$ 15,000		$ —	$ 33,000
EARNINGS						
Sales	$ —	$ 18,000	$ —		$ —	$ 18,000
Cost	—	(15,000)	—	(a)	5,000	(10,000)
Consolidated change in net assets	—	3,000	—		5,000	8,000
Noncontrolling interests	—	—	—	(b)	(1,100)	(1,100)
Controlling interest	$ —	$ 3,000	$ —		$ 3,900	$ 6,900

Notes:

[a] Computation of controlling interest in earnings: [Year 1—Sub B—$5,000 × .90 = $4,500] + [Year 2—Sub A—$3,000 × .80 = $2,400] = $6,900

[b] Computation of noncontrolling interests in earnings: [Year 1—Sub B—$5,000 × .10 = $500] + [Year 2—Sub A—$3,000 × .20 = $600] = $1,100

Intra-entity Profit in Noncurrent Nondepreciable Assets

If the parent organization sold land costing $30,000 to an 80%-owned subsidiary for $50,000 in 20X6, the eliminating entries would be as follows:

20X6 eliminating entry:		
Gain on sale of land	20,000	
Land		20,000
20X7 eliminating entry:[a]		
Net assets	20,000	
Land		20,000

Note:

[a] This eliminating entry would be made in preparing the consolidated financial statements in 20X7 and each year thereafter until the subsidiary sold the land to an entity that is not part of the consolidated group.

If an 80%-owned subsidiary sold land costing $30,000 to the parent for $50,000 in 20X6, the eliminating entries would be as follows:

20X6 eliminating entry:		
Gain on sale of land	20,000	
Land		20,000
20X7 eliminating entry:[a]		
Net assets	20,000	
Land		20,000

Note:

[a] This eliminating entry would be made in preparing the consolidated financial statements in 20X7 and each year thereafter until the parent sold the land to an entity that is not part of the consolidated group.

Intra-entity Profit in Depreciable Assets

The sale of a depreciable asset by the parent to a subsidiary at a profit results in an intra-entity profit that must be eliminated in preparing the consolidated financial statements. The sale also causes the purchasing subsidiary's annual depreciation expense to be greater than the consolidated entity's annual depreciation expense should be. Therefore, because consolidated financial statements present the financial results of the entities in the consolidated group as if no intra-entity transactions had occurred, both the intra-entity profit on the sale of the asset and the "excess" depreciation must be eliminated when preparing the consolidated financial statements.

To illustrate, assume that on January 1, 20X6, the parent sells equipment with a five-year remaining life, a carrying amount of $50,000 (cost of $60,000 and accumulated depreciation of $10,000) to a wholly owned subsidiary for $65,000. Assume that both entities use the straight-line depreciation method. The following chart shows the cost and accumulated depreciation that would be shown on the subsidiary's and the consolidated financial statements:

	Subsidiary's Financial Statements		Consolidated Financial Statements	
	Accumulated Depreciation	Carrying Amount	Accumulated Depreciation	Carrying Amount
1-1-X6	$ —	$ 65,000	$ 10,000	$ 50,000
1-1-X7	13,000	52,000	20,000	40,000
1-1-X8	26,000	39,000	30,000	30,000
1-1-X9	39,000	26,000	40,000	20,000
1-1-Y0	52,000	13,000	50,000	10,000
1-1-Y1	65,000	—	60,000	—

The following eliminating entries would be made in preparing the consolidated financial statements:

20X6 eliminating entries:		
Gain on sale of equipment	15,000	
Equipment ($65,000–$60,000)		5,000
Accumulated depreciation ($10,000–$0)		10,000
Accumulated depreciation	3,000	
Depreciation expense ($13,000–$10,000)		3,000
20X7 eliminating entries:		
Net assets—parent ($52,000–$40,000, which represents $15,000 unrealized intra-entity profit as of the date of sale, January 1, 20X6, less $3,000 profit realized in 19X6 through "excess" depreciation)	12,000	
Equipment		5,000
Accumulated depreciation ($20,000–$13,000)		7,000
Accumulated depreciation	3,000	
Depreciation expense ($13,000–$10,000)		3,000
20X8 eliminating entries:		
Net assets—parent ($39,000–$30,000, which represents $15,000 unrealized intra-entity profit as of the date of sale, January 1, 20X6, less $6,000 profit realized in 20X6 and 20X7 through "excess" depreciation)	9,000	
Equipment		5,000
Accumulated depreciation ($30,000–$26,000)		4,000
Accumulated depreciation	3,000	
Depreciation expense		3,000

Similar entries would be recorded through the fifth year. In the sixth and future years after the asset is fully depreciated, the following eliminating entry would be made until the equipment is disposed of:

Accumulated depreciation	5,000	
Equipment		5,000

Intra-entity Sales of Services

Entities in the consolidated group may engage in intra-entity sales of services. The type of eliminating entries that would be made depends on how the services are recorded by the purchasing entity. If the purchasing entity charges the cost of services to expense, the only eliminating entry would eliminate the service revenue and the service expense (at the cost of the services to the purchasing entity) in the period that the intra-entity sale of services had taken place. On the other hand, if the purchasing entity capitalized the cost of the intra-entity services, any intra-entity profit and the amortization of the capitalized services would be eliminated.

Intra-entity Leases

Entities in the consolidated group sometimes engage in intra-entity leases. The type of eliminating entries necessary is influenced by how the lease is accounted for by the entities. For example, if the lease is accounted for as an operating lease by both the lessor and the lessee, it is necessary to eliminate the intra-entity rent expense and rent revenue and any related rent receivable or rent payable.

The eliminating entries become more complex when the lease is recorded as a capital lease by the lessee and as a direct financing or sales-type lease by the lessor.

Illustration—Carrying Amounts the Lessor and the Lessee Would Report in Separate Financial Statements Are the Same. To illustrate the basic eliminating entries in the case of a capital lease (lessee)/direct financing lease (lessor), assume that the parent leases some of its operating equipment to a wholly owned subsidiary on January 1, 20X7, under a five-year lease with annual payments of $10,000 commencing on January 1, 20X7. Assume further that:

a. The incremental borrowing rate of the lessee and the implicit rate are each 10%.

b. The lessor's carrying amount is equal to the fair value of $41,699.

c. The parent would have recognized depreciation expense of $13,900 in 20X7 if it had not entered into the lease.

d. There is no residual value.

e. The subsidiary will depreciate the leased equipment over five years using the straight-line method.

The following illustrates the entries the lessee (subsidiary) and the lessor (parent) would make in 20X7 and the eliminating entries needed to consolidate their financial results for 20X7.

Entries in 20X7 for the lessee (subsidiary):

January 1	Leased equipment	41,699	
	Cash		10,000
	Leased liability		31,699
December 31	Interest expense (10% of $31,699)	3,170	
	Interest payable		3,170
December 31	Depreciation expenses ($41,699 × 1/5)	8,340	
	Accumulated depreciation		8,340

Entries in 20X7 for the lessor (parent):

January 1	Lease receivable	40,000	
	Cash	10,000	
	Equipment		41,699
	Unearned interest		8,301
December 31	Unearned interest	3,170	
	Interest income (10% of $31,699)		3,170

Eliminating entries in 20X7 to prepare consolidated financial statements:

	Interest income	3,170	
	Interest expense		3,170
	Interest payable	3,170	
	Lease liability	31,699	
	Equipment	41,699	
	Unearned interest	5,131	
	Lease receivable		40,000
	Leased equipment		41,699

	Depreciation expense ($13,900–$8,340)	5,560	
	Accumulated depreciation		5,560

The eliminating entries restore the respective carrying amounts in the consolidated financial statements to what they would have been if the intra-entity lease transaction had not taken place, i.e., equipment with a carrying amount of $27,799 ($41,699 at the beginning of 20X7–$13,900 depreciation expense) at the end of 20X7.

Illustration—Carrying Amounts the Lessor and the Lessee Would Report in Separate Financial Statements Are Different. To illustrate the basic eliminating entries for a capital lease (lessee)/sales-type lease (lessor), assume that the parent leases some of its operating equipment to a wholly owned subsidiary on January 1, 20X7, under a five-year lease with annual payments of $10,000 commencing on January 1, 20X7. Assume further that:

a. The incremental borrowing rate of the lessee and the implicit rate are each 10%.

b. The lessor's carrying amount is $31,699.

c. The fair value of the equipment is $41,699.

d. The parent would have recognized depreciation expense of $12,680 in 20X7 if it had not entered into the lease.

e. There is no residual value.

f. The subsidiary will depreciate the leased equipment over five years using the straight-line method.

The following illustrates the entries the lessee (subsidiary) and the lessor (parent) would make in 20X7 and the entries needed to consolidate their financial results for 20X7.

Entries in 20X7 for the lessee (subsidiary):

January 1	Leased equipment (PV of minimum lease payments)	41,699	
	Cash		10,000
	Leased liability		31,699
December 31	Interest expense (10% of $31,699)	3,170	
	Interest payable		3,170
December 31	Depreciation expenses ($41,699 × 1/5)	8,340	
	Accumulated depreciation		8,340

Entries in 20X7 for the lessor (parent):

January 1	Lease receivable	40,000	
	Cash	10,000	
	Gain on lease ($41,699–$31,699)		10,000
	Equipment		31,699
	Unearned interest (lease receivable − PV of lease receivable)		8,301
December 31	Unearned interest (10% of $31,699)	3,170	
	Interest income		3,170

Eliminating entries in 20X7 to prepare the consolidated financial statements:

	Interest income	3,170	
	Interest expense		3,170

Interest payable	3,170	
Lease liability	31,699	
Equipment	31,699	
Gain on lease	10,000	
Unearned interest	5,131	
Leased equipment		41,699
Lease receivable		40,000
Depreciation expense ($12,680–$8,340)	4,340	
Accumulated depreciation		4,340

The eliminating entries restore the carrying amounts in the consolidated financial statements to what they would have been if the intra-entity lease transaction had not taken place, i.e., equipment with a carrying amount of $19,019 ($31,699 at the beginning of 20X7–$12,680 depreciation at the end of 20X7). The preceding eliminating entry adjusts depreciation expense reported in the consolidated financial statements to the amount the lessor (parent) would have reported if the lease transaction had not taken place.

Materiality Guidelines for Eliminating Intra-entity Profit

The role of financial statement materiality in assessing the effects of departures from GAAP is not discussed in this lesson. However, the following general benchmarks are suggested:

Effect of Departure on Total Assets or Support and Revenue	Materiality to Financial Statements
< 1/2%	Not material
1/2%–2%	Danger area—could be material
>2%	Probably is material

In applying the benchmarks to consolidated financial statements, the consolidated amounts serve as the reference points rather than those of any of the individual entities being consolidated. Thus, for example, when evaluating whether a given amount of intra-entity profit is material, the determination should be made with respect to consolidated support and revenue and consolidated assets, liabilities, and net assets.

Income Taxes

The consolidated financial statements of a nonprofit organization with for-profit subsidiaries will likely contain many of the same tax accounts that are found in for-profit financial statements, such as current and deferred tax provisions, assets, and liabilities. Accounting for income taxes of for-profit subsidiaries is beyond the scope of this course. However, such guidance is available in *PPC's Guide to Accounting for Income Taxes*.

Noncontrolling Interests

Since an organization's consolidated financial statements present the financial results of the reporting entity and the entities it controls, the consolidated statement of activities should reflect consolidated revenues, expenses, gains, losses, and change in net assets. In other words, the consolidated amounts include amounts attributable to the parent, subsidiary, and noncontrolling interests, if any. Also, as discussed above, the existence of a noncontrolling interest does not affect the amount of intra-entity income or loss that should eliminated. That is, the entire intra-entity income or loss from transactions between entities in the consolidated group should be eliminated, not just the portion related to the controlling interest.

In most cases, the income from a for-profit subsidiary will not have donor restrictions and, accordingly, the noncontrolling interest should be presented as a component of the change in unrestricted net assets (net assets without donor restrictions after the adoption of ASU 2016-14). If income from the subsidiary is restricted, for example if the subsidiary was donated with the stipulation that its income be used for a specific purpose, the noncontrolling interest should be shown as a component of the change in the appropriate class of restricted net assets (net assets with donor restrictions after the adoption of ASU 2016-14). The noncontrolling interests' share of

earnings, if material, is presented as a separate line item before the cumulative effects of accounting changes, if any. When losses exceed the amount of equity attributable to the parent or the noncontrolling interest, the losses should continue to be attributed to those interests even if it results in a deficit balance for the noncontrolling interest.

FASB ASC 958-810-50-4 also requires that nonprofit parent organizations with one or more less-than-wholly owned subsidiaries provide a schedule of changes in consolidated net assets that reconciles beginning and ending balances attributable to the parent and to the noncontrolling interest by net asset class either on the face of the consolidated financial statements or in the notes to financial statements. Many nonprofit organizations may choose to provide the required disclosure in the notes.

CONSOLIDATED STATEMENT OF CASH FLOWS

If financial statements report both financial position and activities (results of operations), FASB ASC 230-10-15-3 requires a statement of cash flows to be presented for each year for which results of operations are presented. The requirements for presenting consolidated cash flows are generally the same as for presenting cash flows of individual nonprofit organizations. Either the direct or indirect methods may be used. However, as discussed in this section, presenting consolidated cash flows requires some special considerations.

When the indirect method is used, FASB ASC 230-10-45-28 requires the operating activities section of the statement of cash flows to reconcile the change in net assets with cash flow from operating activities. However, FASB ASC 230 does not mention consolidated financial statements, and a consolidated statement of cash flows is not included with the illustrative financial statements in FASB ASC 958-810-55-17 through 55-24.

Although GAAP does not discuss or illustrate a consolidated statement of cash flows, it seems logical that because FASB ASC 958-810-45-1 requires reporting the noncontrolling interest as a component of the change in net assets, the primary goal of the consolidated statement of cash flows is to present cash flows for the consolidated group. Accordingly, it is believed that when the indirect method is used, the operating activities should reconcile the *consolidated* change in net assets with *consolidated* cash flows from operating activities.

If the amounts of the consolidated change in net assets attributable to the controlling and noncontrolling interests are reflected in the consolidated statement of activities, the bottom line of the consolidated statement of activities is the amount of consolidated change in net assets attributable solely to the controlling interest. Nevertheless, best practices suggest that the operating activities section of the consolidated statement of cash flows should start with the consolidated change in net assets, even though that is not the bottom line of the consolidated statement of activities.

If two separate statements, a "consolidated statement of unrestricted revenues, expenses, and other changes in unrestricted net assets" or "consolidated statement of revenues, expenses, and other changes in net assets without donor restrictions" (after the adoption of ASU 2016-14) and a "consolidated statement of changes in net assets," are presented, the increase in the net assets line of the consolidated statement of changes in net assets is the consolidated change in net assets. That is the amount that generally should reconcile with consolidated cash flows from operating activities in the operating activities section of the consolidated statement of cash flows.

If the operating activities section of the consolidated statement of cash flows starts with the consolidated change in net assets, the attribution of the consolidated change in net assets to the controlling and noncontrolling interests is not shown in the consolidated statement of cash flows.

However, some preparers may wish to reconcile consolidated cash flows from operating activities beginning with the change in net assets attributable to the parent. When the indirect method is used, the noncontrolling interest's share of the change in net assets that is reported as a deduction in arriving at the consolidated change in net assets

should be added back to the change in net assets attributable to the parent to arrive at consolidated cash flows from operating activities. For example:

CASH FLOWS FROM OPERATING ACTIVITIES	
Change in net assets attributable to the parent	$ 41,500
Adjustment to reconcile change in net assets to net cash provided by operating activities:	
Noncontrolling interest in subsidiary's net income	8,300
NET CASH PROVIDED BY OPERATING ACTIVITIES	49,800

The noncontrolling interest's share of the consolidated change in net assets would not be reported in the consolidated statement of cash flows under the direct method.

Earnings and Distributions of Subsidiaries

When a reporting entity presents consolidated financial statements, the carrying amount of the parent's investment in the subsidiary is eliminated by offsetting it against the equity or net assets of the subsidiary. Accordingly, a parent organization's equity in the undistributed earnings of a consolidated subsidiary requires no separate presentation or adjustment in the consolidated statement of cash flows.

Dividends received by the parent also are eliminated in consolidated financial statements through an offset against the amount of distributions paid by the subsidiary. Although the dividends reflect cash flows between the entities, since they offset each other in the consolidated reporting entity they require no separate presentation in the consolidated statement of cash flows. However, dividends paid by the subsidiary to the noncontrolling interest are not eliminated for the consolidated financial statements because they are paid to an entity that is not part of the consolidated group. Dividends paid to a noncontrolling interest should be shown as a financing activity in the consolidated statement of cash flows.

To illustrate, assume that an 80% owned subsidiary paid dividends totaling $100 during the year, $80 to the nonprofit parent and $20 to the noncontrolling interest. In the consolidated financial statements, the intra-entity dividend of $80 paid by the subsidiary should be eliminated through an offset against the $80 dividend received by the parent. The $20 dividend paid to the noncontrolling interest is shown as a financing activity and reflected on the consolidated statement of cash flows as a use of $20 of the reporting entity's cash.

Acquisition of a Controlling Financial Interest

The acquisition of another nonprofit activity or a business usually affects several line items in the consolidated statement of cash flows. There may also be non-cash components of the transaction that will not be reflected in the statement at all. The following highlights some of the major considerations for preparing the consolidated statement of cash flows in the reporting period of an acquisition transaction:

- The cash consideration paid to acquire another entity is an investing activity.
- The portion of the consideration for the acquisition that was financed should be disclosed as a noncash investing and financing activity.
- An acquisition may include (a) acquisition of operating assets such as accounts receivable and inventories and (b) assumption of operating liabilities such as accounts payable. The adjustments of the consolidated change in net assets to derive consolidated cash flows from operating activities should only report changes in the operating assets and liabilities from the acquisition date to the end of the year.

To illustrate, assume that the nonprofit reporting entity previously had no inventory and that it paid $100 for inventory as part of acquiring a for-profit subsidiary. At the end of the year, inventory had increased to $150. The operating activities section of the consolidated statement of cash flows would only reflect a use of cash of $50 for the increase in inventory from $100 to $150 rather than the total $150 increase in inventory for the year. The $100

payment for the inventory is included with investing activities in the line item that reports cash consideration paid as part of the acquisition transaction. The overall effect reported in the consolidated statement of cash flows is a $150 decrease in cash.

Disposition of a Controlling Financial Interest

If a transaction or event occurs such that a previously consolidated subsidiary is no longer a part of the reporting entity, the consolidated statement of cash flows should report any cash received from disposal of the business or nonprofit activity as an investing activity. The portion of the consideration received for the disposition that was financed, if any, should be disclosed as a noncash investing and financing activity. Any gain or loss on the disposition should be subtracted from or added to the consolidated change in net assets in deriving cash flows from operating activities.

The disposition of a business or nonprofit activity often includes the disposal of operating assets such as accounts receivable and inventories and may include obtaining relief from obligations under operating liabilities such as accounts payable. The adjustments of the change in net assets to derive cash flows from operating activities should include changes in the operating assets and the operating liabilities less the carrying amounts settled through the disposition.

To illustrate, assume that the carrying amount of inventory reported in the consolidated financial statements was $330 at the beginning of the year. As part of a transaction to dispose of a subsidiary, the reporting entity received $100 in cash for inventory that had a carrying amount of $75. Accordingly, it recognized a $25 gain in the transaction. At the end of the year, the carrying amount of inventory for the reporting entity was $175. The change in the reporting entity's inventory is reported in the consolidated statement of cash flows as follows:

- Inventory decreased in total by $155 during the year, from $330 to $175, incorporating two components; (a) $80 related to operating activities, and (b) $75 related to inventory in the disposal of the subsidiary. The $80 provided from the reporting entity's normal operations is reported as an operating activity.

- The $100 of cash received for inventory due to the disposal of the subsidiary, net of the $25 gain, accounts for the remaining $75 decrease in inventory. The $100 received for inventory in the disposal transaction is reported as an investing activity. The $25 noncash gain from disposal of the subsidiary's inventory is deducted from the change in net assets to derive consolidated cash flows from operating activities.

The overall effect reported in the consolidated statement of cash flows is a $155 increase in cash. Operating activities provided $55 ($80–$25) of the increase and investing activities provided $100.

CONSOLIDATED STATEMENT OF FUNCTIONAL EXPENSES

Prior to the effective date of ASU 2016-14, FASB ASC 958-205-45-6 requires voluntary health and welfare organizations to provide a separate statement of functional expenses that shows how the natural expense classifications (such as salaries, rent, electricity, interest expense, depreciation, awards and grant to others, and professional fees) are allocated to significant program and supporting services (i.e., by each program and by the fund-raising, management and general, and membership development functions). The level of detail should be such that it provides an understanding of the nature of the expenses incurred in carrying out the programs and activities of the organization.

Eliminating Intra-entity Transactions

If consolidated financial statements are prepared, GAAP requires all intra-entity transactions and balances to be eliminated. For example, if Organization A paid administrative expenses to its subsidiary Company B, that expense and the corresponding revenue recognized by Company B should be eliminated. The eliminating entries described earlier that are used to prepare the consolidated statement of activities can be used as a model for the eliminating entries that are necessary to prepare the consolidated statement of functional expenses. Since this statement only presents consolidated expenses, only those eliminating entries that relate to presenting consolidated expenses for the reporting entity need be considered. In most cases, the applicable eliminating entries will contain more line

items in order to eliminate intra-entity transactions in the level of detail that is presented in the consolidated statement of functional expenses.

Format Considerations

The primary issue in preparing a consolidated statement of functional expenses is how to present the expenses of the consolidated subsidiary. FASB ASC 958-720-45-2 states that nonprofit organizations should report expenses by their functional expense classification, such as major classes of program services and supporting activities. Accountants should follow that same consideration for classifying expenses of consolidated subsidiaries in the statement of functional expenses. Accordingly, an organization would include expenses from a for-profit subsidiary that relate to the organization's programs in the statement of functional expenses under program services expense. Expenses that do not relate to the organization's programs would be included as supporting services expense, probably management and general.

An easy way to include the amounts from the subsidiary is to have a separate program or supporting service column on the statement for the subsidiary's expenses. For example, if all of the expenses for a for-profit subsidiary with retail activities are considered to be supporting services, the consolidated statement of functional expenses might include two separate columns under the heading "Management and general expenses." One column could be labeled "Retail activities," and the other could be labeled "Other activities." If the retail activities are segregated in a separate section of the consolidated statement of activities, this course recommends that a total for expenses of the retail activities be included on both the consolidated statement of activities and the consolidated statement of functional expenses so that the amounts in each statement will agree. Although there is no requirement in GAAP to show a total for management and general expenses, a column could also be included in the consolidated statement of functional expenses showing that total.

DISCLOSURES IN CONSOLIDATED FINANCIAL STATEMENTS

The disclosure requirements for the consolidated financial statements of nonprofit reporting entities are generally the same as for financial statements of individual nonprofit organizations. This section discusses and illustrates the special considerations for disclosure in consolidated financial statements. Additional disclosures are required in the year of a business combination.

Materiality Considerations for Disclosures in Consolidated Financial Statements

Whether information should be disclosed depends on whether it is material to the consolidated financial statements. General considerations for assessing financial statement materiality were discussed earlier. Those considerations also apply when considering materiality for financial statement disclosures.

To illustrate the overall concept of materiality for disclosures in consolidated financial statements, assume that one of the organizations in the consolidated group is informed it is probable that it will lose a large grant subsequent to year-end. Further, while the amount of that grant is material to the financial results of that organization, it is not material to the consolidated financial results. Disclosure of the contingency is not necessary to keep the financial statements from being misleading because the loss of the grant is not material to the consolidated financial statements.

Consolidation Policy

FASB ASC 810-10-50-1 requires disclosure of the reporting entity's consolidation policy. The disclosure may be included in the summary of significant accounting policies, as the following examples illustrate:

> Principles of Consolidation
>
> The consolidated financial statements include the accounts of ABC Organization and its wholly owned subsidiary, DEF Company. All material intra-entity transactions have been eliminated.

or

> The consolidated financial statements include the accounts of ABC Organization and its 90%-owned subsidiary, DEF Company. All material intra-entity transactions have been eliminated in consolidation.
>
> *or*
>
> The consolidated financial statements include the accounts of ABC Organization and DEF Organization. DEF Organization is consolidated since ABC Organization has both an economic interest in DEF Organization and control of the Organization through a majority voting interest in its governing board. All material intra-entity transactions have been eliminated.

It is a best practice that the consolidation policy disclosure should identify situations when one or more subsidiaries have not been consolidated, the reasons they have not been included in the consolidated financial statements, and the method under which the unconsolidated subsidiaries are being reported in the consolidated statements that is, the equity method or the cost method). An illustrative disclosure follows:

> Principles of Consolidation
>
> The consolidated financial statements include the accounts of the Organization and all subsidiaries that are more than 50% owned except for its ABC subsidiary, which is accounted for by the cost method. The subsidiary is not consolidated because control of the subsidiary does not rest with the parent organization.

Financial Information about Members of the Consolidated Group

The amounts disclosed in the notes to consolidated financial statements generally should be the consolidated amounts rather than the amounts for the parent organization alone. Because consolidated financial statements are designed to present the financial results of the consolidated group, there is no need to also report the financial results of individual members of the consolidated group. Consistent with this notion, FASB ASC 850-10-50-1 states that transactions that are eliminated in consolidated or combined financial statements are not required to be disclosed in those statements.

Nevertheless, depending on the facts and circumstances, there may be a need for information about one or more of the entities in the consolidated group. The information could be disclosed in the notes to the consolidated financial statements or in supplementary information. *Consolidating* financial statements also could be issued.

Restrictions on Distributions

FASB ASC 958-810-50-1 requires disclosure if an entity that is not part of the consolidated group restricts distributions from a subsidiary to the nonprofit parent. The amount of the subsidiary's net assets unavailable for distribution to the parent because of the restriction should also be disclosed.

Noncontrolling Interests

FASB ASC 958-810-50-4 and 50-5 require nonprofit reporting entities with one or more less-than-wholly-owned subsidiaries to provide a schedule of changes in consolidated net assets reconciling beginning and ending balances attributable to the parent and to the noncontrolling interest by net asset class, either on the face of the consolidated financial statements or in the notes to financial statements. The disclosure should present amounts attributable to discontinued operations, changes in ownership interests in a subsidiary, presenting separately amounts for contributions from and distributions to noncontrolling interest owners, and all other changes in each class of net assets, in aggregate.

Losses in Excess of Equity in Subsidiaries

Losses from a subsidiary should be attributed to the interests of both the parent and the noncontrolling interest even if it results in a deficit balance for the noncontrolling interest. If the consolidated change in net assets attributable to the parent would have been significantly different if the noncontrolling interest had not been allocated a portion of the subsidiary's loss, the pro forma consolidated change in net assets attributable to the parent as if the previous requirements were applied should be disclosed.

Deconsolidation of a Subsidiary

If a subsidiary is deconsolidated, FASB ASC 810-10-50-1B requires disclosures about the gain or loss recognized as a result of the deconsolidation.

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 is accurate regarding presentation of consolidated financial statements?

    a. A nonprofit organization cannot be considered a subsidiary for consolidation purposes.

    b. Consolidated statement headings must contain the names of all subsidiaries.

    c. The term *consolidated* cannot be present in the financial statement title.

    d. Nonprofit organizations usually present comparative statements for both prior and current years.

15. Nonprofit A has an ownership interest in Subsidiary B. Nonprofit A is preparing a consolidated statement of financial position. What is the first step Nonprofit A should perform in order to eliminate the investment in Subsidiary B?

    a. Eliminate the carrying amount of the investment in Subsidiary B as of the beginning of the period.

    b. Eliminate the effects of all entries affecting the investment in Subsidiary B during the period.

    c. Record Nonprofit A's share of Subsidiary B's earnings.

    d. Eliminate transactions between Nonprofit A and Subsidiary B that took place prior to the date Subsidiary B qualified for consolidation.

16. Which of the following statements regarding differing fiscal years of parent and subsidiary is most accurate?

    a. A subsidiary should be excluded from consolidation if its fiscal year is not the same as the parent.

    b. A policy change of the use of different year-ends should be reported as a change in accounting principle.

    c. Consolidation is permitted using the subsidiary's fiscal period if it differs from the parent by no more than six months.

    d. GAAP provides specific detailed guidance on preparing consolidated statements involving different fiscal years.

17. When a nonprofit organization is preparing a consolidated statement of activities, which of the following tasks is it required to perform?

    a. Eliminate the profit on an asset sold to an entity outside the consolidated group.

    b. Allocate any intra-entity eliminated loss between itself and the noncontrolling interest.

    c. Eliminate any excess depreciation resulting from an intra-entity sale of a depreciable asset.

    d. Eliminate amortization of intra-entity sales of service if the purchasing entity expensed the service expenses.

18. Which of the following should be shown as a financing activity in a consolidated statement of cash flows?

    a. Dividends paid to a noncontrolling interest.

    b. Dividends received by a parent from a consolidating subsidiary.

    c. Cash received as a result of disposing of a consolidated subsidiary.

    d. Cash paid to acquire another nonprofit organization.

19. Which of the following statements regarding format considerations for the consolidated statement of functional expenses is correct?

    a. The main issue in preparing a consolidated statement of functional expenses is how to reconcile the change in net assets with cash flow from operating activities.

    b. Authoritative guidance states that nonprofit organizations should report expenses by their financial classifications.

    c. Expenses that are not associated with the organization's programs would be classified as supporting service expense.

    d. GAAP requires a total be shown for management and general expense on the consolidated statement of functional expenses.

20. Community Food Bank is preparing disclosures for their consolidated financial statements. Which of the following is correct for Community Food bank to consider during this process?

    a. Community Food Bank should disclose all events material to its subsidiaries.

    b. Community Food Bank must disclose its consolidation policy.

    c. The amounts disclosed in the consolidated statements should be for Community Food Bank alone.

    d. Community Food Bank should disclose all eliminated transactions.

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 is accurate regarding presentation of consolidated financial statements? **(Page 316)**

    a. A nonprofit organization cannot be considered a subsidiary for consolidation purposes. [This answer is incorrect. FASB ASC 810-10-20 terminology recognizes that a parent and subsidiary may be any form of legal entity, including nonprofit organizations.]

    b. Consolidated statement headings must contain the names of all subsidiaries. [This answer is incorrect. The headings of consolidated financial statements typically name the parent and refer to the subsidiaries collectively rather than listing them individually.]

    c. The term *consolidated* cannot be present in the financial statement title. [This answer is incorrect. Best practice indicates that the title *should* include the word *consolidated.* However, it is acceptable to place that term in front of the statement name or prior to the results presented.]

    d. Nonprofit organizations usually present comparative statements for both prior and current years. [This answer is correct. Nonprofit organizations typically present comparative financial statements for the current and prior year. However, authoritative accounting literature does not preclude presenting consolidated financial results in comparison with financial results for years not requiring consolidation.]

15. Nonprofit A has an ownership interest in Subsidiary B. Nonprofit A is preparing a consolidated statement of financial position. What is the first step Nonprofit A should perform in order to eliminate the investment in Subsidiary B? **(Page 317)**

    a. Eliminate the carrying amount of the investment in Subsidiary B as of the beginning of the period. [This answer is correct. The first step is to eliminate the carrying amount of the investment as of the beginning of the period by offsetting the investment against the stockholders' equity accounts of the subsidiary as of the beginning of the period.]

    b. Eliminate the effects of all entries affecting the investment in Subsidiary B during the period. [This answer is incorrect. Eliminating the effects of any entries recorded during the period that affected the carrying amount of the investment is the second step in the process to eliminate the investment in the subsidiary.]

    c. Record Nonprofit A's share of Subsidiary B's earnings. [This answer is incorrect. As a practical matter, unless consolidating financial statements are being issued, there is no need for an organization to record its share of the activities or earnings of subsidiaries. Most nonprofits account for their interest internally using the cost method instead.]

    d. Eliminate transactions between Nonprofit A and Subsidiary B that took place prior to the date Subsidiary B qualified for consolidation. [This answer is incorrect. Transactions between the organization and the subsidiary entity prior to the date the interest or relationship met the criteria for consolidation should not be eliminated.]

16. Which of the following statements regarding differing fiscal years of parent and subsidiary is most accurate? **(Page 322)**

    a. A subsidiary should be excluded from consolidation if its fiscal year is not the same as the parent. [This answer is incorrect. According to FASB 810-10-15-11, a subsidiary should not be excluded from consolidation just because its fiscal year differs from that of its parent.]

    b. A policy change of the use of different year-ends should be reported as a change in accounting principle. [This answer is correct. According to guidance in FASB 810-10-45-13, this type of policy change is considered a change in accounting principle and should be reported as such.]

c. Consolidation is permitted using the subsidiary's fiscal period if it differs from the parent by no more than six months. [This answer is incorrect. Guidance permits consolidation using the subsidiary's financial statements for its fiscal period if the parent's and subsidiary's fiscal years differ by no more than "about three months." Therefore, six months would not be acceptable.]

d. GAAP provides specific detailed guidance on preparing consolidated statements involving different fiscal years. [This answer is incorrect. GAAP actually provides little additional guidance about the unique accounting and presentation issues that may arise in preparing consolidated financial statements of entities having different fiscal years.]

17. When a nonprofit organization is preparing a consolidated statement of activities, which of the following tasks is it required to perform? **(Page 326)**

a. Eliminate the profit on an asset sold to an entity outside the consolidated group. [This answer is incorrect. Any intra-entity profit or loss on asset sales must be eliminated when consolidated financial statements are prepared. Intra-entity profit or loss is not considered to be realized until the asset is sold to an entity that is not a member of the consolidated group. Since the asset was sold outside the group, the profit will not need to be eliminated.]

b. Allocate any intra-entity eliminated loss between itself and the noncontrolling interest. [This answer is incorrect. All intra-entity profit or loss should be eliminated regardless of whether the selling entity is the parent, or wholly owned, or partially owned subsidiary. FASB ASC 810-10-45-18 states that intra-entity profit or loss that is eliminated may be allocated between the parent and noncontrolling interests, but it is not required.]

c. Eliminate any excess depreciation resulting from an intra-entity sale of a depreciable asset. [This answer is correct. The sale of a depreciable asset by the parent to a subsidiary at a profit causes the purchasing subsidiary's annual depreciation expense to be greater than the consolidated entity's annual depreciation should be. Both the intra-entity profit on the sale and the excess depreciation must be eliminated when preparing consolidated financial statements.]

d. Eliminate amortization of intra-entity sales of service if the purchasing entity expensed the service expenses. [This answer is incorrect. If the purchasing entity charges the cost of service to expense, the only eliminating entry would be to eliminate the service revenue and service expense. Elimination of amortization would only be necessary if the purchasing entity capitalized the cost of the intra-entity services.]

18. Which of the following should be shown as a financing activity in a consolidated statement of cash flows? **(Page 332)**

a. Dividends paid to a noncontrolling interest. [This answer is correct. Dividends paid by the subsidiary to a noncontrolling interest are not eliminated for the consolidated statements because they are paid to an entity that is not part of the consolidated group. Therefore, dividends paid to a noncontrolling interest should be shown as a financing activity in the consolidated statement of cash flows.]

b. Dividends received by a parent from a consolidating subsidiary [This answer is incorrect. Dividends received by the parent are eliminated in consolidated financial statements through an offset against the amount of distributions paid by the subsidiary. They offset each other in the consolidated reporting entity and require no separate presentation in the consolidated statement of cash flows.]

c. Cash received as a result of disposing of a consolidated subsidiary. [This answer is incorrect. If a transaction occurs such that a previously consolidated subsidiary is no longer a part of the reporting entity, the consolidated statement of cash flows should report any cash received from disposal of the business or nonprofit activity as an investing activity, not a financing activity.]

d. Cash paid to acquire another nonprofit organization. [This answer is incorrect. The acquisition of another nonprofit activity or organization usually affects several line items in the consolidated statement of cash flows. Cash consideration paid to acquire another entity is classified as an investing activity, not a financing activity.]

19. Which of the following statements regarding format considerations for the consolidated statement of functional expenses is correct? **(Page 334)**

a. The main issue in preparing a consolidated statement of functional expenses is how to reconcile the change in net assets with cash flow from operating activities. [This answer is incorrect. The primary issue in preparing a consolidated statement of functional expenses is how to present the expenses of the consolidated subsidiary.]

b. Authoritative guidance states that nonprofit organizations should report expenses by their financial classifications. [This answer is incorrect. FASB ASC 958-720-45-2 states that nonprofit organizations should report expenses by their functional expense classification, such as major classes of program services and supporting activities.]

c. Expenses that are not associated with the organization's programs would be classified as supporting service expense. [This answer is correct. Expenses that do not relate to the organization's programs would be included as supporting service expense, probably management and general.]

d. GAAP requires a total be shown for management and general expense on the consolidated statement of functional expenses. [This answer is incorrect. There is no GAAP requirement to show a total for management and general expenses. However, a column could also be included in the consolidated statement of functional expenses showing that total.]

20. Community Food Bank is preparing disclosures for their consolidated financial statements. Which of the following is correct for Community Food bank to consider during this process? **(Page 334)**

a. Community Food Bank should disclose all events material to its subsidiaries. [This answer is incorrect. Whether information should be disclosed depends on whether it is material to the consolidated financial statements. If an event is material to one organization but not material to the consolidated financial results then disclosure is not necessary in the consolidated statements.]

b. Community Food Bank must disclose its consolidation policy. [This answer is correct. FASB ASC 810-10-50-1 requires disclosure of the reporting entity's consolidation policy. The disclosures may be included in the summary of significant accounting policies.]

c. The amounts disclosed in the consolidated statements should be for Community Food Bank alone. [This answer is incorrect. The amounts disclosed in the notes to consolidated financial statements generally should be the consolidated amounts rather than the amounts for the parent organization alone.]

d. Community Food Bank should disclose all eliminated transactions. [This answer is incorrect. FASB ASC 850-10-50-1 states that transactions that are eliminated in consolidated or combined financial statements are not required to be disclosed in those statements.]

SEPARATE FINANCIAL STATEMENTS FOR ENTITIES IN THE CONSOLIDATED GROUP

GAAP provides guidance about whether financial statements of a parent organization can be issued as stand-alone financial statements or only as a supplement to consolidated financial statements. FASB ASC 810-10-45-11 states that presenting financial statements that include the financial results of the parent but not its subsidiaries is not a valid substitute for issuing consolidated financial statements. The nonauthoritative guidance at Q&A 1400.32 of the AICPA Technical Questions and Answers clarifies that if consolidation is required, and as a condition of a legal or regulatory agreement a nonprofit organization is required to submit parent-only financial statements without related consolidated financial statements, those statements are not in accordance with GAAP. If financial statements prepared in accordance with GAAP are necessary, FASB ASC 810-10-45-11 states that consolidating financial statements, in which one column is used for the parent and other columns for particular subsidiaries or groups of subsidiaries, often is an effective means of presenting the pertinent information.

Although not addressed in the authoritative literature, in some cases the financial statements of a subsidiary, branch, division, or affiliate of a parent organization may need to be presented alone. To illustrate, assume that ABC Organization has controlling financial interests in DEF Company and GHI Partnership. ABC Organization has no debt covenants or other requirements to issue financial statements.

a. ABC Organization could choose to issue financial statements for either DEF Company or GHI Partnership, or both DEF Company and GHI Partnership, for example, because of debt covenants of one or both of the entities.

b. ABC Organization could also choose to issue combined financial statements for DEF Company and GHI Partnership.

This course recommends the financial statements should clearly indicate that they are the financial statements of a subsidiary, branch, division, or affiliate. Such disclosure may be made in the heading of the financial statements [for example, DEF Company (a wholly-owned subsidiary of ABC Organization)], in other appropriate captions, or in the notes to the financial statements.

The separate financial statements issued for a subsidiary should disclose the related-party information required by FASB ASC 850-10-50-1 for transactions among it, the parent organization, and any other subsidiaries of the parent. If combined financial statements are issued for both subsidiaries, they need only disclose transactions with the parent because transactions among subsidiaries are eliminated in combined financial statements and are not required to be disclosed.

FASB ASC 850-10-50-5 states:

> Transactions involving related parties cannot be presumed to be carried out on an arm's-length basis, as the requisite conditions of competitive, free-market dealings may not exist. Representations about transactions with related parties, if made, shall not imply that the related party transactions were consummated on terms equivalent to those that prevail in arm's-length transactions unless such representations can be substantiated.

Most users of nonprofit organizations' financial statements do not expect transactions with related parties to be at arm's-length. Accordingly, the related-party disclosures only need to provide information about the terms of the transactions. There is no need to disclose information about how those terms were reached or how they would be different with a party that is not related.

Pushdown Accounting

Pushdown accounting allows an acquired entity to use the acquirer's basis when preparing its separate financial statements; essentially the amount the parent organization recognizes for the acquired organization's assets and

liabilities is "pushed down" to the subsidiary organization. Control may be obtained in various ways, including the following:

- Transferring cash or other assets
- Incurring liabilities
- Issuing equity interests
- Providing more than one type of consideration
- By contract alone or otherwise without providing consideration as discussed in FASB ASC 805-10-25-11

FASB ASC 805-50-25-4 provides acquired entities the option of applying pushdown accounting in their separate financial statements as of the date a controlling interest is obtained. The application of pushdown accounting is optional and may be elected (or not elected) when a change-in-control event occurs. If pushdown accounting is not elected in the period the change-in-control occurs, pushdown accounting may not be subsequently applied without a change in accounting principle. Each individual change-in-control event provides an opportunity for an organization to make an independent decision regarding the application of pushdown accounting; however, once an organization elects pushdown accounting for a specific change-in-control, it may not revoke the election. Because the option is only available when there has been a change in control, it is not available for a transaction that is a combination of commonly-controlled entities.

According to FASB ASC 805-50-30-10, pushdown accounting generally pushes down the values recorded by the acquiring entity in a business combination accounted for under FASB ASC 805. However, although goodwill may be recognized by the acquiree, FASB ASC 805-50-30-11 prohibits including bargain purchase gains, if any, in income. Instead, the gains would be recognized as an adjustment of the net assets of the organization. In addition, under FASB ASC 805-50-30-12, any acquisition-related liability incurred by the acquirer is pushed down only if the liability represents an obligation of the acquiree.

In the period pushdown accounting is applied, an organization is required to disclose that pushdown accounting was applied and sufficient information for the users of the financial statements to understand the effects of its application. This information may include the following:

- Name of the acquirer and description of how control was obtained.
- Date of the transaction.
- Fair value of the total consideration transferred to the acquiree.
- Amounts for each major class of assets and liabilities that the acquiree recognized as a result of applying pushdown accounting. If the recognition of pushdown accounting is incomplete for any amounts, the reasons why the initial recognition is incomplete.
- Qualitative factors that make up any goodwill recognized (e.g. synergies gained, intangible assets that may not be recognized separately) or the amount of any bargain purchase recognized in net assets and the reasons for the gain.
- Information about the financial effects of any adjustments recognized in the current reporting period related to the application of pushdown accounting occurring in the current or previous reporting periods.
- Any additional information considered necessary for the user to evaluate the effects of applying pushdown accounting.

CONSOLIDATING FINANCIAL STATEMENTS

Consolidated financial statements present the financial position, changes in net assets, and cash flows of the parent and its subsidiaries as if they were a single entity. *Consolidating* financial statements usually present in columnar form the financial position, changes in net assets, and cash flows of the parent and each of its subsidiaries, together with columns that show eliminations of intra-entity transactions and balances and the consolidated totals.

Consolidating financial statements for a parent organization and its two subsidiaries, for example, might be presented in the following format (left to right):

Column A—Parent's financial statements
Column B—Subsidiary #1's financial statements
Column C—Subsidiary #2's financial statements
Column D—Eliminations
Column E—Consolidated totals

Some organizations change the format (left to right) as follows—Columns E, D, A, B, and C. The two formats are equally acceptable.

Consolidating financial statements contain all the balances in columns A through E, but *consolidated* financial statements would include only the balances in column E.

Reporting Implications of Consolidating Financial Statements

When consolidating financial statements are presented, the consolidating amounts for each of the respective entities (columns A through C above) may be presented as part of the financial statements or as supplemental information. In either case, the consolidated totals in column E are part of the financial statements.

If the consolidating amounts for each of the respective entities (columns A through C above) are presented as part of the financial statements, accountants should report on each entity's financial statements that are included in the consolidated totals. In that case, accountants would report on columns A through C and E. Accordingly, the consolidating financial statements and accompanying notes should need to include all the disclosures that are necessary to present the separate financial statements of each entity in conformity with generally accepted accounting principles.

The balances shown in columns A through C (i.e., the balances for the individual entities—the parent and each of the subsidiaries) should be adjusted balances that are in accordance with GAAP. For example, the balances in column B for subsidiary #1 should be the same adjusted balances as those that would be reported in separate financial statements for subsidiary #1. Similarly, the balances shown in column A for the parent organization should be the adjusted balances that would be reported in parent organization only financial statements. That means, for example, that the carrying amount of the parent's investment account should be determined using the equity method of accounting. Nonprofit organizations that have a controlling financial interest in another entity typically account for their interest internally using the cost method. Those organizations will need to record their share of the activities or earnings of subsidiaries when consolidating financial statements are to be issued. However, there is no need for the parent to enter these adjustments into their accounting systems.

If the consolidating amounts (columns A through C) are presented as supplemental information only, generally accountants would report only on the consolidated financial statements (that is, the amounts in column E) as financial statements. The consolidating information would be reported on as supplemental information that would not be considered necessary for the fair presentation of the consolidated financial statements in conformity with generally accepted accounting principles. This seems to be the more common presentation for consolidating amounts.

When the consolidating amounts are presented as supplemental information, some accountants believe the balances shown in column A should be adjusted balances that are in accordance with GAAP. That is, they believe

that if the carrying amount of the investment in the subsidiary is determined using the cost method, it should be adjusted to reflect the equity method. Others believe it is permissible to show the investment in the subsidiary at cost in column A. Either approach is acceptable; however, if the investment is carried at cost, best practices suggest that this fact be disclosed in a note to the supplemental schedule. Some organizations even disclose that using the cost method is not in accordance with GAAP. (For a more detailed discussion of the reporting implications of consolidating financial statements, see *PPC's Guide to Auditor's Reports*.)

COMBINED FINANCIAL STATEMENTS

FASB ASC 810-10-55-1B points out that combined financial statements (as distinguished from consolidated financial statements) may be useful or even necessary in some cases. Combined financial statements are not limited to particular forms of entities. The following are two principal prerequisites for preparing combined financial statements:

a. The entities are under common management or are two or more entities that are related in their activities and controlled by the same entity.

b. Combined financial statements are more meaningful than separate statements.

The considerations in preparing combined financial statements are similar to those that apply to preparing consolidated financial statements. FASB ASC 810-10-45-10 states that intra-entity transactions and profits and losses should be eliminated in preparing combined financial statements as they would be in preparing consolidated financial statements. Noncontrolling interests, foreign operations, and differences resulting from different fiscal periods should be treated in the same manner as in consolidated financial statements.

The principal difference between consolidated and combined financial statements is that in combined financial statements, the net asset and equity accounts of the entities are combined rather than offset against an investment in subsidiaries account held by the parent entity.

Style and Format Considerations

Combined financial statements are similar to consolidated financial statements in that they present financial position, changes in net assets, and cash flows of an "economic" rather than a "legal" entity. Accordingly, the name in the heading of the financial statements should indicate the nature of the economic entity, such as ABC Organization and Affiliates.

Net Assets Section. The authoritative accounting literature does not address how to present the components of net assets and equity in combined financial statements. Since nonprofit organizations exist in various legal forms such as corporations, partnerships, and joint ventures, judgment will be required when the combined net assets and equity of entities of different legal forms are presented. Appropriate disclosure, therefore, will depend on the particular circumstances. The following examples show possible ways to show the components of net assets and equity in combined financial statements issued before the adoption of ASU 2016-14:

NET ASSETS (for two nonprofit organizations)	
Unrestricted	100,000
Temporarily restricted	50,000
Permanently restricted	30,000
TOTAL NET ASSETS	180,000

or

NET ASSETS (for two nonprofit organizations)	
Unrestricted	
ABC Organization	70,000
XYZ Organization	30,000
	100,000

Temporarily restricted	
ABC Organization	20,000
XYZ Organization	30,000
	50,000
Permanently restricted	
ABC Organization	15,000
XYZ Organization	15,000
	30,000
TOTAL NET ASSETS	180,000

or

NET ASSETS AND UNRESTRICTED MEMBERSHIP EQUITY	
Net Assets—ABC Organization	
Unrestricted	10,000
Temporarily restricted	15,000
Permanently restricted	20,000
TOTAL NET ASSETS	45,000
Unrestricted Membership Equity—DEF Association	
Capital stock, $1 stated value, 1,000 shares authorized and outstanding	1,000
Cumulative excess of revenue over expenses	14,000
TOTAL UNRESTRICTED MEMBERSHIP EQUITY	15,000
TOTAL NET ASSETS AND UNRESTRICTED MEMBERSHIP EQUITY	60,000

The following examples show possible ways to show the components of net assets and equity in combined financial statements issued after the adoption of ASU 2016-14:

NET ASSETS (for two nonprofit organizations)	
Without donor restrictions	100,000
With donor restrictions	80,000
TOTAL NET ASSETS	180,000

or

NET ASSETS (for two nonprofit organizations)	
Without donor restrictions	
ABC Organization	70,000
XYZ Organization	30,000
With donor restrictions	
ABC Organization	35,000
XYZ Organization	45,000
	80,000
TOTAL NET ASSETS	180,000

or

NET ASSETS AND UNRESTRICTED MEMBERSHIP EQUITY	
Net Assets—ABC Organization	
Without donor restrictions	10,000
With donor restrictions	35,000
TOTAL NET ASSETS	45,000

Unrestricted Membership Equity—DEF Association	
Capital stock, $1 stated value, 1,000 shares authorized and outstanding	1,000
Cumulative excess of revenue over expenses	14,000
TOTAL UNRESTRICTED MEMBERSHIP EQUITY	15,000
TOTAL NET ASSETS AND UNRESTRICTED MEMBERSHIP EQUITY	60,000

The components of net assets (and equity) also could be disclosed in a note to the financial statements.

EQUITY METHOD INVESTMENTS

The equity method is used to account for an investment in a for-profit entity if a nonprofit organization (a) has the ability to significantly influence the entity's financial and operating policies, (b) 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 increased for the organization's proportionate share of the investee's earnings and 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 also are made.

The carrying amount of 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 net assets and change in 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."

Measurement Using the Equity Method

Under the equity method, the investment is initially recorded at cost. Cost should be measured by cash paid (including transaction costs) or if not cash, the cost to the organization based on the fair value of the consideration given or the fair value of the assets received, whichever is more clearly evident. That investment is then increased or decreased by recording the investor's share of earnings or losses of such an investee. The basic principles to be observed are as follows:

a. An investor's equity in the operating results of an investee should be based on the shares of common stock held.

b. Intra-entity profits and losses should be eliminated until realized by the investor or investee.

c. Dividends on the investee's cumulative preferred stock should be deducted in computing an investor's share of earnings, whether or not such dividends are declared.

d. The investor ordinarily should discontinue applying the equity method when accounting for its share of losses reduces the investment to zero and should not provide for additional losses unless the investor has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee. If the investee subsequently reports net income, the investor should resume applying the equity method only after its share of that net income equals the share of net losses not recognized during the period the equity method was suspended. (See below for an exception to this treatment.)

If there is a difference between the cost of the investment and the organization's proportionate equity in the investee at acquisition, the difference should first be related to tangible and intangible assets of the investee based on their fair values. The investor should adjust the investment account and investment earnings by an amount that represents any additional depreciation or amortization related to the difference as if it were actually recorded by the investee. Any difference that cannot be related to specific assets is considered to be attributable to goodwill. As a

practical matter, unless the difference is material, it usually is accounted for as goodwill instead of attempting to associate it with specific assets and recording the related depreciation.

FASB ASC 323-10-35-23 through 35-26 state that if previous losses have reduced an equity investment to zero and the investor is not required to advance additional funds to the investee, the investor should continue to report its share of equity method losses to the extent of any other investments in the investee. Other investments in the investee include (but are not limited to) preferred stock, debt securities, and loans to the investee. The equity method losses should reduce the adjusted basis in other investments in the order of their priority in liquidation. The basis of the other investments should be adjusted for the equity method losses before adjusting their basis for fair value adjustments required by other accounting principles. Equity method losses should not be recorded after the adjusted basis of the other investments reaches zero. However, the investor should continue to track the amount of equity method losses so that if the investee subsequently reports net income, the investor can resume applying the equity method after its share of that net income equals the share of net losses not recognized during the period the equity method was suspended. The subsequent recording of equity method income should be applied to the adjusted basis of the other investments in reverse order of the application of the equity method losses.

Impairment. FASB ASC 323-10-35-32A states the investor should record its share of any impairment loss that is recognized by the investee. It should also consider the effect of that impairment on goodwill, if any, that was initially recorded because of a difference between the organization's cost for the investment and its proportional equity in the investee.

FASB ASC 323-10-35-31 states that a series of operating losses sustained by an equity method investee, or other factors, could indicate that an other than temporary decrease in value of the investment has occurred. An other than temporary impairment should be recorded even if it reduces the investment more than what would have been recognized in the normal application of the equity method. The investor should not separately test an investee's underlying assets when assessing impairment.

Examples of Equity Calculations

Assume the following facts for DEF Company (an equity investee):

			Net Book Value	
	Earnings	Dividends	100%	40%
At Acquisition			$ 75,000	$ 30,000
End of Year:				
1	$ 25,000	$ —	100,000	40,000
2	30,000	10,000	120,000	48,000
3	35,000	15,000	140,000	56,000
4	30,000	5,000	165,000	66,000
5	15,000	—	180,000	72,000

If ABC Organization buys 40% of the stock of DEF Company at book value, its statements would reflect the following:

	Increase for Earnings	Decrease for Dividends	Investment
At Acquisition			$ 30,000
End of Year:			
1	$ 10,000	$ —	40,000
2	12,000	4,000	48,000
3	14,000	6,000	56,000
4	12,000	2,000	66,000
5	6,000	—	72,000

To illustrate the mechanics of applying the equity method, the following entries would be made by ABC Organization in year 2:

Cash	4,000	
Investment		4,000
To record receipt of dividend.		
Investment	12,000	
Equity in earnings of DEF Company		12,000
To record earnings on investment.		

An Example with Intra-entity Profits. FASB ASC 323-10-35-7 requires eliminating all intra-entity profits or losses until realized by the investor or investee as if the investee were consolidated. (Note that if the investee is consolidated, GAAP requires the elimination of all intra-entity profit or loss, even though the investor owns less than 100% of the stock.) This course offers the following guidance on eliminating intra-entity profits and losses under the equity method:

a. Only intra-entity profits or losses on assets held by the investor or investee are candidates for elimination.

b. Upstream sales (i.e., the investee sells to the investor):

   (1) Eliminate all intra-entity profit or loss.

   (2) Compute the equity in the investee's earnings following the guidance earlier in this lesson.

c. Downstream sales (i.e., the investor sells to the investee):

   (1) The nonprofit investor should eliminate from its increase or decrease in net assets all of the intra-entity profit or loss less the related tax effect if the profit or loss is unrelated business income.

   (2) Compute the equity in the investee's earnings following the guidance earlier in this lesson. Note that the intra-entity profit or loss does not affect computation of the equity pick-up.

   (3) The eliminated profit and loss may be reflected in the investor's statement of financial position and statement of activities in the most meaningful manner in the circumstances.

The preceding guidance differs from the provisions of FASB ASC 323-10-35-9 and 35-10 about how to recognize intra-entity profit or loss from downstream sales when the investor holds less than a majority interest. Essentially, recognition of a portion of the intra-entity profit or loss is permitted when the sale is on an arm's-length basis. In that circumstance, the majority interest is, in effect, treated as a third party, and intra-entity profit or loss is recognized in proportion to the majority interest. This course recommends adopting a blanket policy of deferring all profit or loss on intra-entity sales because it complies with these provisions and also avoids the need to make subjective evaluations of whether sales are on an arm's-length basis.

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 measuring it at fair value at each reporting date. The earnings and losses that were accrued before the change should not be reversed or adjusted; such amounts should be included in the investment's carrying amount on the date that it no longer qualifies for equity method accounting.

b. When an investment in the common stock of a for-profit entity previously reported at fair value or by 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 10% 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) none 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.

Guidance in FASB ASC 250-10-45-1, indicates that changing to or from the equity method in these circumstances is not considered to be an accounting change.

Considerations for Financial Statement Presentation

Presenting the carrying amount of an equity method investment in an organization's statement of financial position and its net earnings or losses in the organization's statement of activities is not usually complicated. However, there are more considerations when the statement of cash flows is prepared.

When reconciling the change in net assets with cash flows from operating activities using the indirect method, the amount of the net earnings (loss) of the equity method investee included in the change in net assets must be subtracted from (added back to) the consolidated change in net assets to arrive at cash provided by operating activities. The amount of distributions received must be added because they provided cash. These adjustments convert the earnings recognized under the equity method to the amount of cash distributions received.

To illustrate, assume an organization recognized its proportionate share of earnings amounting to $100 from its equity method investee. It also received a distribution of $60 from this investee. The earnings of $100 from the equity method investee that is recognized in the statement of activities is subtracted from the change in net assets in the operating activities section of the statement of cash flows. The $60 dividend received from the investee is added to the same section of the statement of cash flows. The overall effect is that the organization's proportionate share of undistributed earnings ($40) is not reflected in the statement and only the $60 increase in cash is reported in the operating activities section of the statement of cash flows.

APPLYING THE EQUITY METHOD IN CERTAIN NONPROFIT TRANSACTIONS

GAAP provides guidance for nonprofit organizations that facilitate transfers of resources from a donor to an ultimate beneficiary. These transactions generally involve three parties:

- a donor that transfers assets to a recipient entity,
- a recipient entity that accepts the assets, and
- a specified beneficiary.

The transferred assets may be cash or noncash contributions, including securities, land, buildings, the use of facilities or utilities, supplies, services, intangible assets, and unconditional promises to give those assets in the future. In certain situations, the accounting for transactions involving transfers of assets is similar to equity method accounting. This section discusses how the equity method is applied in asset transfers that (a) are revocable, repayable, or reciprocal, and (b) involve financially interrelated entities.

Transactions That Are Revocable, Repayable, or Reciprocal

Transfers from a nonprofit organization to a foundation that raises, holds, or invests resources for the organization may be equity transactions as described in FASB ASC 958-20. The manner in which the transfers are recognized depends on whether the resource provider named itself or its affiliate as the beneficiary of the transferred assets.

The Resource Provider Names Itself as Beneficiary. If a resource provider specifies itself as beneficiary, it reports the transfer as a decrease of the asset transferred (or a payable if the transfer has not yet taken place but an agreement has been signed to transfer the assets) and an increase in another asset—an interest in the net assets of the recipient entity. The recipient entity reports the transfer as an increase in assets and as an equity transaction, which would appear as a separate line item in its statement of activities.

In subsequent periods, the resource provider adjusts its interest in the net assets of the recipient entity for its share of the change in net assets of the recipient entity. The method is similar to the equity method discussed earlier. For example, the recipient entity earns income or gains from the transferred assets. If those income and gains accrue to the resource provider, the resource provider increases its interest in the net assets of the recipient entity and reports a change in its interest in the net assets. The change should appear as a separate line item in the resource provider's statement of activities. Similarly, if the recipient entity incurs expenses or losses that reduce the resource provider's interest, the resource provider decreases its interest in the net assets of the recipient entity and reports a change in its interest in the net assets in its statement of activities. When the recipient entity eventually distributes income or gains to the resource provider, the resource provider reports the assets received and a decrease in its interest in the net assets of the recipient entity. (That accounting is similar to recognizing a dividend received from an investee when using the equity method.) The recipient entity reports a decrease in its assets and a distribution. Best practices indicate that the distribution would appear as a separate line item in that entity's statement of activities.

The Resource Provider Names Its Affiliate as Beneficiary. If a resource provider specifies its affiliate as beneficiary, it reports the transfer as a decrease of the asset transferred (or a payable if the transfer has not yet taken place but an agreement has been signed to transfer the assets) and an equity transaction, which would appear as a separate line item in its statement of activities. The affiliate reports the transfer as an asset—an interest in the net assets of the recipient entity—and an equity transaction, which would appear as a separate line item in its statement of activities. The recipient entity reports the transfer as an increase in assets and as an equity transaction, which would appear as a separate line item in its statement of activities. In subsequent periods, the beneficiary adjusts its equity interest for its share of the change in net assets of the recipient entity similar to the guidance discussed above for resource providers.

Transactions Involving Financially Interrelated Organizations

FASB ASC 958-20 also provides guidance for certain types of transactions that involve financially interrelated organizations. An example of financially interrelated entities involves a university foundation formed to raise financial support for a university, in which the university foundation can choose the timing of distributions to the university and the university does not control the university foundation. According to FASB ASC 958-20-15-2, recipient entities and specified beneficiaries are *financially interrelated entities* if the relationship between them has both of the following characteristics:

- One entity has the ability to influence the operating and financial decisions of the other, and
- One entity has an ongoing economic interest in the net assets of the other.

The university can influence the financial and operating decisions of the university foundation because the foundation's bylaws limit its activities to those that benefit the university; and since the foundation's activities accrue to the benefit of the university, the university has an ongoing economic interest in the net assets of the foundation.

When a recipient entity receives assets for a financially interrelated specified beneficiary, and the recipient entity is not a trustee, it reports the receipt of assets as contribution revenue. This contrasts with the general treatment of most common agency transactions as liabilities by recipient entities, and the treatment of certain asset transfers as equity transactions by recipient entities. The following paragraphs discuss how the beneficiary recognizes its interest in a financially interrelated organization.

The beneficiary recognizes its rights to the assets held by the recipient entity using a method similar to the equity method. Thus, periodically, such as in connection with preparing the financial statements, the specified beneficiary recognizes an increase (or decrease) in an asset—interest in the net assets of the recipient entity—and a change in its interest in the net assets of the recipient entity. That change should appear as a separate line item in the

beneficiary's statement of activities. Any distributions from the recipient entity to the beneficiary would be recorded by the beneficiary as a decrease in its interest in the net assets of the recipient entity. (That accounting is similar to recognizing a dividend received from an investee when using the equity method.) The recipient entity would report those distributions as decreases in its net assets, appearing on a separate line in its statement of activities. According to FASB ASC 958-20-45-3, the beneficiary's interest in the net assets of the recipient entity needs to be eliminated if the beneficiary and the recipient entity are included in consolidated financial statements.

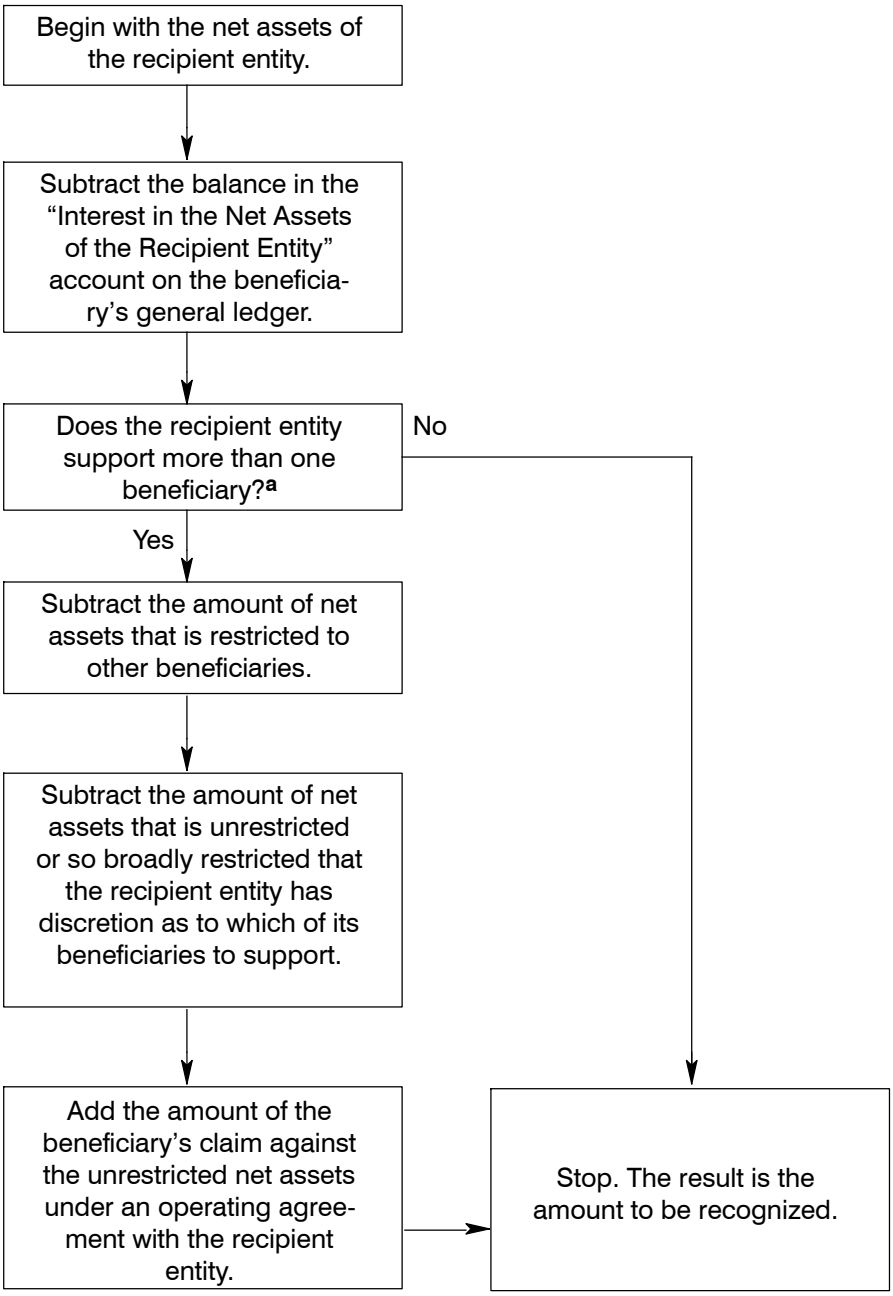
Exhibit 2-2 illustrates how to compute the amount of the change in the interest in the net assets of the recipient entity (often called the equity pickup when using the equity method). Before beginning the calculation, the beneficiary should book any entries necessary to reconcile its "Receivable from Recipient Entity" account on its general ledger to the "Payable to Beneficiary" account on the recipient entity's general ledger. That ensures that any distributions promised by the recipient entity, but not yet paid, are properly reflected in the "Interest in the Net Assets of the Recipient Entity" account before the period-end adjustments are made.

If the specified beneficiary is the only beneficiary of the recipient entity, the change that is recognized by the beneficiary is the difference between the net assets of the recipient entity and the beneficiary's general ledger balance of the "Interest in the Net Assets of the Recipient Entity" account. (An alternate computation that results in the same amount for recognition is the sum of the change in net assets and the distributions to the beneficiary, as reported in the recipient entity's statement of activities.)

If the specified beneficiary is one of several beneficiaries, the computation of the amount of the change is more complex. When measuring its interest in the recipient entity, the specified beneficiary excludes any net assets of the recipient entity that are restricted to other beneficiaries' use. By including the total restricted net assets (net assets with donor restrictions after the adoption of ASU 2016-14) of the recipient entity and excluding those restricted to other beneficiaries' use, the specified beneficiary records its interest in the recipient's net assets that are restricted to that beneficiary's use. It includes only its share of the unrestricted net assets (net assets without donor restrictions after the adoption of ASU 2016-14) of the recipient entity, computing that amount using any agreement that determines the beneficiary's claim against the unrestricted net assets (net assets without donor restrictions after the adoption of ASU 2016-14). If there was no agreement specifying the distribution and the recipient entity could choose how to distribute the unrestricted net assets (net assets without donor restrictions after the adoption of ASU 2016-14) among the beneficiaries, the specified beneficiary would not include a share of the recipient entity's unrestricted net assets (net assets without donor restrictions after the adoption of ASU 2016-14). Similarly, if the recipient entity had any net assets on which the only restriction was a time restriction (and, thus, those net assets would be unrestricted (without donor restrictions after the adoption of ASU 2016-14) once the specified time had elapsed), the beneficiary includes its share of those restricted net assets, computing that amount using the same agreement that determined the beneficiary's claim against the unrestricted net assets (net assets without donor restrictions after the adoption of ASU 2016-14), if any. The change to be recognized by the beneficiary is the difference between the amount of net assets held by the recipient entity for the benefit of the beneficiary and the amount recorded in the beneficiary's general ledger in the "Interest in the Net Assets of the Recipient Entity" account immediately before the entry.

Exhibit 2-2

Computing the Amount of the Change in Interest in the Recipient Entity Before the Effective Date of ASU 2016-14



Note:

[a] If the recipient entity supports only a single beneficiary, an alternate formula (that yields the same results) is the change in net assets of the recipient entity plus the distributions to the beneficiary expensed by the recipient entity during the year.

* * *

The change in the interest in the net assets of the recipient entity should be reported as a change in the appropriate class or classes of net assets of the beneficiary. Nonauthoritative guidance at Q&A 6140.13–.18 of the AICPA Technical Questions and Answers clarifies how the beneficiary should classify that change and when expenditures of the beneficiary result in a reclassification of net assets held by the recipient entity for the benefit of the beneficiary.

In general, according to the nonauthoritative guidance at Q&A 6140.13–.18 of the AICPA Technical Questions and Answers, the classification depends on whether the beneficiary can influence the financial decisions of the recipient entity to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient entity to the beneficiary. If the beneficiary has that ability, the beneficiary entity classifies the change in net assets as though the recipient entity had not participated in the contribution transactions (that is, as if the transactions had occurred directly between the donor and the beneficiary). A change in the unrestricted net assets of the recipient entity results in a similar change in the unrestricted net assets of the beneficiary. A change in temporarily restricted net assets of the recipient entity often results in a similar change in the temporarily restricted net assets of the beneficiary. However, if the only restriction on the temporarily restricted net assets of the recipient entity is a restriction to direct the net assets to the beneficiary, then those temporarily restricted net assets are unrestricted net assets when reported by the beneficiary.

If the beneficiary does not have influence to such an extent that it can determine the timing and amount of the distributions from the recipient entity, then the beneficiary implies a time restriction on any net assets held on its behalf by the recipient entity. Because payments from the recipient entity will be paid in future periods, a time restriction is implied on the net assets in the same manner as time restrictions are implied on promises to give that are due in future periods. That implied time restriction is in addition to any restrictions placed by the donor. Thus, an increase in the unrestricted net assets of the recipient entity generally is classified as an increase in temporarily restricted net assets by the beneficiary. Similarly, a change in temporarily restricted net assets of the recipient entity is classified as a change in temporarily restricted net assets of the beneficiary because the net assets are subject to some or all of the following restrictions:

- Donor-imposed purpose restrictions.
- Donor-imposed time restrictions—explicit or implied.

The guidance in the AICPA Technical Q&As also notes that the timing of the release of restrictions also depends on whether the beneficiary can influence the financial decisions of the recipient entity to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient entity to the beneficiary. If the beneficiary has that ability, the beneficiary entity recognizes the release of restrictions as if the recipient entity had not participated in the contribution transactions (that is, as if the transactions had occurred directly between the donor and the beneficiary). Accordingly, expenditures by the beneficiary that meet purpose restrictions on the net assets of the recipient entity result in both the beneficiary and the recipient entity reporting reclassifications from temporarily restricted net assets to unrestricted net assets (net assets without donor restrictions after the adoption of ASU 2016-14). There are three exceptions to that rule. Those reclassifications are not made (a) if the net assets at the recipient entity are subject to time restrictions that have not lapsed, (b) until the asset is placed in service (instead of when the expenditure is incurred) if the purpose is to purchase or build a fixed asset, or (c) if the beneficiary chooses to use its own net assets that are restricted for the same purpose.

If the beneficiary does not have influence to such an extent that it can determine the timing and amount of the distributions from the recipient entity, then the beneficiary recognizes the release of restrictions when the recipient entity distributes or obligates itself to distribute the net assets (time restriction) and the beneficiary incurs an

expenditure consistent with the purpose restriction. There are two exceptions to that rule. First, reclassifications are made if the recipient entity has no discretion in determining whether the restriction is met (for example, the net assets are restricted to a specific one-time event that is currently occurring, such as defraying a Museum's costs of inviting a traveling exhibit of Monet's water lilies). Second, if the purpose is to purchase or build a fixed asset, the purpose restriction does not expire until the asset is placed in service (rather than when the expenditure is incurred).

Example Involving Financially Interrelated Entities

The FASB has issued new guidance in ASU 2016-14 which reduces the three classes of net assets in current GAAP 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* upon adoption of ASU 2016-14. To avoid unnecessary complexity in the illustrative example, the authors combine the net asset descriptions and certain other descriptions that are applicable before and after the adoption of the ASU.

Assume that Hometown Church and Hometown Religious Foundation are financially interrelated. The Church does not control the Foundation, but the Foundation does raise funds exclusively for the benefit of the Church. Assume the following information:

Unrestricted Net Assets/Net Assets without donor restrictions of the Foundation	
January 1, 20X7	$ 50,000
December 31, 20X7	60,000
December 31, 20X8	35,000

Distributions Made by the Foundation to the Church	
March 30, 20X7	$ 15,000
June 30, 20X8	20,000

The Church would record the following journal entries to reflect its interest in the net assets of the Foundation:

January 1, 20X7		
Interest in net assets of Foundation	50,000	
Change in interest in net assets of Foundation—temporarily restricted/with donor restrictions		50,000
March 30, 20X7		
Cash	15,000	
Interest in net assets of Foundation		15,000
December 31, 20X7		
Interest in net assets of Foundation	25,000	
Change in interest in net assets of Foundation—temporarily restricted/with donor restrictions		25,000
June 30, 20X8		
Cash	20,000	
Interest in net assets of Foundation		20,000
December 31, 20X8		
Change in interest in net assets of Foundation—temporarily restricted/with donor restrictions	5,000	
Interest in net assets of Foundation		5,000

CHANGES IN THE GROUP OF ENTITIES FOR WHICH FINANCIAL RESULTS ARE REPORTED

Consolidated financial statements present the financial results of entities that are part of the consolidated group, and combined financial statements present the financial results of entities that are part of the combined group. Is a change in the entities whose financial results are reported in consolidated or combined financial statements an *accounting change* under FASB ASC 250-10? Determining when a change in reporting entity occurs is important because:

a. If the change in the entities whose financial results are reported is considered to be a *change in the reporting entity*, as discussed below, it is an accounting change that requires retrospective application. Under retrospective application, the financial results of all periods presented in the financial statements should be for the same group of entities.

b. If the change in the entities whose financial results are reported is not considered to be a change in the reporting entity, it is not considered to be an accounting change and generally does not require retrospective application.

Recognizing an organization's share of another entity's activities (earnings) through the equity method does not mean that the other entity's financial results are being presented.

FASB ASC 250-10 provides guidance on how to account for an accounting change, which FASB ASC 250-10-20 defines as "a change in an accounting principle, an accounting estimate, or the reporting entity." The guidance for accounting changes only applies if the change in the entities whose financial results are reported constitutes a *change in the reporting entity*. FASB ASC 250-10-20 states that a change in the reporting entity takes place when the one of the following occurs:

a. Consolidated or combined financial statements are presented in place of the financial statements of individual entities,

b. Specific subsidiaries comprising the group of entities for which consolidated financial statements are presented change, or

c. Entities included in combined financial statements change.

FASB ASC 958-810 permits (but does not require) a nonprofit organization that has control over, and an economic interest in, another nonprofit organization by contract, affiliation agreement, or other means to consolidate that entity's activities. In such cases, if the controlling organization changes its policy and does not consolidate the controlled entity in a subsequent year, a change in reporting entity has occurred. (Best practices indicate that the key factor is whether the consolidated entities change as a result of a change in policy or the occurrence of an event or transaction. In this example, a change in reporting entity has occurred because the controlling organization changed its consolidation policy to another acceptable policy. However, if it did not change its policy and did not consolidate the controlled entity as the result of an event, such as the expiration of the affiliation agreement, a change in reporting entity would not have occurred.)

The guidance does not distinguish between voluntary and involuntary changes in the group of entities whose financial results are presented. Generally, there is an underlying notion that a change in accounting caused by a change in facts and circumstances is not an accounting change. FASB ASC 250-10-45-1 indicates that the following items are not considered a change in accounting principle:

a. Adoption of an accounting principle related to events or transactions that are occurring for the first time or that were previously immaterial.

b. Adoption or modification of an accounting principle due to the occurrence of transactions or events that, in substance, are clearly different from those occurring in the past.

While that guidance is only specifically in the context of one type of accounting change—a change in accounting principle— it likely applies to all accounting changes and that the guidance in FASB ASC 250-10 relates to selecting alternative treatments.

Consistent with this notion, FASB ASC 250-10-20 states that a business combination, which is the acquisition of a controlling financial interest, is not a change in the reporting entity and is therefore not an accounting change. An organization can only acquire a controlling financial interest in another entity through a transaction or event. Although the guidance only addresses whether the acquisition of a controlling financial interest is a change in reporting entity, best practices indicate the disposition of a controlling financial interest also is not a change in reporting entity. Just as a controlling financial interest can only be acquired through a transaction or event, an organization can cease to have a controlling financial interest in another entity only because of a transaction or event.

Nonprofit organizations should rarely have a change in the group of entities whose financial results are presented that would be considered an accounting change and require retrospective application. Such a change in the group of entities will likely be limited to—

a. A change required to be applied retrospectively by a change in generally accepted accounting principles.

b. A decision to issue financial statements just for the subsidiaries and to not issue consolidated financial statements.

c. A change in the entities whose financial results are presented in combined financial statements that is prompted by a change in policy. (Best practices indicate that a change in the reporting entity that is considered to be an accounting change does not occur if the change is prompted by a transaction or event, such as when one of the entities ceases to be commonly controlled.)

SELF-STUDY QUIZ

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

21. When consolidating financial statements are presented, nonprofit organizations that have a controlling financial interest in another entity usually account for the investment internally using which accounting method?

    a. Cost method.

    b. Carryover method.

    c. Acquisition method.

    d. Equity method.

22. How are combined financial statements and consolidated financial statements similar?

    a. Net assets and equity accounts are combined.

    b. Financial position is presented for a "legal" entity.

    c. Intra-entity transactions and profits and losses are eliminated.

    d. Financial position is presented in a columnar form for each separate entity.

23. Which of the following is an accurate basic principle of measurement using the equity method?

    a. Intra-entity losses cannot be eliminated until the loss is realized by the investee or the investor.

    b. Dividends on the investee's stock should be added when computing the investor's share of earnings.

    c. The equity of the investor in the operating results of an investee should be calculated on the held shares of common stock.

    d. The investor should continue using the equity method when the investment is reduced to zero after accounting for its share of losses.

24. Which of the following is accurate regarding changing to or from the equity method?

    a. If the ability to significantly influence an entity is lost, an organization should stop accruing its share of the entity's earnings.

    b. An organization cannot change from the equity method once it has been adopted.

    c. Earnings and losses accrued while using the equity method should be reversed if the organization no longer qualifies for equity method accounting.

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. When consolidating financial statements are presented, nonprofit organizations that have a controlling financial interest in another entity usually account for the investment internally using which accounting method? **(Page 344)**

    a. Cost method. [This answer is correct. Nonprofit organizations that have a controlling financial interest in another entity typically account for their interest internally using the cost method. Those organizations will need to record their share of the activities or earnings of subsidiaries when consolidating statements are issued. However, the parent will not need to enter these adjustments into their accounting system.]

    b. Carryover method. [This answer is incorrect. The carryover method of accounting is used during combination transactions involving two or more nonprofit organizations qualifying as a merger. Under the carryover method, a new organization is created by combining assets, liabilities, and net assets of the merged organization.]

    c. Acquisition method. [This answer is incorrect. The acquisition method of accounting is used if a combination of two or more organizations is not a merger. It is required to be used for all business combinations involving nonprofit organizations and for-profit entities.]

    d. Equity method. [This answer is incorrect. If consolidated financial statements are not presented, the nonprofit reporting entity's interest in another entity may be required to be reported using the equity method. However, this is not an internal only option to be used in consolidating statements.]

22. How are combined financial statements and consolidated financial statements similar? **(Page 345)**

    a. Net assets and equity accounts are combined. [This answer is incorrect. The principal difference between consolidated and combined financial statements is that in combined statements, net assets and equity accounts of the entities are combined rather than offset against an investment in subsidiaries account held by the parent entity.]

    b. Financial position is presented for a "legal" entity. [This answer is incorrect. Combined financial statements are similar to consolidated statements in that they present financial position, changes in net assets, and cash flows of an "economic" rather than "legal" entity.]

    c. Intra-entity transactions and profits and losses are eliminated. [This answer is correct. Per FASB 810-10-45-10, intra-entity transactions and profits and losses should be eliminated in preparing combined financial statements as they would be in preparing consolidated financial statements.]

    d. Financial position is presented in a columnar form for each separate entity. [This answer is incorrect. Consolidating financial statements, not combined or consolidated statements, are usually presented in a columnar form showing financial position, changes in net assets, and cash flows of the parent and each of its subsidiaries along with columns showing eliminations and the consolidated total.]

23. Which of the following is an accurate basic principle of measurement using the equity method? **(Page 347)**

    a. Intra-entity losses cannot be eliminated until the loss is realized by the investee or the investor. [This answer is incorrect. One of the basic principles under the equity method is that intra-entity profits and losses *should be* eliminated until realized by the investor or investee.]

    b. Dividends on the investee's stock should be added when computing the investor's share of earnings. [This answer is incorrect. Dividends on the investee's cumulative preferred stock should be *deducted,* not added, in computing an investor's share of earnings. This should be done whether or not such dividends are declared.]

c. The equity of the investor in the operating results of an investee should be calculated on the held shares of common stock. [This answer is correct. Under the equity method, the investment is initially recorded at cost. One of the basic principles to be observed under this method is that an investor's equity in the operating results of an investee should be based on the shares of common stock held.]

d. The investor should continue using the equity method when the investment is reduced to zero after accounting for its share of losses. [This answer is incorrect. The investor ordinarily should *discontinue* applying the equity method when accounting for its share of losses reduces the investment to zero and should not provide for additional losses unless the investor has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee.]

24. Which of the following is accurate regarding changing to or from the equity method? **(Page 349)**

a. If the ability to significantly influence an entity is lost, an organization should stop accruing its share of the entity's earnings. [This answer is correct. When an organization loses its ability to significantly influence the entity, it should stop accruing its share of the entity's earnings or losses.]

b. An organization cannot change from the equity method once it has been adopted. [This answer is incorrect. 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. This can occur when an organization buys or sells shares of the investee's stock changing the ownership percentage and ability to exercise influence.]

c. Earnings and losses accrued while using the equity method should be reversed if the organization no longer qualifies for equity method accounting. [This answer is incorrect. If an organization loses its ability to significantly influence an entity, any earnings and losses that were accrued before the change should not be reversed or adjusted. The amounts should be included in the investment's carrying amount on the date that it no longer qualities for equity method accounting.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Preparing Nonprofit Financial Statements—Course 3—Affiliated Organizations and Other Related Entities (NFSTG183)

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.tr.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 $95 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 ($95 for email or fax; $105 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
     NFSTG183 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 ($95 for answer sheets sent by email or fax; $105 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 $271 (a 5% discount on all three courses). If you complete four courses, the price for

grading all four is $342 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $404 (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 **May 31, 2019**. 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 Preparing Nonprofit Financial Statements—Course 3—Affiliated Organizations and Other Related Entities (NFSTG183)

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. What percentage of outstanding voting interest in a for-profit entity must a reporting nonprofit organization own to have the controlling financial interest?

   a. Over 25%

   b. Over 40%

   c. Over 45%

   d. Over 50%

2. Which of the following is commonly referred to as a one-line consolidation?

   a. The equity method.

   b. Combined financial statements.

   c. The acquisition method.

   d. The carryover method.

3. Which of the following is considered the reporting entity?

   a. The entity that appoints the most board members.

   b. The entity that reports its financial results in the financial statements.

   c. The entity that retains more key senior officers.

   d. The entity that retains the most operating by-laws, policies and practices.

4. FASB ASC 958-805-55-1 states which of the following is the sole determinative criterion of a merger?

   a. Yielding of control by the combining organizations.

   b. The financial capacity of the participants.

   c. The new organization forming a new legal entity.

   d. One organization dominating the combination process.

5. Two merging nonprofit organizations that combine assets and liabilities should use which accounting method?

   a. Pooling of interest method.

   b. Acquisition method.

   c. Purchase method.

   d. Carryover method.

6. Which of the following should not be reflected in the statement of cash flows of a new organization formed in a merger?

   a. The merger itself.

   b. Assets.

   c. Liabilities.

   d. Net assets.

7. Nonprofit A has acquired assets and liabilities that do not constitute a nonprofit activity or a business. How would these transactions be accounted for?

   a. Contribution revenue.

   b. Purchase.

   c. Asset acquisition.

   d. Intangible asset.

8. Generally, identifiable assets acquired during a business combination should be measured how?

   a. At fair value as of the year end date of the acquiree.

   b. At fair value as of the acquisition date.

   c. At original cost of the assets.

   d. Using a valuation allowance.

9. Which of the following best describes contingent consideration?

   a. The acquirer's obligation to transfer additional assets or equity to original owners if specified future events occur.

   b. A right to the return of consideration transferred previously that should be classified as a liability.

   c. The assets transferred by the acquirer in an acquisition.

   d. Liabilities incurred by the acquirer for the former owners of the acquiree.

10. What are acquisition-related costs in an acquisition transaction?

    a. Expenses of the acquiree during the period after the transaction.

    b. Assets transferred by the acquiree to an unrelated third party as a required part of the transaction.

    c. An obligation to pay contingent consideration to the former owner.

    d. Costs incurred by the acquirer to effect an acquisition.

11. Which of the following is referred to as the highest level of control?

    a. Investment interest.

    b. Economic interest.

    c. Controlling financial interest.

    d. Consolidated financial interest.

12. Which of the entities listed below can use the fair value option for financial instruments?

    a. A lease with a special-purpose leasing entity.

    b. A contractual management relationship with another entity

    c. A general partnership when the organization is a partner in a partnership engaged in real estate activities.

    d. A corporation when the organization owns a majority of the investee's outstanding common stock.

13. In which of the following cases would the nonprofit organization consolidate a for-profit entity's financial results into its financial statements?

    a. The subsidiary is in legal reorganization; therefore, the nonprofit organization does not have controlling financial interest.

    b. The subsidiary operates under foreign exchange restrictions.

    c. The noncontrolling shareholders have veto rights that restrict power over operations.

    d. The nonprofit organization directly owns 60% of outstanding voting shares of the for-profit entity.

14. How might an entity exercise significant influence over operating and financial policies of another entity?

    a. Participating in policy-making processes.

    b. Eliminating the current board of directors.

    c. Filing a complaint against the organization.

    d. Remaining technologically independent.

15. Which of the following is correct regarding consolidation of a corporate entity?

    a. The holder of 15% to 25% of the corporate voting stock usually has the ability to exercise significant influence.

    b. Holding 20% or more of voting stock does not create an unqualified requirement to use the equity method.

    c. Holding 20% ownership of a nonpublic company is always considered adequate for significant influence.

    d. In-substance common stock holdings do not have to be considered when determining significant influence.

16. If a nonprofit organization forms a general partnership with another entity, how should the interest be reported by the organization?

    a. At fair value even though the organization did not elect the fair value option until year-end.

    b. Using the equity method if control of the general partnership rests with the nonprofit organization.

    c. At fair value assuming the nonprofit elected the fair value option at the time of becoming a partner.

    d. If it is a noncontrolling interest with control divided equally, it should be consolidated.

17. Which of the following is accurate regarding programmic investments?

    a. The production of income is a significant purpose of the investment.

    b. The primary purpose is to advance the organization's charitable objectives.

    c. Programmic equity interests are typically in nonprofit entities with a contribution element.

    d. Programmic equity investments will never generate net losses.

18. Nonprofit A allows Nonprofit B to use its national name if Nonprofit B agrees to certain financial relationships with Nonprofit A. This is an example of what type of control?

    a. Oversight relationship.

    b. Ownership.

    c. Charter or articles of incorporation.

    d. Contract.

19. Nonprofit A chooses not to consolidate its interest in Nonprofit B. Nonprofit A has an economic interest and control in Nonprofit B by contract rather than a controlling financial interest or majority voting interest. Which of the following is **not** a required disclosure in Nonprofit A's financial statements?

    a. External restrictions on distributions from Nonprofit B.

    b. The identification of Nonprofit B and the nature of their relationship.

    c. A summary of Nonprofit B's financial information.

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

20. If a newly formed nonprofit organization has economic interest over another nonprofit organization but no control, how should it be reported?

    a. The financial statements for the two organizations should be consolidated.

    b. Their financial statements should be consolidated but with disclosures on external restrictions.

    c. The reporting nonprofit organization should make disclosures as required by FASB ASC 850-10-50 but not consolidate.

    d. Do not select this answer choice.

21. When presenting consolidated financial statements for two nonprofit organizations, which of the following is accurate?

    a. Classifications of assets must be the same in the consolidated statements and the separate statements of the parent and subsidiary.

    b. Net asset classifications should be applied from the reporting entity's perspective.

    c. Subsidiary names should be individually listed in the heading of the consolidated statements.

    d. Third-party restrictions placed on distributions from a subsidiary to a parent do not have to be disclosed.

22. When preparing a consolidated statement of financial position, what should be eliminated?

    a. Only the account receivable recognized by the parent organization.

    b. Only the account payable recognized by the subsidiary organization.

    c. All transactions and balances between the entities.

    d. No transactions are eliminated unless they are recorded in the accounting system.

23. Which of the following is accurate for consolidations when there is a preexisting relationship?

    a. The organization is required to include the activities of the other entity in its statements for the entire initial year.

    b. Intra-entity transactions and balances from the date the investee qualifies for consolidation through the reporting period end should be eliminated.

    c. Transactions that took place prior to the date the relationship met the criteria for consolidation must be eliminated.

    d. Any financial transactions made prior to the business combination date should be considered part of the consideration for the purchase.

24. Which of the below intra-entity balances and transactions typically include profit or loss?

    a. Intra-entity sales with markup.

    b. Promises to give and grant payable.

    c. Advances between subsidiary and parent.

    d. Notes receivable and notes payable.

25. When is it appropriate to realize intra-entity profit on the sale of an asset in a consolidated statement of activities?

    a. When one member of the consolidated group sells the asset to another member of the consolidated group for a gain.

    b. When the year-end consolidated statements are prepared.

    c. When the asset is sold to an entity that is not a member of the consolidated group.

    d. Only when the selling entity is the parent or a wholly owned subsidiary.

26. When an intra-entity sale of services occurs, which of the following types of eliminating entries would be made if the purchasing entity charges the cost of services to expense?

    a. The elimination of any intra-entity profit and the amortization of the capitalized services.

    b. The elimination of the service revenue and the service expense in the period that the intra-entity sale of services takes place.

    c. The elimination of the intra-entity rent expense and rent revenue and any related rent receivable or rent payable.

    d. No eliminating entry is necessary for this type of transaction.

27. When preparing a consolidated statement of cash flows, the noncontrolling interest's share of the consolidated changes in net assets is not reported under which of the following methods?

    a. Fair value.

    b. Cost.

    c. Indirect.

    d. Direct.

28. What treatment does a parent's equity in undistributed earnings of a consolidated subsidiary require in a consolidated statement of cash flows?

    a. No separate presentation or adjustment is required.

    b. It should be shown as a financing activity in the consolidated statement of cash flows.

    c. Adjustments and disclosures are required in the consolidated statement.

    d. It should be disclosed as a noncash investing and financing activity.

29. If a previously consolidated subsidiary is sold, how should the cash received from the disposal of the business be reported in the consolidated statement of cash flows?

    a. Noncash investing and financing activity.

    b. Investing activity.

    c. Operating activity.

    d. Not reflected in the statement.

30. The decision as to whether information should be disclosed in consolidated financial statements depends on which of the following?

    a. How expenses are classified and allocated to significant programs.

    b. If the subsidiary's net assets are available for distribution to the parent.

    c. If it is material to the consolidated financial statements.

    d. The year of the business combination.

31. Which of the following is accurate regarding consolidating financial statements?

    a. Consolidating amounts for each entity may be presented as part of the financial statements or as supplemental information.

    b. The format for consolidating statements requires the consolidated total to be presented first.

    c. They present the financial position of the parent and its subsidiaries as if they were a single entity.

    d. Eliminations of intra-entity transactions and balances are not included.

32. What is the main difference between combined and consolidated financial statements?

    a. Combined financial statements are limited to certain forms of entities.

    b. In combined statements, the net assets and equity accounts are combined rather than offset against an investment in subsidiaries account.

    c. Foreign operations are treated differently in combined statements than in consolidated statements.

    d. Intra-entity transactions are not eliminated when preparing combined financial statements.

33. Which of the following statements regarding the style and format of combined financial statements is the most accurate?

    a. Combined financial statements present the financial position of a legal entity rather than an economic entity.

    b. Presentation of net asset components in combined financial statements is addressed in authoritative accounting literature.

    c. The components of net assets and equity can be disclosed in a note to the financial statements.

    d. The heading of combined financial statements should only contain the name of the parent entity.

34. Under the equity method, an investment is initially recorded how?

    a. At cost.

    b. At fair value.

    c. The purchase method.

    d. The carryover method.

35. Which of the options below accurately describes how impairment should be handled if using the equity method for investments?

    a. The investor's share of impairment loss recognized by the investee should not be recorded.

    b. The investor should not separately test the underlying assets of an investee when assessing impairment.

    c. The effect of impairment on goodwill should not be considered by the investor.

    d. If an other than temporary impairment occurs, it should not be recorded.

36. When an investment in common stock of a for-profit entity that was previously reported at fair value becomes eligible for equity accounting, what treatment is correct?

    a. The organization should add the cost of acquiring the additional interest to its existing investment and adopt the equity method at the date significant influence was obtained.

    b. The organization should adopt the equity method back to the original investment date and expense the cost of acquiring the additional interest.

    c. The organization should continue measuring the investment at fair value at each reporting date.

    d. Do not select this answer choice.

37. A nonprofit organization may facilitate transfers of assets from a donor to an interrelated beneficiary. If the transaction is revocable, repayable, or reciprocal, what accounting method should be applied?

    a. The carryover method.

    b. The acquisition method.

    c. The equity method.

    d. The cost method.

38. If a resource provider specifies its affiliate as beneficiary in a reciprocal transfer of assets, how is the transfer reported by the resource provider?

    a. The resource provider reports the transfer as an increase in assets and an equity transaction.

    b. The resource provider reports the transfer as a decrease of the asset transferred and an equity transaction.

    c. The resource provider reports the transfer as decrease of the asset transferred and an increase in another asset.

    d. The transaction does not need to be reported since the entities are financially interrelated.

39. When assets are received for a financially interrelated specified beneficiary and the recipient is not a trustee, how does the recipient report the receipt of assets?

    a. As a contribution of revenue.

    b. As a liability.

    c. As an equity transaction.

    d. As a decrease in assets.

40. According to FASB ASC 250-10-20, which of the following is **not** a change that results in a change in the reporting entity?

    a. Consolidated statements are presented in place of financial statements of individual entities.

    b. A change in specific subsidiaries comprising the group of entities for which consolidated statements are presented.

    c. A change in entities included in the combined financial statements.

    d. Using the equity method to recognize an organization's share of another entity's earnings.

GLOSSARY

Acquisition: For nonprofits an acquisition is a transaction or other event in which the organization obtains control of one or more nonprofit organizations or activities, or one or more for-profit businesses and recognizes their assets and liabilities in its financial statements.

Acquisition method: Under the acquisition method, the acquirer recognizes and measures at fair value the identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquire as of the acquisition date.

Business: An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants.

Carryover method: Under the carryover method, a new organization is created by combining the assets, liabilities, and net assets of the merged organizations.

Control: The direct or indirect ability to determine the direction of management and policies through ownership, contract, or otherwise.

Consolidated financial statements: Statements that present the financial position, changes in net assets, and cash flows of the parent and its subsidiaries as if they were a single entity.

Consolidating financial statements: Statements that usually present in columnar form the financial position, changes in net assets, and cash flows of the parent and each of its subsidiaries, together with columns that show eliminations of intra-entity transactions and balances and the consolidated totals.

Financially interrelated entities: Entities that have both of the following characteristics:

- One entity has the ability to influence the operating and financial decisions of the other, and
- One entity has an ongoing economic interest in the net assets of the other.

Fresh start accounting: When an entity is allowed to elect or reverse accounting methods or options restricted to the initial acquisition or recognition of an item.

General partnership: A partnership in which partners share equally in both responsibility and liability.

Intra-entity: The notion of the consolidated group being the reporting entity in consolidated financial statements may be the reason the FASB uses the term intra-entity in the Codification. The prefix intra conveys the notion of transactions within the consolidated group.

Kick-out rights: Rights that may underlie the limited partner's ability to liquidate the limited partnership or otherwise remove the general partners without cause.

Limited partnership: A partnership where the partners have limited liability rather than partners sharing equally in both responsibility and liability.

Merger: For nonprofits, a merger is a transaction or event in which governing bodies of two or more nonprofit organizations cede control of those entities to create a new nonprofit organization.

Noncontrolling interest: The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a minority interest.

Nonprofit activity: An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing benefits, other than goods or services at a profit or profit equivalent, as fulfillment of an entity's purpose or mission.

Parent: As defined by FASB ASC 810-120-20, a parent is an entity that has controlling financial interest in one or more subsidiaries.

Participating rights: Rights that allow the limited partners of the limited partnership to block or participate in certain significant financial and operating decisions that are made in the ordinary course of business.

Pushdown accounting: Accounting that allows an acquired entity to use the acquirer's basis when preparing its separate financial statements; essentially the amount the parent organization recognizes for the acquired organization's assets and liabilities is "pushed down" to the subsidiary organization.

Protective rights: Rights that allow the limited partners to protect their investments by blocking certain transactions or events that occur outside of the normal course of business.

Reporting entity: Conceptually, the reporting entity is the entity or entities whose financial results are reported in the financial statements. In consolidated financial statements, the reporting entity is the group of entities whose financial results are consolidated.

Subsidiary: As used in this course, subsidiary is an entity that meets the criteria to be included in a reporting entity's consolidated financial statements. It is an entity in which another entity holds a controlling financial interest.

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EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Preparing Nonprofit Financial Statements—Course 1— Financial Statement Notes and Special Purpose Frameworks (NFSTG181)

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EXAMINATION FOR CPE CREDIT ANSWER SHEET

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9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

You may complete the exam online for $95 by logging onto our Online Grading Center at **cl.tr.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 $95; the price for answer sheets sent by regular mail is $105.

Expiration Date: May 31, 2019

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Preparing Nonprofit Financial Statements—Course 2—Form, Style, and the Statements of Functional Expenses and Cash Flows

Course Acronym: NFSTG182

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 Preparing Nonprofit Financial Statements—Course 3—Affiliated Organizations and Other Related Entities (NFSTG183)

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.	○	○	○	○

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Expiration Date: May 31, 2019

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Preparing Nonprofit Financial Statements—Course 3—Affiliated Organizations and Other Related Entities

Course Acronym: NFSTG183

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. _____

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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** ○ ○

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