

**SELF-STUDY CONTINUING PROFESSIONAL EDUCATION**

**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. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **OnlineGrading.Thomson.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **April 30, 2011**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

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Each course is divided into lessons. Each lesson addresses an aspect of nonprofit financial statements. 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 which follow each lesson**. You may either record your answer choices on the printed **Examination for CPE Credit Answer Sheet** or by logging on to our Online Grading System.

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**COMPANION TO PPC'S GUIDE TO PREPARING NONPROFIT FINANCIAL STATEMENTS****COURSE 1****LIABILITIES AND OTHER TOPICS RELATED TO THE STATEMENT OF FINANCIAL POSITION (NFSTG101)****OVERVIEW**

**COURSE DESCRIPTION:** This interactive self-study course takes a look at a variety of topics related to the statement of financial position for nonprofit organizations, including an in-depth look at liabilities. Lesson 1 provides general information related to the statement of financial position, including such topics as its authoritative basis, materiality, and fair value measurement. It also covers form and style considerations. Lesson 2 examines how nonprofit organizations present liabilities on the statement of financial position.

**PUBLICATION/REVISION DATE:** April 2010

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

**PREREQUISITE/ADVANCE PREPARATION:** Basic knowledge of accounting

**CPE CREDIT:** 7 QAS Hours, 7 Registry Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at [www.nasba.org](http://www.nasba.org) for a listing of states that accept QAS hours.

**FIELD OF STUDY:** Accounting

**EXPIRATION DATE:** Postmark by **April 30, 2011**

**KNOWLEDGE LEVEL:** Basic

**Learning Objectives:****Lesson 1—The Basics of the Statement of Financial Position**

Completion of this lesson will enable you to:

- Summarize general guidelines, terms, and concepts related to the statement of financial position and how they are used in its preparation by nonprofit organizations.
- Identify form and style considerations relevant to a nonprofit organization's statement of financial position.

**Lesson 2—Liabilities and the Statement of Financial Position**

Completion of this lesson will enable you to:

- Compare and contrast the different types of liabilities commonly found in a nonprofit organization's statement of financial position.
- Identify the basic taxes to which a nonprofit organization may be subject and how they affect the statement of financial position.
- Summarize how long-term debt affects a nonprofit organization's statement of financial position.
- Identify presentation differences in the liabilities section of a classified statement of financial position presented by a nonprofit organization.

- Summarize how net assets and accounting changes affect a nonprofit organization's statement of financial position.

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# Lesson 1: The Basics of the Statement of Financial Position

## INTRODUCTION

This lesson examines a series of general topics about nonprofit organizations and the statement of financial position. Some of the topics discussed in this lesson include authoritative literature, authoritative basis, offsetting assets and liabilities, materiality, present value information, and fair value. This lesson also takes a look at form and style considerations.

### Learning Objectives:

Completion of this lesson will enable you to:

- Summarize general guidelines, terms, and concepts related to the statement of financial position and how they are used in its preparation by nonprofit organizations.
- Identify form and style considerations relevant to the statement of financial position.

## GENERAL TOPICS RELATED TO THE STATEMENT OF FINANCIAL POSITION

### Authoritative Basis for Statement of Financial Position

The authoritative guidance for reporting assets, liabilities, and net assets in the statement of financial position resides in two primary locations within the FASB Accounting Standards Codification (FASB ASC). [For periods ending after September 15, 2009, FASB ASC Topic 105, *Generally Accepted Accounting Principles* (formerly SFAS No. 168), establishes the FASB Accounting Standards Codification as the single source of authoritative, nongovernmental U.S. GAAP for nonpublic entities.] The guidance that is generally applicable to all entities resides in FASB ASC Topic 210, *Balance Sheet*. Incremental guidance applicable specifically for nonprofit organizations is codified in FASB ASC 958-210, *Not-for-Profit Entities—Balance Sheet*. FASB ASC 958-210 codifies the now superseded guidance previously provided by SFAS No. 116, *Accounting for Contributions Received and Contributions Made*, SFAS No. 117, *Financial Statements of Not-for-Profit Organizations*, SFAS No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, SFAS No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, and the AICPA Audit and Accounting Guide, *Not-for-Profit Organizations* (Audit Guide). The nonauthoritative guidance in FASB Statement of Financial Accounting Concepts (SFAC) No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, provides a broad framework for external financial reporting for nonprofit organizations, and SFAC No. 6, *Elements of Financial Statements*, defines assets, liabilities, net assets, revenues, expenses, gains, and losses for nonprofit organizations. Beginning with the March 1, 2009, edition, the Audit Guide was renamed *Not-for-Profit Entities*.

This course is relevant to all types of nonprofit organizations; however, when necessary, distinctions are made between accounting and presentation considerations that apply to voluntary health and welfare organizations and those that apply to other nonprofit organizations.

### Statement of Financial Position Format

According to FASB ASC 958-210-45-1 (formerly Paragraph 10 of SFAS No. 117), a statement of financial position focuses on the nonprofit organization as a whole and, therefore, reports total assets, liabilities, and net assets. In so doing, the statement of financial position should provide information about liquidity, financial flexibility, and the interrelationship of assets and liabilities. GAAP does not require a particular format or prohibit any presentations for the statement of financial position. However, the statement of financial position is required to disclose the following:

- Total assets,
- Total liabilities, and

- Information about the three classes of net assets, including total net assets.

It is common for organizations to present a one-column statement of financial position. Because there are no prohibited presentations, however, some organizations may choose a less common format such as a multicolumn statement. A multicolumn statement may separate individual asset, liability, and net asset captions into unrestricted, temporarily restricted, and permanently restricted classifications. Although only net assets are required to be presented by classification, as a practical matter, some organizations may choose to track and present specific assets attributable to those net asset classifications.

Liquidity is the nearness of an asset or liability to cash, and financial flexibility is the ability to take effective actions to alter amounts and timing of cash flows to respond to unexpected needs and opportunities. FASB ASC 958-210-45-8 (formerly Paragraph 12 of SFAS No. 117) requires using one or more of the following methods of presenting information about liquidity, and it is also possible to use these methods to provide information about financial flexibility:

- a. *Sequenced Statement.* Assets are sequenced according to their nearness of conversion to cash, and liabilities are sequenced according to the nearness of their maturity and resulting use of cash.
- b. *Classified Statement.* Assets and liabilities are classified as current and noncurrent following the requirements of FASB ASC 210-10-45-1 through 45-12 (formerly ARB No. 43, Chapter 3A).
- c. *Other Format.* The statement groups assets and liabilities, in no required format, with information about liquidity (including restrictions on the use of particular assets) disclosed in the notes to the financial statements.

**Sequenced Statement of Financial Position.** Sequencing assets and liabilities may require reporting some items, such as cash and unconditional promises to give, on more than one line to distinguish between their relative liquidity. For example, the listing of assets may start with unrestricted cash, but cash that is restricted to the purchase of fixed assets or to the payment of long-term notes may be sequenced further down the list. In addition, unconditional promises to give may appear two or more times, depending on the nature of the donor's restrictions. The organization may also choose to combine items with similar restrictions into one line. For example, cash and unconditional promises to give that are restricted for the purchase of fixed assets could be combined in the caption "Assets restricted for the purchase of fixed assets." That caption would be sequenced closer to fixed assets than to unrestricted cash in the statement of financial position. FASB ASC 958-210-45-6 (formerly Paragraph 3.03 of the 2008 Audit Guide) requires the kind of assets included in that caption to be disclosed in the notes to the financial statements if their nature is not clear from the description on the face of the statement of financial position. Thus, in the preceding example, the notes would disclose that assets restricted for the purchase of fixed assets consist of cash and unconditional promises to give.

**Classified Statement of Financial Position.** A classified statement of financial position can be presented but is not required. If a nonprofit organization elects to present a classified statement of financial position, unconditional promises to give, long-term debt, and any other applicable assets and liabilities must be separated into current and noncurrent portions. A classified statement of financial position distinguishes current assets and current liabilities from other assets and liabilities. In general, separate disclosure of the significant components of financial statements is presumed to make them more useful. Separate disclosure of the components of working capital (current assets less current liabilities) can also be useful to some readers of the financial statements.

The criteria for separating current and noncurrent items are specified by FASB ASC 210-10-45-1 through 45-12 (formerly ARB No. 43, Chapter 3A) and are summarized as follows:

- a. *Current Assets.* Cash and other assets that are reasonably expected to be realized in cash or sold or consumed during one year or within the organization's normal operating cycle if it is longer than a year. (Current assets normally include cash, short-term investments not restricted for long-term purposes, receivables, inventories, and prepaid expenses.)
- b. *Current Liabilities.* Obligations whose liquidation is reasonably expected to require the use of current assets or the creation of other current liabilities. (Current liabilities include short-term obligations such as

payables for materials and supplies, wages, taxes, amounts collected in advance of delivery of goods or services, the current portion of long-term obligations, and any other obligations expected to be liquidated within a year.)

- c. *Operating Cycle.* The time needed to convert cash first into materials and services, then into products, then by sale into receivables, and finally by collection back into cash. Most nonprofit organizations have an operating cycle of no greater than one year.

In some cases, authoritative literature specifically states how certain assets and liabilities are to be classified. For example:

- FASB ASC 470-10-45-13 (formerly SFAS No. 6) provides guidance for the classification of certain short-term obligations.
- FASB ASC 470-10-45-12 (formerly SFAS No. 78) provides guidance for the classification of demand notes payable.
- FASB ASC 740-10-45 (formerly SFAS No. 109) provides guidance for the classification of deferred tax assets and liabilities.
- FASB ASC 715-20-45-3 (formerly SFAS No. 158) provides guidance about the classification of pension-related assets and liabilities.

If the operating cycle is shorter than one year or is not determinable, a one-year period is used for both assets and liabilities. If the operating cycle exceeds a one-year period, common practice is to use the operating cycle for classifying assets as current but to apply a one-year period for classifying liabilities.

**Other Format.** If the organization does not present a sequenced statement of financial position or a classified statement of financial position, there are no presentation requirements for other formats. The statement can be presented in whatever manner the preparer likes as long as information about liquidity and financial flexibility is disclosed in the notes to the financial statements. The format used should be the one that is most meaningful for the organization.

**Format Used in This Course.** This course has been prepared assuming that the statement of financial position will be presented with assets and liabilities sequenced according to their nearness of conversion to or use of cash.

### Comparative Statements of Financial Position

Nonprofit organizations may choose, but are not required, to present comparative statements of financial position.

### Offsetting Assets and Liabilities

**General Requirements.** According to FASB ASC 210-20-05-1 (formerly APB Opinion No. 10, Paragraph 7), "It is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except if a right of setoff exists." FASB ASC 210-20-45-1 through 45-10 and FASB ASC 210-20-05-2 (formerly FIN 39) define right of setoff and identify the criteria necessary for a right of setoff to exist, and also clarify when it is appropriate to offset amounts recognized related to certain specific types of transactions (forward interest rate swaps, currency swaps, options, and derivative instruments). FASB ASC 210-20-20 and FASB ASC 210-20-45-1 and 45-2 (formerly FIN 39, Paragraph 5) state:

*A right of setoff* is a debtor's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor. A right of setoff exists when all of the following conditions are met:

1. Each of *two* parties owes the other determinable amounts.
2. The reporting party has the right to set off its amount owed with the amount owed by the other party.

3. The reporting party intends to set off.
4. The right of setoff is enforceable by law.

An important aspect of the preceding definition is the requirement that the reporting party intends to set off amounts owed. Thus, items reported in the financial statements should not be offset if the reporting party does not intend to set off, even though the ability to offset may exist. According to FASB ASC 210-20-45-5 (formerly Paragraph 45 of FIN 39), a reporting party can evidence its intent to set off by acknowledging that it has that intent and, if applicable, by providing evidence that it has actually set off in similar circumstances.

An entity is allowed to elect an accounting policy to offset fair value amounts recognized for the right to reclaim cash collateral, or the obligation to return cash collateral, against fair value amounts recognized for derivative instruments executed with the same counterparty that have been offset under the same master netting arrangement.

If a right of setoff exists, assets and liabilities may, but are not required to, be offset in the financial statements. Thus, presenting accounts at their gross amounts would not be a departure from GAAP even though they qualify for offsetting. Best practices indicate that accounts should be offset and reported at their net amounts whenever the criteria are met.

**Circumstances Not Covered.** GAAP does not apply to offsetting cash balances on deposit in banks and other financial institutions because it states that amounts on deposit should not be considered to be amounts owed to the depositor. Accordingly, the right of setoff condition set forth in item 1. listed previously is not met.

GAAP also does not address derecognition or nonrecognition of assets or liabilities. Derecognition is the removal of a *recognized* asset or a liability (e.g., by sale of the asset or extinguishment of the liability), and generally results in a gain or loss. Nonrecognition, on the other hand, involves not recognizing assets or liabilities (commonly known as off-balance-sheet financing) and, therefore, results in no gain or loss. The pronouncement clarifies that offsetting relates solely to the display of a recognized asset or liability, in contrast to derecognition or nonrecognition, which relates to the *measurement* of assets or liabilities.

In considering whether certain amounts should be offset in the financial statements, FASB ASC 210-20-15-3 (formerly FIN 39) does not supersede or amend other pronouncements that require a particular accounting treatment in specific circumstances. This guidance cites the following pronouncements as examples of authoritative literature that provide guidance about offsetting in specific circumstances:

- FASB ASC 840-30-35-32 through 35-52 (formerly SFAS No. 13) (leveraged leases).
- FASB ASC 715-30 (formerly SFAS No. 87) (accounting for pension plan assets and liabilities).
- FASB ASC 715-60 (formerly SFAS No. 106) (accounting for plan assets and liabilities).
- FASB ASC 740-10-45 (formerly SFAS No. 109) (net tax asset or liability amounts reported).

### **Materiality in the Statement of Financial Position**

Matters that would be considered material for a commercial enterprise generally would be considered material for a nonprofit organization. In determining whether departures from GAAP are material, both qualitative and quantitative factors should be considered (such as the dollar effects, the significance of the item, the pervasiveness of a misstatement, and the effect of the misstatement on the financial statements taken as a whole). Generally, materiality should be based on the total of all classes of net assets. That would mean, for example, that materiality would be determined using total support and revenue or total assets. The total of all classes of net assets is appropriate for materiality judgments since the nonprofit organization's financial statements are considered to be the financial statements taken as a whole and not the financial statements of the classes of net assets individually.

The Audit Guide discusses several alternative bases that can be used to determine materiality for planning an audit. Those bases could also be used in determining what is material to the financial statements. Although quantitative measurements such as the change in net assets could be used to determine materiality, such quantitative bench-

marks, if used, should be based on items such as total assets or total revenue and support rather than changes in net assets because most nonprofit organizations closely match revenue and expenses and operate on small margins.

The following benchmarks are suggested for determining the role of materiality in assessing departures from GAAP:

<b>Effect of Departure on Total Assets or Revenue</b>	<b>Materiality to Financial Statements</b>
1–5%	Not material
6–9%	Danger area—could be material
10% or greater	Probably is material

Although benchmarks may serve as guidelines, it cannot be overemphasized that materiality, in the final analysis, must be based on the accountants’ professional judgment about the facts and circumstances peculiar to each situation.

The benchmarks listed previously may be used for GAAP measurement departures that affect both the statement of financial position and the statement of activities. However, they are not useful in answering the following questions that arise concerning statement of financial position presentation:

- Does qualitative information need to be disclosed to keep the presentation from being misleading?
- Should items be disclosed separately or combined with other captions?
- Does a measurement or classification departure that affects only the statement of financial position need to be corrected?

**Disclosing Qualitative Information.** Decisions about whether to disclose qualitative information are among the most subjective in accounting. About the only guide to follow is to consider whether a reader of the financial statements would reach a wrong conclusion about the organization’s financial position or change in net assets based on a reasonable reading of the statements and notes.

**Separate Disclosure.** Generally, the quantitative benchmarks suggested earlier may be adapted for evaluating whether to separately disclose an item or combine it with other captions as follows:

<b>Relation of Item to Total Assets or Major Captions</b>	<b>Materiality to Statement of Financial Position</b>
1–5%	Combine with other captions
6–9%	Consider separate disclosure
10% or greater	Disclose separately

The major statement of financial position captions are discussed later in this lesson. Items that fall in the middle range may be decided on the basis of tradition or convenience; however, as the item approaches 10% of total assets, careful consideration should be given to separate disclosure.

**Measurement or Classification Departures.** In evaluating the need to correct a GAAP departure that affects only the statement of financial position, the effect on significant captions or, if a classified statement of financial position is presented, subtotals (for example, current assets and current liabilities) needs to be carefully considered. Accordingly, the percentage guidelines discussed in the “Separate Disclosure” paragraph should be considered in deciding whether the departure is material.

## Cutoff Date

The statement of financial position presents an organization's financial position at a specific point in time. Assets or liabilities are included in the statement of financial position only if the event or transaction that gives rise to them has already occurred as of the statement of financial position date.

## Using Present Value Information in Accounting Measurements

Statement of Financial Accounting Concepts (SFAC) No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, provides a framework for using future cash flows as the basis for measuring assets and liabilities. According to SFAC No. 7:

- *The Present Value of Future Cash Flows Should Be Used to Value an Asset or Liability Only When Observable Marketplace Transactions for Similar Items Are Not Available.*
- *Estimated Cash Flows Should Reflect the Range of Possible Outcomes Rather Than a Single Amount.* Even though present value measurements traditionally have used a single "most-likely" cash flow amount, SFAC No. 7 states that using *all* estimates of possible cash flows rather than the single "most-likely" estimate may be a more effective method for measuring cash flows in many circumstances.
- *Estimated Interest Rates Should Reflect the Range of Possible Outcomes Rather Than a Single Rate.* Even though present value measurements traditionally have used a single interest rate that reflects the risk associated with the future cash flows, SFAC No. 7 states that such a rate cannot reflect uncertainties in timing. However, the "expected" cash flow method can be used to measure present value when the timing of cash flows is uncertain.
- *Financial Statement Preparers May Consider Cost-benefit Constraints When Deciding Whether to Use the "Expected" Cash Flow Method.*
- *The Measurement of a Liability Always Should Consider the Credit Standing of the Debtor.* The effect of a debtor's credit standing on a liability's fair value depends on the debtor's ability to pay as well as provisions that protect debt holders. SFAC No. 7 states that the effect of a debtor's credit standing generally is considered by adjusting the interest rate in the liability's present value measurement.
- *A Catch-up Approach Is the Preferable Technique for Reporting Changes in Estimated Cash Flows.* A *catch-up* approach adjusts the carrying amount of an asset or liability to the present value of the revised estimated cash flows, discounted at the original effective interest rate.

Although FASB Concepts Statements do not change generally accepted accounting principles (for example, the discounting of long-term promises to give), they establish the objectives and concepts that the FASB uses in developing standards of financial accounting and reporting. FASB ASC 820-10 (formerly SFAS No. 157) incorporates aspects of and clarifies the guidance in SFAC No. 7 for using present value techniques to measure fair value.

## Fair Value Measurement

Generally accepted accounting principles require fair value measurements in a number of situations. FASB ASC 820-10 (formerly SFAS No. 157) provides a common definition of fair value, establishes a framework to measure fair value within GAAP, and increases the disclosures about fair value measurements. It generally applies under other existing accounting standards that require or permit fair value measurements.

FASB ASC 820-10 (formerly SFAS No. 157) does not (a) eliminate the practicability exceptions to fair value or (b) apply to accounting standards that require or permit measurements that are similar to, but not intended to represent, fair value. The effective date of FASB ASC 820-10 (formerly SFAS No. 157) and transition issues as they relate to the guidance about fair value measurement presented in this course, are discussed later in this lesson, followed by a discussion of current FASB projects to provide further guidance for fair value measurements.

**Applicability for Leases.** According to FASB ASC 820-10-15-2 (formerly FSP FAS 157-1) FASB ASC 820-10 does not apply under FASB ASC 840 (formerly SFAS No. 13) and other pronouncements 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.

**Definition of Fair Value.** FASB ASC 820-10-20 (formerly SFAS No. 157) 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.” FASB ASC 820-10 provides additional information about many of the key phrases in its definition of fair value. In summary—

- An *asset* or *liability* may be a standalone asset or liability or a group of assets or liabilities. Attributes that are specific to the asset or liability, such as its condition or location and restrictions on its sale or use, should be considered when measuring fair value. Whether an asset or liability is measured on a standalone basis or as a group is determined by the provisions of the accounting pronouncement that requires or permits fair value measurement.
- The *price that would be received* in a transaction to sell the asset or transfer the liability is considered from the perspective of a market participant that holds the asset or owes the liability. A fair value measurement is an exit price—the price at which an asset owner can sell the asset, or the cost a borrower would incur to transfer the duty to pay to another entity. Conceptually, exit prices and entry prices (the price that would be paid to acquire the asset or received to assume the liability) are different. However, in many cases, at initial recognition a transaction price (entry price) will equal the exit price and, therefore, will represent the fair value of the asset or liability.
- The *price that would be received* should not be adjusted for transaction costs. Thus, fair value is different from net realizable value because net realizable value subtracts from a selling price the direct costs necessary to accomplish the sale. However, transportation costs are different from transaction costs if location is an attribute of the asset or liability being measured (as might be the case for a commodity). If location is an attribute of the asset or liability being measured, the price in the principal (or most advantageous) market used to measure the fair value of the asset or liability should be adjusted for the costs, if any, that would be incurred to transport the asset or liability to (or from) that market.
- An *orderly transaction* is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities. It is not a forced transaction (for example, a forced liquidation or distress sale).
- *Market participants* are participants in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The *principal market* is the market in which the organization would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability. The *most advantageous market* is the market in which the organization would sell the asset to obtain the maximum price for it. For a liability, it is the market that would minimize the amount that would be paid to transfer the liability. In either case, the transaction costs in the respective market(s) should be considered. If a price in the most advantageous market is better than the price in the principal market, the price in the principal market should still be used.

The authoritative literature emphasizes that fair value is a market-based measurement, not an entity-specific measurement. A fair value measurement should be based on the assumptions that a market participant would use in determining a price for the asset or liability. For example, it would require expectations of future cash flows to be those of market participants, discounted at the rate that market participants would use to discount them. In contrast, entity-specific measurements include expectations of future cash flows that the entity expects to receive, discounted at a rate that reflects the entity's cost of capital, even if these differ from those of other entities. Thus, entity-specific value may differ from fair value in that entity-specific value includes cash inflows or outflows expected by the entity that would not be expected by other market participants. In some cases, an entity-specific measurement would be higher than fair value, such as when an entity expects greater inflows related to superior management talent or to use the asset in combination with other assets that market participants do not have access to. In other cases, an entity specific measurement may be lower than fair value.

**Measuring Assets.** The highest and best use of the asset by market participants should be assumed when measuring the fair value of an asset. The highest and best use maximizes the value of the asset, or group of assets within which the asset would be used, even if that use is different from the entity's intended use of the asset. Considerations such as what is physically possible, legally permissible, and financially feasible at the measurement date should be included in this evaluation. The highest and best use of an asset may be—

- *In-use* when the asset provides maximum value to market participants when used in combination with other assets as a group. For example, value in-use might be appropriate for nonfinancial assets, such as equipment.
- *In-exchange* when the asset provides maximum value to market participants primarily on a standalone basis. For example, value in-exchange might be appropriate for financial assets, such as securities.

FASB ASC 820-10 (formerly SFAS No. 157) states that market participant assumptions should also include assumptions about the effect of a restriction on the sale or use of an asset. A fair value measurement for a restricted asset should consider the effect of the restriction if market participants would consider the effect of the restriction in pricing the asset. FASB ASC 820-10-55-54 [formerly Example 9 (Paragraph A30) of SFAS No. 157] explains that only restrictions that are an attribute of an asset and, therefore, would transfer to a market participant are reflected in fair value. Donor restrictions that are specific to the donee are only reflected in the classification of net assets, not in the measurement of fair value.

**Measuring Liabilities.** A fair value measurement of a liability assumes that the liability is transferred to a market participant at the measurement date and that the nonperformance risk (the risk that the obligation will not be fulfilled) relating to that liability is the same before and after its transfer. It further assumes that the liability to the counterparty is not settled. Because nonperformance risk includes a debtor's credit risk, the organization should consider the effect of its credit standing on the fair value of the liability in all periods in which the liability is measured at fair value. Further, if the liability has an inseparable third-party credit enhancement (for example, there is a guarantee), the effects of the credit enhancement should not be measured as though the credit enhancement was not present, because to measure the liability with the guarantee is a measurement of the guarantor's credit standing rather than the debtor's credit standing.

In August 2009, the FASB issued Accounting Standards Update (ASU) No. 2009-05, *Fair Value Measurements and Disclosures—Measuring Liabilities at Fair Value*, which was effective for the first reporting period, including interim periods, beginning after the standard was issued. The guidance in ASU No. 2009-05 notes that although the fair value of a liability assumes an exchange in an orderly transaction between market participants, transfers of liabilities in the marketplace rarely occur due to contractual or legal restrictions. FASB ASC 820-10-35-16B (formerly ASU No. 2009-05) indicates that when available, a quoted price in an active market for the identical liability represents a Level 1 measurement, as discussed later in this lesson. However, when a quoted price is not available, the new guidance states fair value for a liability should be measured using one or more of the following:

- a. A valuation technique that uses the quoted price of the identical liability when traded as an asset, quoted prices for similar liabilities, or quoted prices for similar liabilities when traded as assets.
- b. Another valuation technique that is consistent with the principles discussed in this course, for example, a present value technique or a market approach.

Relevant observable inputs should be used to the maximum extent possible, and the overall objective of fair value measurement for liabilities, as previously discussed, should be achieved.

When measuring fair value based on the quoted price of a liability when traded as an asset, the quoted price of the asset should not be adjusted for the effect of a restriction preventing its sale. However, the quoted price of the asset should not be adjusted for the effect of a restriction preventing its sale. However, the quoted price should be adjusted for factors specific to the asset that are not applicable to fair value measurement of the liability. If adjustments to quoted prices are necessary, the measurement is not longer a Level 1 input. Also, when estimating the fair value of a liability, no separate adjustment should be made for a restriction that prevents transfer of the liability.

**Framework for Measuring Fair Value.** FASB ASC 820-10 (formerly SFAS No. 157) establishes a framework that describes how to use inputs and valuation techniques to develop fair value measures. The framework has the following features:

- Three approaches for measuring fair value using valuation techniques.
- A hierarchy of fair value inputs that has three levels.
- Additional standards for present value measurements.

Since FASB ASC 820-10 does not eliminate the practicability exceptions to fair value measurements granted in other standards. For example, organizations may still measure unconditional promises to give due within one year at net realizable value as an alternative to fair value.

**Valuation Techniques.** FASB ASC 820-10-35-29 through 35-35 (formerly SFAS No. 157) describe three approaches to measuring fair value.

- a. *Market approach.* This approach uses prices or relevant information derived from market transactions for identical or comparable assets or liabilities. Valuation techniques consistent with the market approach may use market multiples derived from a set of comparables or matrix pricing for valuing debt securities.
- b. *Income approach.* This approach converts future amounts, such as cash flows or earnings, to a single present amount (i.e., discounted) based on current market expectations about those future amounts. A present value technique is an example of a valuation technique consistent with the income approach.
- c. *Cost approach.* This approach is based on the amount that currently would be required to replace the service capacity of an asset (i.e., current replacement cost). The fair value of an asset using this approach is a market participant's cost to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence.

Depending on the situation, a single technique or multiple techniques for measuring fair value may be appropriate. Entities should use valuation techniques that are appropriate in the circumstances and for which sufficient data are available. For example, a single technique may be appropriate when quoted market prices exist in an active market for identical assets. Multiple techniques may be appropriate, however, when an active market does not exist and the fair value inputs are more subjective. When multiple techniques are used, the respective indications of fair value should be evaluated and weighted as appropriate. When an organization arrives at different measures of fair value using different valuation techniques, it should consider the following in determining which value is most representative of fair value in the circumstances and should be used in its financial statements:

- The reasonableness of the range indicated by the results of the valuation techniques.
- The relative reliability of the inputs to the valuation techniques.
- The degree of comparability between the asset or liability being measured and the observations in the marketplace.
- Other factors, as appropriate.

Valuation techniques used to measure fair value should be consistently applied. However, a change in a valuation technique or its application is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. Such a change would be accounted for as a change in accounting estimate in accordance with the provisions of FASB ASC 250-10 (formerly SFAS No. 154).

**Hierarchy of Fair Value Inputs.** A fair value measurement should be determined based on the assumptions—referred to as inputs—that market participants would use in pricing the asset or liability. FASB ASC 820-10-35 (formerly SFAS No. 157) establishes a fair value hierarchy that distinguishes between market participant assumptions and the organization's own assumptions about market participant assumptions. *Observable inputs* are

assumptions based on market data obtained from independent sources. In contrast, *unobservable inputs* are the organization's own assumptions about what market participants would assume based on the best information available in the circumstances. Observable inputs should be used to the maximum extent possible. The level in the hierarchy in which the resulting fair value measurement falls is based on the lowest level input that is significant to the overall valuation, regardless of the valuation technique(s) used. Determining whether an input is significant is a judgmental matter requiring consideration of factors specific to the asset or liability.

Level 1 Inputs. A quoted price in an active market for an identical asset or liability (that is, a Level 1 input) is considered to be the most reliable evidence of fair value. Active markets are those in which transactions occur with sufficient frequency and volume to provide pricing information on an ongoing basis. Level 1 inputs should be used to measure fair value whenever they are available, except in the following situations:

- a. The entity is required to measure a large number of similar assets or liabilities at fair value (for example, debt securities). Quoted prices might be available, but are not readily assessable for each of the individual assets or liabilities. In that case, as a practical expedient, fair value may be measured using an alternative method, such as matrix pricing, that does not exclusively use quoted prices.
- b. A quoted price does not represent fair value at the measurement date. That could occur if a significant event occurs after the market close but prior to the measurement date. In such cases, the reporting entity is required to establish and consistently apply a policy for identifying those events that could impact fair value measurements. The quoted price may be adjusted for that new information. The use of an alternative pricing method or quoted price adjusted for new information results in a fair value measurement that falls in a lower level of the fair value hierarchy.

Level 2 Inputs. Level 2 inputs are those that are observable for the asset or liability, either directly or indirectly, other than quoted prices included within Level 1. Adjustments to Level 2 inputs will vary depending on factors specific to the asset or liability. An adjustment that is significant to the fair value measurement in its entirety might render the measurement a Level 3 measurement, depending on the level in the fair value hierarchy within which the inputs used to determine the adjustment fall. Level 2 inputs include:

- a. Quoted prices for similar assets or liabilities in active markets.
- b. Quoted prices for identical or similar assets or liabilities in markets that are not active. A market is not active if, for example, there are limited transactions for the asset or liability, the prices are not current, little public information is available, or price quotations vary substantially either over time or among market makers.
- c. Other observable inputs, such as interest rates and yield curves observable at commonly quoted intervals, volatilities, default rates, prepayment speeds, loss severities, and credit risks.
- d. Other inputs that are primarily derived from or corroborated by observable market data.

Adjustments of Level 2 inputs will vary based on factors specific to the asset or liability such as:

- Condition or location of the asset or liability.
- Volume and activity in the markets in which the inputs are observed.
- Extent to which the inputs relate to items that are comparable to the asset or liability.

Level 3 Inputs. Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs should be used to measure fair value only when observable inputs are not available. Thus, those inputs apply when there is little, if any, market activity for the asset or liability at the measurement date. For example, estimates of future cash flows based on prior years' experience would be a Level 3 input if measuring unconditional promises to give. When there is little, if any, market activity, the organization does not need to undertake an exhaustive effort to obtain information about market participant assumptions. Unobservable inputs should reflect the organization's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk). The organization must not ignore information about market participant assumptions that is reasonably available without undue cost and effort.

**Inactive Markets.** In many cases, there are some observable market transactions for a contributed asset, but there are not enough observable transactions to be considered an active market. Further, because of the recent economic downturn, some formerly active markets have become inactive. FASB ASC 820-10-35-51A through FASB ASC 35-51H (formerly FSP FAS 157-4) provide guidance on using level 2 inputs. A significant adjustment to the observed transactions or quoted prices may be necessary to estimate fair value in any of the following circumstances:

- If the observed transactions or quoted prices are in a market that is inactive (FASB ASC 820-10-35-51A provides characteristics of a market for which the volume and level of activity have significantly decreased).
- If a price for a similar asset requires significant adjustment to make the asset more comparable to the asset being measured.
- If the observed price is stale.

In those circumstances, a change in valuation technique or the use of multiple valuation techniques might be appropriate (for example, the use of a market approach and a present value technique). Additionally, an organization might consider the use of quoted prices provided by third parties, such as pricing services or brokers. If quotes from a third party are used, the organization must determine whether the quotes reflect the result of orderly transactions in the current market or if they instead are based on a valuation technique that reflects market participant assumptions (including assumptions about risks). In weighting a quoted price as an input to a fair value measurement, less weight should be placed on quotes that do not reflect the result of transactions. Furthermore, the nature of the quote should be considered. More weight should be placed on quotes based on binding offers, and less placed on quotes that are an indicative price. Regardless of the valuation technique used, an organization must include appropriate risk adjustments that market participants would make for nonperformance and liquidity risks.

**Prioritizing the Inputs.** The availability of inputs relevant to the asset or liability and the relative reliability of the inputs might affect the selection of appropriate valuation techniques. However, the fair value hierarchy prioritizes the inputs to valuation techniques, not the valuation techniques themselves. In some cases, the inputs used to measure fair value might fall in different levels of the fair value hierarchy. The level in the fair value hierarchy within which the fair value measurement in its entirety falls is based on the lowest level input that is significant to the overall fair value measurement. For example, a fair value measurement using a present value technique might fall within Level 2 or Level 3, depending on the inputs that are significant to the measurement in its entirety and the level in the fair value hierarchy within which those inputs fall.

**Present Value Techniques.** As discussed previously, GAAP describes three categories of valuation techniques that may be used to measure fair value. Present value techniques are an example of valuation techniques consistent with the income approach. FASB ASC 820-10-55-4 through 55-20 (formerly Appendix B of SFAS No. 157) provides guidance on present value techniques. That guidance does not, however, prescribe the use of one specific present value technique nor does it limit the use of present value techniques to the three techniques discussed therein.

FASB ASC 820-10-55-5 (formerly Appendix B of SFAS No. 157) states that a fair value measurement of an asset or liability using present value techniques should capture the following elements from the perspective of market participants as of the measurement date:

- An estimate of future cash flows.
- Expectations about potential variations in the amount or timing (or both) of cash flows.
- The time value of money.
- The price for bearing the uncertainty inherent in the cash flows (the risk premium).
- Other case-specific factors that market participants would consider.
- If the entity is measuring a liability, the nonperformance risk relating to that liability, including the credit risk of the entity.

The general principles that govern any present value technique include:

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

Present value techniques differ in how they adjust for risk and the type of cash flows they use. For example, the discount rate adjustment technique (also called the traditional present value technique) uses a risk-adjusted discount rate and contractual, promised, or most likely cash flows. In contrast, expected present value techniques use the probability-weighted average of all possible cash flows (referred to as expected cash flows). The traditional present value technique and two methods of expected present value techniques are discussed more fully at FASB ASC 820-10-55-4 through 55-20 (formerly Appendix B of SFAS No. 157).

**Practical Considerations for Implementation.** It is probable that the procedures to develop fair value measurements in place at most organizations have not changed significantly due to implementation of FASB ASC 820-10 (formerly SFAS No. 157). For example, most gifts of stocks and bonds are measured using Level 1 inputs because trading prices in active markets are generally available. Most gifts of real estate are measured using Level 2 inputs because, although prices for *identical* assets are generally not available, prices for similar assets are. Gifts of goods and services are measured using Level 1 inputs if prices for identical items or services are available; otherwise, they are measured using Level 2 inputs. Unconditional promises to give are generally measured with valuation techniques that use a combination of Level 2 and Level 3 inputs because sales of those assets in active markets are generally not available.

However, because FASB ASC 820-10-35-36 (formerly SFAS No. 157) requires that use of observable inputs be maximized and the use of unobservable inputs be minimized, it was necessary in some cases to change some procedures for measuring certain assets and liabilities. This was particularly true for those items for which present value techniques were used as an expedient, rather than gathering available market data to interpolate a price when similar, but not identical, assets and liabilities traded in the marketplace. Even if using present value measurements remains appropriate, some changes to previous practices may have been necessary. If an organization used an internally determined discount rate (e.g., endowment return) in its present value calculations, it now needs to look to market sources for similar assets with similar time horizons and risk factors to determine the appropriate rate. Similarly, if it used a risk-free rate in its present value calculations, it now needs to use a rate appropriate for the risks of the asset or liability being valued.

Increased documentation is necessary to demonstrate compliance with FASB ASC 820-10 (formerly SFAS No. 157). Organizations need to document the sources of the inputs to the valuation techniques they use and the sources for any adjustments that are necessary because an asset or liability being measured is not identical to the asset or liability observed in the marketplace. Because contributions are received throughout the year, documentation of inputs to the valuation techniques used to measure the fair value of contributed assets (such documentation of market rates, sales prices of identical or similar assets, and so forth) need to be maintained contemporaneously with the contribution. Reconstructing the documentation at the fiscal year's end, or upon the arrival of the auditor, will prove challenging, if not impossible.

Finally, new disclosure requirements for fair value measurements require the organization to develop internal reports to provide needed information. Such reports are particularly important because of the requirement to

provide a reconciliation of beginning and ending balances for each major category of assets and liabilities measured on a recurring basis at fair value using Level 3 inputs (e.g., beneficial interests in trusts and certain investments). Because many organizations use fair value measures for investments, including investments that do not trade in active markets, the disclosure requirements are proving to be among the most burdensome parts of this new standard.

This course generally describes measuring the fair value of contributed assets (promises to give and beneficial interests in trusts) and related liabilities (split-interest obligations) using traditional present value techniques. That guidance is not intended to suggest that the income approach is the only one of the three approaches (market, income, or cost) that is appropriate in the circumstances; other approaches may also be appropriate. Nor is the use of traditional present value techniques intended to suggest that that technique is preferred over other present value techniques. Rather, the inclusion of that guidance merely reflects that, prior to the issuance of FASB ASC 820-10 (formerly SFAS No. 157), present value techniques were specifically mentioned in various standards. In many cases, those techniques remain appropriate provided that the use of observable inputs in those techniques is maximized. Thus, this course identifies traditional present value techniques as one technique to consider for fair value measurements.

**Disclosures.** Certain new disclosures about fair value are required by FASB ASC 820-10-50 (formerly SFAS No. 157), including information about the inputs used to develop fair value measurements. A full discussion of these disclosures is outside the scope of this course, but more information can be found in *PPC's Guide to Preparing Nonprofit Financial Statements*.

**Effective Date and Transition.** FASB ASC 820-10-65-1 (formerly FSB FAS 157-2) delays the effective date of FASB ASC 820-10 for one year until fiscal years beginning after November 15, 2008, for certain nonfinancial assets and nonfinancial liabilities. The deferral does not apply to financial assets and liabilities or nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The deferral is not available for entities that have issued interim or annual financial statements in which the measurement and disclosure provisions of FASB ASC 820-10 have been applied. Specific disclosures are required until those provisions are fully applied.

As noted previously, the deferral applies to certain nonfinancial assets and nonfinancial liabilities. The following are examples of items subject to the deferral:

- Nonfinancial assets and nonfinancial liabilities initially measured at fair value in a business combination or other new basis event, but not measured in subsequent periods at fair value.
- Reporting units measured at fair value in the initial step of a goodwill impairment test.
- Nonfinancial assets and nonfinancial liabilities measured at fair value in the second step of a goodwill impairment test.
- Intangible assets with indefinite lives measured at fair value for impairment assessment.
- Nonfinancial long-lived assets (asset groups) measured at fair value for an assessment of impairment.
- Asset retirement obligations initially measured at fair value.
- Nonfinancial liabilities for exit or disposal activities initially measured at fair value.

Examples of items to which the deferral of the effective date does *not* apply include the following:

- Items recognized or disclosed at fair value on a recurring basis for which an entity has elected the fair value option.
- Items subject to the provisions of FASB ASC 825-10 (formerly SFAS No. 107), regardless of whether the items are recognized or not.

- Derivatives (financial and nonfinancial) subject to the provisions of FASB ASC 815 (formerly SFAS No. 133).
- Servicing assets and servicing liabilities subject to the provisions of FASB ASC 860-50-35-3 and FASB ASC 860-50-35-6 and 35-7 (formerly SFAS No. 156).
- Loans measured for impairment using the practical expedient in FASB ASC 310-10 (formerly SFAS No. 114), even if the underlying collateral is nonfinancial.
- Financial assets and financial liabilities initially measured at fair value in a business combination or other new basis event, regardless of whether such items are measured during subsequent periods at fair value.

FASB ASC 820-10 (formerly SFAS No. 157) is generally applied on a prospective basis as of the beginning of the fiscal year of adoption. However, the guidance should be applied retrospectively as of the beginning of the fiscal year of adoption for certain financial instruments [including split interest agreements with embedded derivatives accounted for in accordance with FASB ASC 958-30-30-9 (formerly SFAS No. 133).] The transition adjustment, representing the difference between carrying amount and fair value in the year of adoption, should be recognized as a cumulative-effect adjustment to beginning net assets.

**Current Projects to Provide Further Guidance on Fair Value Measurements.** Fair value measurements and disclosures continue to be an evolving area of practice. Since the issuance of FASB ASC 820-10 (formerly SFAS No. 157), the FASB has issued or is planning to issue a number of additional documents interpreting and enhancing the standards relating to fair value measurements and disclosures. Recent developments include:

- FSP FAS No. 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, issued in August 2009, discusses considerations for assessing whether there has been a significant decrease in the volume or level of activity in the market for an asset or liability when compared to normal market activity. Guidance for making fair value measurements in inactive markets is provided. FSP FAS No. 157-4 is codified at FASB ASC 820-10-35-51A through 35-51H, and is effective for interim and annual reporting periods ending after June 15, 2009.
- ASU No. 2009-05, *Measuring Liabilities at Fair Value*, issued in August 2009, provides guidance for applying the fair value measurement framework in FASB ASC 820-10 to measuring liabilities. The guidance was effective in the first reporting period beginning after issuance of the ASU. ASU No. 2009-05 is included in the FASB Codification primarily at FASB ASC 820-10-35 and FASB ASC 820-10-55.
- ASU No. 2009-12, *Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*, issued in September 2009, provides guidance for applying the fair value measurement framework in FASB ASC 820-10 to measuring the fair value of alternative investments. ASU No. 2009-12 is included in the FASB Codification primarily at FASB ASC 820-10-35.
- ASU No. 2010-06, *Improving Disclosures about Fair Value Measurements*, issued in January 2010, amends and expands the required disclosures about fair value measurements in financial statements. Most of the new requirements that expand existing disclosures are effective for reporting periods beginning after December 15, 2009; other requirements related to the disclosures about Level 3 fair value measurements are effective for fiscal years beginning after December 15, 2010. ASU No. 2010-06 is included in the FASB Codification primarily at FASB ASC 820-10-50 and FASB ASC 820-10-55.
- A joint project with the International Accounting Standards Board (IASB) to create converged fair value measurement guidance is expected to result in issuance of a proposed ASU on fair value measurements in the second quarter of 2010. Accountants may monitor developments in their project at the FASB website at [www.fasb.org](http://www.fasb.org).

### The Fair Value Option

FASB ASC 825-10 (formerly SFAS No. 159) permits an organization to irrevocably elect fair value as the initial and subsequent measure for certain financial assets and liabilities. Generally, the guidance permits the fair value option

for all financial assets and financial liabilities. However, the following items that would be applicable to nonprofit organizations are specifically excluded:

- a. Investments in other entities that must be consolidated.
- b. Obligations for pension and other postretirement and postemployment benefits, compensated absences, and costs associated with exit or disposal activities.
- c. Financial assets and financial liabilities recognized under leases except for guarantees of third-party lease obligations or contingent obligations arising from cancelled leases.

Generally, a *financial asset* is defined as a financial instrument that conveys a right to the entity, and a *financial liability* is defined as a contract that imposes an obligation on the entity. For example, a nonprofit organization could elect the fair value option for an investment that would otherwise be accounted for using the equity method. The guidance requires, however, that if an organization uses the fair value option to measure an investment that would otherwise be accounted for under the equity method of accounting, the fair value option must also be applied to all of the financial interests the organization has in that entity that are eligible items (for example, equity interests, debt instruments, and guarantees). Similarly, an entity could elect the fair value option for a fixed-rate long-term note. The fair value election generally is made when an eligible financial asset or financial liability is initially recognized in the financial statements. Organizations may, however, choose to elect the fair value option for eligible items on their election dates, as described in the authoritative literature. When the fair valued option is elected, the changes in the fair value of a financial instrument are recognized in the statement of activities as those changes occur.

The fair value option can generally be applied on an instrument-by-instrument basis, but it can be elected as an accounting policy for all similar items. Furthermore, the fair value option does not need to be applied to all instruments issued or acquired in a single transaction. For example, at each measurement date, an organization could choose to report all of its unconditional promises to give at fair value or just some or none at fair value and report the remainder using other authoritative literature.

**Applying the Fair Value Option.** One reason that some nonprofit organizations may elect the fair value option to measure financial instruments such as receivables from unconditional promises to give and obligations under split-interest agreements at fair value is because it may simplify the recordkeeping. Under the fair value option, the organization does not amortize discounts, use valuation accounts, or use historical discount rates. Rather, it determines the fair value of the asset or liability at the date of the statement of financial position and adjusts the carrying amount to that number. On the other hand, the organization must document the inputs to the techniques it uses to measure fair value at each measurement date and maintain the records to make the required disclosures. Also, because changes in fair value under the fair value option are reported in the statement of activities, the organization should realize that the amounts that will be recognized year to year are somewhat unpredictable and economic factors could cause larger fluctuations than would have been reported otherwise.

If an organization elects the fair value option for measuring an eligible financial asset or liability, the same valuation technique must be used for subsequent measures as was used for the initial fair value measurement. All inputs to the fair value measure are updated at the remeasurement date. If present value techniques are used, this would include the discount rate and the estimates of future cash flows. Organizations should ensure the sources of all the inputs are documented, even if an input has not changed from a prior measure.

**Presentation and Disclosure.** FASB ASC 825-10 (formerly SFAS No. 159) also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. Organizations should report financial instruments that are measured using the fair value option separately from the carrying amounts of similar assets and liabilities measured using another measurement attribute. To accomplish that, an organization should do one of the following:

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

There is no guidance in GAAP for presenting the change in fair value in the statement of activities. Best practices indicate that the adjustment should generally be reported with other similar transactions or events. For example, if the adjustment is an increase in an asset account such as contributions receivable from promises to give, the offset may be reported as contribution revenue. If the adjustment is a decrease in the asset account, the offset may be reported with bad debt expense or loss. Alternatively, the adjustment may be recognized as its own line item.

**SELF-STUDY QUIZ**

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

1. What piece of authoritative literature defines the elements (assets, liabilities, gains, losses, etc.) used in a nonprofit organization's financial statements?
  - a. SFAC No. 4.
  - b. SFAC No. 6.
  - c. SFAS No. 116.
  - d. SFAS No. 124.
2. Helping Hands, a nonprofit organization, is preparing its statement of financial position in accordance with GAAP. Which of the following is required?
  - a. Disclosure of total assets and total liabilities.
  - b. Avoidance of certain presentation formats.
  - c. Adherence to the prescribed one-column format.
  - d. A focus on the different parts of the organization.
3. Define the term *financial flexibility* as it relates to the statement of financial position.
  - a. An organization's ability to take actions that are effective in altering amounts and timing of cash flows in response to unexpected opportunities and needs.
  - b. A debtor's legal right to discharge the debt owed to another party by applying an amount the other party owes the debtor against the debt.
  - c. An asset or liability's nearness to cash.
  - d. Removal of an asset or liability that is recognized.
4. Greater Good, a nonprofit organization, presents a classified statement of financial position. Which of the following should it classify as current liabilities?
  - a. Inventories and prepaid expenses.
  - b. Cash and receivables.
  - c. Wages and taxes.
  - d. A debt due in 18 months.

5. Joe, a CPA, is engaged by Hope for Peace, a nonprofit organization. As part of his engagement, Joe must assess the materiality of any GAAP departures in its statement of financial position. He determines that a departure has a 7% effect on the organization's total assets. Is this departure material to the financial statements?
- Yes.
  - Possibly.
  - No.
6. Sharing Warmth, a nonprofit organization, uses future cash flows as its basis for measuring assets and liabilities as they are listed on its statement of financial position. Which of the following measurements would apply to this nonprofit organization in this situation?
- Though observable marketplace transactions are available, the organization uses future cash flows to value a liability.
  - When measuring a liability, the organization considers the debtor's credit standing.
  - The organization ensures that estimated cash flows reflect a single amount.
  - The organization ensures that estimated interest rates reflect a single rate.
7. Haven House, a nonprofit organization, must make fair value measurements for its statement of financial position. It uses the definition of *fair value* found in FASB ASC 820-10-20. Which of the following concepts would apply to Haven House's measurements?
- The *price that would be received* should be adjusted for any applicable transaction costs.
  - A forced liquidation or distress sale would be considered an *orderly transaction*.
  - When determining *market participants*, the most advantageous market for the asset or liability should be used.
  - The *asset or liability* to be measured can either stand alone or be part of a group.
8. Haven House must determine the highest and best use of its assets for its fair value measurements. Generally, which of the following would be considered the highest and best use of Haven House's securities assets?
- In-use.
  - In-exchange.
9. When making its fair value measurements, Haven House would prefer to use the most reliable evidence available. Which of the following would be considered the best according to the fair value hierarchy?
- Quoted price.
  - Observable input.
  - Unobservable input.
  - Inactive markets.

10. Which of the following statements most accurately describes the use of present value techniques in measuring fair value?
- a. Authoritative literature mandates which present value techniques are used in which circumstances.
  - b. Use of present value techniques is consistent with the cost approach.
  - c. As of the measurement date, these techniques should capture an estimate of future cash flows from the perspective of market participants.
  - d. When making these measurements, cash flows should consider factors related to the nonprofit organization as a whole.
11. The Golden Retriever Coalition (GRC) issues financial statements subject to the provisions of FASB ASC 820-10. Does the deferral of the effective date of FASB ASC 820-10 apply? ()
- a. Yes.
  - b. No.
12. Which nonprofit organization has dealt with an issue related to the presentation and disclosure of fair value measurements in the best way?
- a. H.E.L.P. aggregates its fair value and non-fair-value amounts in the same line item on its statement of financial position.
  - b. Clean Waters reports its fair value and non-fair-value carrying amounts as separate line items.
  - c. Senior Services follows GAAP guidance for presenting the change in fair value on its statement of activities.

## SELF-STUDY ANSWERS

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

1. What piece of authoritative literature defines the elements (assets, liabilities, gains, losses, etc.) used in a nonprofit organization's financial statements? **(Page 3)**
  - a. SFAC No. 4. [This answer is incorrect. FASB Statement of Financial Accounting Concepts (SFAC) No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, discusses external financial reporting for nonprofit organizations, but it does not specifically define elements such as those listed above.]
  - b. SFAC No. 6. [This answer is correct. SFAC No. 6, *Elements of Financial Statements*, defines assets, liabilities, net assets, revenues, expenses, gains, and losses for nonprofit organizations.]**
  - c. SFAS No. 116. [This answer is incorrect. SFAS No. 116, *Accounting for Contributions Received and Contributions Made*, is relevant to the financial statements of nonprofit organizations, but it is not the piece of authoritative literature that defines the elements of the financial statements.]
  - d. SFAS No. 124. [This answer is incorrect. SFAS No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, applies to the preparation of a nonprofit organization's financial statements, but it is not the piece of guidance that defines the elements of the financial statements.]
2. Helping Hands, a nonprofit organization, is preparing its statement of financial position in accordance with GAAP. Which of the following is required? **(Page 3)**
  - a. Disclosure of total assets and total liabilities. [This answer is correct. Under GAAP, the statement of financial position is required to disclose (1) total assets, (2) total liabilities, and (3) information about the three classes of net assets, including total net assets.]**
  - b. Avoidance of certain presentation formats. [This answer is incorrect. Under GAAP, no presentations are prohibited in the statement of financial position.]
  - c. Adherence to the prescribed one-column format. [This answer is incorrect. GAAP does not require a particular format for the statement of financial position. A one-column statement is commonly used, but nonprofit organizations can choose other formats, such as a multi-column statement.]
  - d. A focus on the different parts of the organization. [This answer is incorrect. According to FASB ASC 958-210-45-1, a statement of financial position focuses on the nonprofit organization as a whole and, therefore, reports total assets, liabilities, and net assets.]
3. Define the term *financial flexibility* as it relates to the statement of financial position. **(Page 4)**
  - a. An organization's ability to take actions that are effective in altering amounts and timing of cash flows in response to unexpected opportunities and needs. [This answer is correct. This is the definition of an organization's *financial flexibility*. Information may be provided about financial flexibility using the sequenced statement, classified statement, and/or other formats.]**
  - b. A debtor's legal right to discharge the debt owed to another party by applying an amount the other party owes the debtor against the debt. [This answer is incorrect. According to FASB ASC 210-20-20 and FASB ASC 210-20-45-1 and 45-2 this is the definition of a *right of setoff*.]
  - c. An asset or liability's nearness to cash. [This answer is incorrect. This is the definition of *liquidity* used by nonprofit organizations when preparing the statement of financial position.]
  - d. Removal of an asset or liability that is recognized. [This answer is incorrect. This is the definition of *derecognition*. GAAP does not address derecognition.]

4. Greater Good, a nonprofit organization, presents a classified statement of financial position. Which of the following should it classify as current liabilities? **(Page 4)**
- Inventories and prepaid expenses. [This answer is incorrect. According to FASB ASC 210-10-45-1 through 45-12, inventories and prepaid expenses are considered current assets, not current liabilities.]
  - Cash and receivables. [This answer is incorrect. According to FASB ASC 210-10-45-1 through 45-12, cash and other assets that are reasonably expected to be realized in cash or sold or consumed during one year or within the organization's normal operating cycle if it is longer than a year are current assets.]
  - Wages and taxes. [This answer is correct. FASB ASC 210-10-45-1 through 45-12 covers the criteria for separating current and noncurrent items. Current liabilities are obligations whose liquidation is reasonably expected to require the use of current assets or the creation of other current liabilities. Examples include short-term obligations such as payables for materials and supplies, wages, taxes, amounts collected in advance of delivery of goods or services, the current portion of long-term obligations, and any other obligations expected to be liquidated within a year.]**
  - A debt due in 18 months. [This answer is incorrect. Since the entire debt is due in more than one year, this is not considered current. However, if Greater Good was required to repay the debt in monthly installments, the current portion would be classified as a current liability.]
5. Joe, a CPA, is engaged by Hope for Peace, a nonprofit organization. As part of his engagement, Joe must assess the materiality of any GAAP departures in its statement of financial position. He determines that a departure has a 7% effect on the organization's total assets. Is this departure material to the financial statements? **(Page 7)**
- Yes. [This answer is incorrect. Using the benchmarks suggested by this course, a departure would definitely be considered material if its effect on total assets or revenue was 10% or greater.]
  - Possibly. [This answer is correct. Based on the benchmarks provided by this course, the departure made by Hope for Peace is in the danger area—departures with a 6 to 9% effect on total assets or revenue could possibly be material. However, though the benchmarks may serve as guidelines, when determining materiality, Joe must base his final analysis on his professional judgment about the facts and circumstances particular to the situation.]**
  - No. [This answer is incorrect. Using the benchmarks suggested by this course, a departure would not be considered material if its effect on total assets or revenue was 1 to 5%.]
6. Sharing Warmth, a nonprofit organization, uses future cash flows as its basis for measuring assets and liabilities as they are listed on its statement of financial position. Which of the following measurements would apply to this nonprofit organization in this situation? **(Page 8)**
- Though observable marketplace transactions are available, the organization uses future cash flows to value a liability. [This answer is incorrect. Under SFAC No. 7, the present value of future cash flows should be used to value an asset or liability only when observable marketplace transactions for similar items are not available. Therefore, the organization should use the observable marketplace transactions under these circumstances.]
  - When measuring a liability, the organization considers the debtor's credit standing. [This answer is correct. The effect of a debtor's credit standing on a liability's fair value depends on the debtor's ability to pay as well as provisions that protect debt holders. SFAC No. 7 states that the effect of a debtor's credit standing generally is considered by adjusting the interest rate in the liability's present value measurement.]**
  - The organization ensures that estimated cash flows reflect a single amount. [This answer is incorrect. According to SFAC No. 7, the organization should make sure estimated cash flows reflect the range of possible outcomes rather than a single amount.]
  - The organization ensures that estimated interest rates reflect a single rate. [This answer is incorrect. The organization should make sure that estimated interest rates reflect the range of possible outcomes rather than a single rate, per SFAC No. 7.]

7. Haven House, a nonprofit organization, must make fair value measurements for its statement of financial position. It uses the definition of *fair value* found in FASB ASC 820-10-20. Which of the following concepts would apply to Haven House's measurements? **(Page 9)**
- a. The *price that would be received* should be adjusted for any applicable transaction costs. [This answer is incorrect. Under FASB ASC 820-10-20, there would be no such adjustment. Thus, fair value is different from net realizable value because net realizable value subtracts from a selling price the direct costs necessary to accomplish the sale.]
  - b. A forced liquidation or distress sale would be considered an *orderly transaction*. [This answer is incorrect. Per FASB ASC 820-10-20, an *orderly transaction* is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities. It is not a forced transaction, such as those listed in this answer choice.]
  - c. When determining *market participants*, the most advantageous market for the asset or liability should be used. [This answer is incorrect. According to FASB ASC 820-10-20, *market participants* are participants in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. If a price in the most advantageous market is better than the price in the principal market, the price in the principal market should still be used.]
  - d. **The asset or liability to be measured can either stand alone or be part of a group. [This answer is correct. Under FASB ASC 820-10-20, an asset or liability may be a standalone asset or liability or a group of assets or liabilities. Whether an asset or liability is measured on a standalone basis or as a group is determined by the provisions of the accounting pronouncement that requires or permits fair value measurement.]**
8. Haven House must determine the highest and best use of its assets for its fair value measurements. Generally, which of the following would be considered the highest and best use of Haven House's securities assets? **(Page 10)**
- a. In-use. [This answer is incorrect. The highest and best use of an asset may be *in-use* when the asset provides maximum value to market participants when used in combination with other assets as a group. For example, value in-use might be appropriate for nonfinancial assets, such as equipment.]
  - b. **In-exchange. [This answer is correct. The highest and best use maximizes the value of the asset, or group of assets within which the asset would be used, even if that use is different from the entity's intended use of the asset. The highest and best use of an asset may be *in-exchange* when the asset provides maximum value to market participants primarily on a standalone basis. For example, value in-exchange might be appropriate for financial assets, such as securities.]**
9. When making its fair value measurements, Haven House would prefer to use the most reliable evidence available. Which of the following would be considered the best according to the fair value hierarchy? **(Page 12)**
- a. **Quoted price. [This answer is correct. FASB ASC 820-10 establishes the fair value hierarchy. A level 1 input on this hierarchy is a quoted price in an active market for an identical asset or liability, and it is considered to be the most reliable evidence of fair value. Therefore, this is the type of input that Haven House should use for its measurements, as described above.]**
  - b. Observable input. [This answer is incorrect. Level 2 inputs are those that are observable for the asset or liability, either directly or indirectly, other than the quoted prices in Level 1. They are not considered the most reliable evidence of fair value under the hierarchy.]
  - c. Unobservable input. [This answer is incorrect. Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs should be used to measure fair value only when observable inputs are not available. Therefore, Haven House should not use level 3 inputs in the scenario above.]
  - d. Inactive markets. [This answer is incorrect. A significant adjustment to the observed transactions or quoted prices might be necessary to estimate fair value under these circumstances. Therefore, this is not the method Haven House should use in the scenario above, if it has other choices under the hierarchy.]

10. Which of the following statements most accurately describes the use of present value techniques in measuring fair value? **(Page 13)**
- a. Authoritative literature mandates which present value techniques are used in which circumstances. [This answer is incorrect. FASB ASC 820-10-55-4 through 55-20 provides guidance on present value techniques. That guidance does not, however, prescribe the use of one specific present value technique, nor does it limit the use of present value techniques to the three techniques discussed therein.]
  - b. Use of present value techniques is consistent with the cost approach. [This answer is incorrect. GAAP describes three categories of valuation techniques that may be used to measure fair value. Present value techniques are an example of valuation techniques consistent with the income approach.]
  - c. As of the measurement date, these techniques should capture an estimate of future cash flows from the perspective of market participants. [This answer is correct. FASB ASC 820-10-55-5 states that a fair value measurement of an asset or liability using present value techniques should capture certain elements from the perspective of market participants as of the measurement date. Examples of those elements include an estimate of future cash flows and the time value of money.]**
  - d. When making these measurements, cash flows should consider factors related to the nonprofit organization as a whole. [This answer is incorrect. One of the general principles governing any present value technique is that cash flows and discount rates should consider only factors related to the asset (or liability) the organization is measuring.]
11. The Golden Retriever Coalition (GRC) issues financial statements subject to the provisions of FASB ASC 820-10. Does the deferral of the effective date of FASB ASC 820-10 apply? **(Page 15)**
- a. Yes. [This answer is incorrect. According to FASB ASC 820-10, the deferral is not available for GRC's financial statements.]
  - b. No. [This answer is correct. FASB ASC 820-10-65-1 delays the effective date of FASB ASC 802-10 for one year until fiscal years beginning after November 15, 2008, for certain nonfinancial assets and nonfinancial liabilities. The deferral is not available for entities that have issued interim or annual financial statements in which the measurement and disclosures provisions of FASB ASC 820-10 have been applied.]**
12. Which nonprofit organization has dealt with an issue related to the presentation and disclosure of fair value measurements in the best way? **(Page 17)**
- a. H.E.L.P. aggregates its fair value and non-fair-value amounts in the same line item on its statement of financial position. [This answer is incorrect. Under FASB ASC 825-10, the organization should report the aggregate of fair value and non-fair-value amounts in the same line item in the statement of financial position, but the organization must also parenthetically disclose the amount measured at fair value included in the aggregate amount.]
  - b. Clean Waters reports its fair value and non-fair-value carrying amounts as separate line items. [This answer is correct. According to FASB ASC 825-10, Clean Waters may choose to report two separate line items to display fair value and non-fair-value carrying amounts. Financial instruments that are measured using the fair value option should be distinct from values reported using other measurement attributes.]**
  - c. Senior Services follows GAAP guidance for presenting the change in fair value on its statement of activities. [This answer is incorrect. There is no guidance in GAAP for presenting the change in fair value in the statement of financial activities.]

# FORM AND STYLE CONSIDERATIONS RELATED TO THE STATEMENT OF FINANCIAL POSITION

## Title and Heading

The title “statement of financial position” is the term predominately used throughout this course. However, the use of that title is not required, and some organizations may choose to title the statement “balance sheet.” When the presentation includes more than one period, most auditors will make the title plural; for example, “statements of financial position.” Some preparers believe that it is a “statement” regardless of the number of years presented.

**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.

**Heading.** In addition to the statement title, the heading of the statement of financial position should include the legal name of the organization and the period or periods for which the statement is presented. For example, a comparative presentation might be headed as follows:

ABC Organization  
Statements of Financial Position  
December 31, 20X7 and 20X6

## Format

**Alternatives.** Once the method of presenting information in the statement of financial position is decided, there are two basic ways that the statement can be arranged.

- *Account Form (Side-by-side Format).* Assets are listed on the left-hand side and totaled to equal the sum of liabilities and net assets on the right-hand side.
- *Report Form (Running Format).* Assets are listed at the top of the page followed by liabilities and net assets. Sometimes total liabilities are deducted from total assets to equal net assets.

## Captions

**Primary and Secondary Captions.** Captions are headings within the statement that designate major groups of accounts to be totaled or subtotaled. Captions are also used to identify major totals or subtotals. The statement of financial position includes three primary captions—“Assets,” “Liabilities,” and “Net Assets.” In a presentation using the report form, placement of the primary captions would be as follows:

	20X7	20X6
ASSETS		
LIABILITIES AND NET ASSETS		

If the account form is used, the placement of the captions would be:

	20X7	20X6		20X7	20X6
ASSETS					
			LIABILITIES AND NET ASSETS		

The assets and liabilities are generally combined into several secondary captions, based on their materiality. Some assets and liabilities may be included in one caption or several captions, depending on the restrictions associated with the accounts. For example, unconditional promises to give may be included on several different lines in a sequenced statement of financial position if they include unrestricted promises and promises restricted for long-

term purposes. Some of the more frequently used secondary captions found in statements of financial position prepared using any of the formats discussed previously (sequenced statement, classified statement, or other format) are:

#### ASSETS

- Cash and Cash Equivalents.
- Investments.
- Receivables (Including Unconditional Promises to Give).
- Inventories.
- Property and Equipment.
- Other Assets.

#### LIABILITIES AND NET ASSETS

- Accounts Payable.
- Accrued Liabilities.
- Short-term Notes.
- Long-term Debt.
- Net Assets.

If a classified statement of financial position is prepared, the statement will usually include the following secondary captions:

Current Assets

Current Liabilities

The remaining assets and liabilities are then generally combined into two or three other secondary captions, based on their materiality.

**Detail in Secondary Captions.** The amount of detail included in secondary captions on the face of the statement of financial position varies. For example, the statement of financial position may be presented as follows:

#### ASSETS

Cash and cash equivalents  
 Short-term investments  
 Receivables  
     Accounts receivable  
     Unconditional promises to give  
     Related party receivables  
     Other receivables  
 Inventories  
     Books and publications  
     Other souvenirs  
     Food and beverage  
 Property and equipment

Land  
Building  
Production equipment  
Vehicles and other equipment  
Less: accumulated depreciation

However, it is also possible to use a more condensed presentation, as shown below. (Additional disclosures necessary to conform with GAAP should be presented in the notes to the financial statements.)

#### ASSETS

Cash and cash equivalents  
Short-term investments  
Unconditional promises to give  
Other receivables  
Inventories  
Property and equipment

**Accounting Policies in Captions.** Some accounting policies for statement of financial position accounts may be disclosed through expanded captions. For example, the method of pricing inventories may be disclosed using a statement of financial position caption such as:

Inventories, at the lower of FIFO cost or market

**Captions on Subtotals and Totals.** Captions also may be used to identify significant subtotals or totals. One method for doing this in the statement of financial position is to only use captions to identify TOTAL ASSETS, TOTAL LIABILITIES, TOTAL NET ASSETS, and TOTAL LIABILITIES AND NET ASSETS. (Total assets, total liabilities, and total net assets are required captions.) Captions may be used to identify subtotals for assets or liabilities that include detail within the secondary captions, such as receivables, but that method may create a cluttered appearance.

**Captions without Amounts.** Sometimes statement of financial position captions are used solely to direct the reader to the notes. For example, a caption such as "Commitments and contingencies" may be inserted between liabilities and net assets. Referencing individual financial statement items to the notes would not normally be considered a best practice. However, if the organization has collections that are not capitalized, the organization is required to include the caption "Collections" on the statement of financial position with no amount shown and a reference to a note to the financial statements that describes them.

**Order of Presentation of Captions.** The following is an example of a possible order of assets on a sequenced statement of financial position:

- a. Start with items that are already cash or are held primarily for conversion into cash and rank them in the order of their expected conversion.
- b. Follow with items held primarily for use in programs or activities but that could be converted into cash, and rank them in the order of liquidity.
- c. Next, include assets restricted for long-term purposes, such as permanent endowments.
- d. Finish with items that could not be converted into cash.

Following those guidelines, the major assets normally would be presented in the following order:

- a. Cash and cash equivalents.
- b. Short-term investments.
- c. Accounts receivable.
- d. Short-term unconditional promises to give.
- e. Inventories.
- f. Long-term investments.
- g. Unconditional promises to give restricted for long-term purposes.
- h. Property and equipment.
- i. Other assets.

Liabilities ordinarily are presented in the order of maturity as follows:

- a. Bank overdrafts.
- b. Accounts payable.
- c. Accrued expenses.
- d. Short-term notes.
- e. Long-term debt.
- f. Other long-term liabilities.

The statement of financial position is required to include totals for the following classes of net assets in addition to a total for net assets:

- a. Unrestricted net assets.
- b. Temporarily restricted net assets.
- c. Permanently restricted net assets.



**SELF-STUDY QUIZ**

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

13. What type of statement of financial position would require a specialized title?
  - a. All statements of financial position.
  - b. Statements using an OCBOA.
  - c. Presentations covering multiple periods.
  - d. Statements using a side-by-side format.
  
14. The Brinkman Foundation, a nonprofit organization, is preparing its statement of financial position in the sequenced statement format. Which of the following is a secondary caption that the foundation might include under the Liabilities and Net Assets caption?
  - a. Assets.
  - b. Cash and Cash Equivalents.
  - c. Current Liabilities.
  - d. Accounts Payable.
  
15. If the Brinkman Foundation's statement of financial position includes a caption that says, "Inventories, at the lower of market or FIFO cost," what is this an example of?
  - a. A condensed presentation.
  - b. Disclosing an accounting policy in a caption.
  - c. Using a caption to identify significant subtotals and totals.
  - d. Including a caption without an amount.

## SELF-STUDY ANSWERS

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

13. What type of statement of financial position would require a specialized title? **(Page 26)**
- All statements of financial position. [This answer is incorrect. The title “statement of financial position” is the term predominately used throughout the course. However, the use of that title is not required, and some organizations may choose to title the statement “balance sheet.” Only certain situations require the use of a specialized title.]
  - Statements using an OCBOA. [This answer is correct. According to the related authoritative guidance, a statement presented on a comprehensive basis of accounting other than GAAP (i.e., an other comprehensive basis of accounting—OCBOA) must have a different title to distinguish it from a GAAP presentation.]**
  - Presentations covering multiple periods. [This answer is incorrect. This is not a situation that requires a specialized title. When the presentation covers more than one period, most auditors will make the title plural, but some preparers believe that it is a “statement” regardless of the number of years presented.]
  - Statements using a side-by-side format. [This answer is incorrect. The format alternative chosen for the statement of financial position does not require a specialized title.]
14. The Brinkman Foundation, a nonprofit organization, is preparing its statement of financial position in the sequenced statement format. Which of the following is a secondary caption that the foundation might include under the Liabilities and Net Assets caption? **(Page 26)**
- Assets. [This answer is incorrect. Assets is a primary caption, and would not be found under Liabilities and Net Assets.]
  - Cash and Cash Equivalents. [This answer is incorrect. This caption would be found under Assets, not Liabilities and Net Assets.]
  - Current Liabilities. [This answer is incorrect. This secondary caption would be used only if the statement of financial position is a classified statement.]
  - Accounts Payable. [This answer is correct. This is an example of a frequently used secondary caption when either the sequenced statement, classified statement, or other format are used. This secondary caption would be placed under the primary caption of Liabilities and Net Assets.]**
15. If the Brinkman Foundation’s statement of financial position includes a caption that says, “Inventories, at the lower of market or FIFO cost,” what is this an example of? **(Page 28)**
- A condensed presentation. [This answer is incorrect. The amount of detail organizations include in their secondary captions on the face of the statement of financial position varies. If the organization wants to use a condensed presentation (e.g., listing only Inventories, instead of also listing subheadings under Inventories, such as Books and publications or Food and beverage), additional disclosures necessary to conform with GAAP should be presented in the notes to the financial statements.]
  - Disclosing an accounting policy in a caption. [This answer is correct. Under basic form and style considerations for the statement of financial position, it is permissible for organizations to disclose some accounting policies through expanded captions. The caption used by the Brinkman Foundation in this scenario is an example of this technique.]**
  - Using a caption to identify significant subtotals and totals. [This answer is incorrect. An example of this would be if the Brinkman Foundation used captions to identify Total Assets, Total Liabilities, Total Net Assets, and Total Liabilities and Net Assets.]
  - Including a caption without an amount. [This answer is incorrect. An example of this would be if the Brinkman Foundation used a caption on its statement of financial position solely to direct the reader to the notes.]

**EXAMINATION FOR CPE CREDIT****Lesson 1 (NFSTG101)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. When determining the authoritative basis for the statement of financial position, what piece of authoritative guidance provides incremental guidance specifically applicable to nonprofit organizations?
  - a. FASB ASC 958-210.
  - b. FASB ASC Topic 210.
  - c. SFAC No. 4.
  - d. SFAC No. 6.
  
2. Match the following methods for presenting the statement of financial position with the appropriate description.

**Statement Methods****Descriptions**

- |                           |  |
|---------------------------|--|
| 1. Sequenced statement.   | i. Assets and liabilities are grouped on the statement using no required format. Liquidity information (including information on any restrictions in place on the use of particular assets) is disclosed in the financial statement notes. |
| 2. Classified statements. | ii. The statement indicates whether assets and liabilities are current or noncurrent using the requirements of FASB ASC 210-10-45-1 through 45-12.   |
| 3. Other format.          | iii. Liabilities are organized based on how near they are to maturity and their resulting use of cash. Assets are organized based on their nearness of conversion to cash.   |
- 
- a. 1., i.; 2., ii.; 3., iii.
  - b. 1., ii.; 2., iii.; 3., i.
  - c. 1., iii.; 2., ii.; 3., i.
  - d. 1., iii.; 2., i.; 3., ii.
- 
3. Helping Paws, a nonprofit organization, reports unrestricted assets first in its listing of assets, but cash restricted to the purchase of fixed assets is included farther down the list. What method has this organization used to prepare its statement of financial position?
    - a. Sequenced statement of financial position.
    - b. Classified statement of financial position.
    - c. Other format.
    - d. Do not select this answer choice.

4. Green Streets, a nonprofit organization and the reporting party, owes another organization \$500 for products it purchased. That organization owes Green Streets \$300 for services rendered. Green Streets has the right to set off its amount owed with the amount owed by the other organization, and Green Streets intends to set those amounts off. The right of set off in this scenario is enforceable by law. Does a valid right of setoff exist under these circumstances?
- Yes, all the necessary conditions for a right of setoff are met.
  - No, a right of setoff does not exist because the amounts owed are not equal.
  - No, a right of setoff does not exist because the other organization would have to be the reporting party.
  - No, a right of setoff does not exist because conditions under FASB ASC 210-20-20 and FASB ASC 210-20-45-1 and 45-2 are not met.
5. Which of the following decisions about the statement of financial position is the most subjective?
- Which items can be combined with other captions and which should be disclosed separately.
  - Whether a classification or measurement departure effecting only the statement of financial position should be corrected.
  - Which cutoff date should be used for including assets and liabilities on the statement of financial position.
  - Whether qualitative information must be disclosed to prevent the presentation from being misleading.
6. If a nonprofit organization is required to make fair value measurements, it should consult FASB ASC 820-10. Which of the following does this piece of authoritative guidance do?
- Requires new fair value measurements.
  - Eliminates practicability exceptions to fair value.
  - Establishes a framework for use in measuring fair value.
  - Applies to accounting pronouncements that represent fair value.
7. Global Peace, a nonprofit organization, must make fair value measurements on its statement of financial position. What type of measurement is this?
- A market-specific measurement.
  - An entity specific measurement.
  - Do not select this answer choice.
  - Do not select this answer choice.
8. Match the following fair value measurement valuation technique approaches to the appropriate definition.

<u>Approaches</u>	<u>Definitions</u>
1. Market approach	i. Converting future amounts to a single present amount based on the current market's expectations about the future amounts.
2. Income approach	ii. An approach based on the amount that would currently be required to replace the service capacity of an asset.
3. Cost approach	iii. Using prices or relevant information derived from market transactions for comparable or identical assets and liabilities.

- a. 1., i.; 2., ii.; 3., iii.
  - b. 1., ii.; 2., iii.; 3., i.
  - c. 1., iii.; 2., ii.; 3., i.
  - d. 1., iii.; 2., i.; 3., ii.
9. When making fair value measurements of its liabilities, Precious Cargo, a nonprofit organization, uses quoted prices for similar liabilities in active markets as the basis for its assumptions. Where do Precious Cargo's assumptions fall in the hierarchy of fair value inputs?
- a. Level 1.
  - b. Level 2.
  - c. Level 3.
  - d. Do not select this answer choice.
10. Precious Cargo also must measure the fair value of gifts of goods and services. What type of inputs should be used?
- a. Level 1.
  - b. Level 2.
  - c. Level 1, if available; otherwise, level 2.
  - d. A combination of levels 1, 2, and 3.
11. Precious Cargo has intangible assets that have indefinite lives. Those assets are measured at fair value for impairment assessment. What is the effective date for FASB ASC 820-10 on these fair value measurements?
- a. Fiscal years beginning after November 15, 2007.
  - b. Fiscal years beginning after February 15, 2008.
  - c. Fiscal years beginning after November 15, 2008.
  - d. Fiscal years beginning after November 15, 2009.
12. Precious Cargo has investments in other entities that have to be consolidated. Can it elect the fair value option for these financial assets?
- a. Yes, but the election is irrevocable.
  - b. No, this type of asset is excluded from the election.
  - c. Yes, but only if the assets would have been accounted for using the equity method.
  - d. No, nonprofit organizations are prohibited from making this election.

13. Kids First, a nonprofit organization, presents its statement of financial position with the assets listed on the left-hand side. They are totaled to equal the sum of liabilities and net assets on the right-hand side. What format is Kids First using?
- a. Account Form.
  - b. Report Form.
  - c. Do not select this answer choice.
  - d. Do not select this answer choice.
14. List the three primary captions found in a statement of financial position.
- |                    |                 |                         |                          |
|--------------------|-----------------|-------------------------|--------------------------|
| i. Assets          | iii. Net Assets | v. Liabilities          | vii. Accrued Liabilities |
| ii. Current Assets | iv. Inventories | vi. Current Liabilities | viii. Long-term Debt     |
- a. i. and v.
  - b. ii. and vi.
  - c. i., iii., and v.
  - d. iv., vii., and viii.
15. The Arbor Foundation, a nonprofit organization, presents a sequenced statement of financial position, and it orders its liabilities in the order of maturity. If the foundation has all of the following liabilities on its statement of financial position, list them in the correct order using the maturity method.
- |                     |                                 |                      |
|---------------------|---------------------------------|----------------------|
| i. Short-term notes | iii. Bank overdrafts            | v. Accrued expenses  |
| ii. Long-term debt  | iv. Other long-term liabilities | vi. Accounts payable |
- a. iii., v., vi., i., ii., and iv.
  - b. iii., vi., v., i., ii., and iv.
  - c. v., iii., i., ii., iv., and vi.
  - d. vi., v., iii., i., ii., and iv.

# Lesson 2: Liabilities and the Statement of Financial Position

## INTRODUCTION

As discussed in Lesson 1, nonprofit organizations have a great deal of flexibility under FASB ASC 958 (formerly SFAS No. 117) in preparing the statement of financial position. For example, the statement of financial position can be prepared or arranged in different ways as long as information about liquidity, financial flexibility, and relationships between assets and liabilities is presented in the financial statements or in the notes to the financial statements. The statement can be classified between current and noncurrent assets and liabilities, sequenced according to the nearness of conversion to cash or use of cash, or prepared in other ways with information about liquidity and financial flexibility included in the notes to the financial statements. A sequenced statement of financial position is generally the most common format used. Therefore, the following discussion of liabilities assumes that a sequenced statement of financial position is prepared. Note that certain considerations that would affect the classification of liabilities in a classified statement of financial position might also affect the positioning of the liability caption in a sequenced statement of financial position.

A statement of financial position that has liabilities sequenced according to their expected use of cash may include the following secondary captions. Significant categories of liabilities should be segregated. The preparer should evaluate the timing of the expected use of cash to determine the sequencing of liabilities. The following are some of the more common liabilities found in nonprofit organization financial statements:

- Bank overdrafts.
- Accounts payable.
- Accrued liabilities.
- Interfund borrowings.
- Agency obligations.
- Deferred revenue.
- Refundable advances.
- Grants payable.
- Annuity obligations.
- Short-term debt (notes and loans).

This lesson discusses secondary captions in more detail. Regardless of the format taken for the statement of financial position, the preparer should ensure that the required information about liquidity, financial flexibility, and relationships between assets and liabilities is included in the financial statements or in the notes to the financial statements.

### Learning Objectives:

Completion of this lesson will enable you to:

- Compare and contrast the different types of liabilities commonly found in a nonprofit organization's statement of financial position.
- Identify the basic taxes to which a nonprofit organization may be subject and how they affect the statement of financial position.

- Summarize how long-term debt affects a nonprofit organization's statement of financial position.
- Identify presentation differences in the liabilities section of a classified statement of financial position presented by a nonprofit organization.
- Summarize how net assets and accounting changes affect a nonprofit organization's statement of financial position.

## SIGNIFICANT CATEGORIES OF LIABILITIES COMMONLY INCLUDED IN A NONPROFIT ORGANIZATION'S STATEMENT OF FINANCIAL POSITION

### Bank Overdrafts

Bank overdrafts are a result of either of the following situations:

- The bank statement at the statement of financial position date reports an overdraft (a real overdraft).
- The bank statement at the statement of financial position date reports a positive balance, and the overdraft, in essence, arises from "playing the float" (a book overdraft).

There is no reason for captions to distinguish between a real overdraft and a book overdraft, and the single caption "Cash overdrafts" or "Bank overdrafts" should be used. If overdrafts are immaterial, they may be netted against positive cash balances even if the accounts are with different banks. If the organization has a positive cash balance in one year and a negative balance in the other, the following captions would be appropriate in comparative statements of financial position:

	20X7	20X6
ASSETS		
Cash	\$ —	\$ 10,000
LIABILITIES		
Bank overdrafts	5,000	—

If overdrafts are material, they should be included with liabilities unless the organization has sufficient free balances in the same bank to offset the overdrafts. As bank overdrafts are usually the result of a book overdraft that is only outstanding for a few days, that caption will generally be the first caption in the liability section in a sequenced statement of financial position. If the organization has sufficient free balances in the same bank, the overdrafts should be netted against the positive cash balances. Some accountants include overdrafts with accounts payable if they are material enough to be included with liabilities.

### Accounts Payable

The statement of financial position caption "Accounts payable" includes costs and expenses that are customarily billed through a third-party invoice. They should normally be recorded at the invoice amount. Conceptually, the amount should be reported net of vendor discounts if the nonprofit organization normally takes cash discounts and is financially capable of continuing to take the discounts, although in practice vendor discounts may not be material. (Since some note holders send periodic "billings" for current debt service payable, preparers should be sure that listings of accounts payable exclude them.) *Material* debit balances in accounts payable should be reclassified as accounts receivable. Most nonprofit organizations pay their accounts payable at least monthly. As a result, most balances in that account do not remain unpaid for any significant length of time. Therefore, the caption usually will follow "Bank overdrafts" in a sequenced statement of financial position.

**Cutoff Problems.** It is not uncommon for nonprofit organizations to "hold open" cash disbursements for a few days after year end. As a result, both cash and accounts payable are understated in the statement of financial position. Although there is no effect on net assets, the understatements may be material to cash, accounts payable, assets, and liabilities and affect the current ratio if a classified statement of financial position is presented. Preparers should be alert for cutoff problems.

**Unrecorded Liabilities.** Many nonprofit organizations do not have voucher systems and, accordingly, must construct accounts payable. Possible sources include all disbursements subsequent to the statement of financial position date, vendor statements dated as of the statement of financial position date, and vendor invoices on hand. Preparers should be alert to the possibility of unrecorded liabilities. Many preparers set a minimum dollar amount for items that will be considered, such as all subsequent disbursements over \$500 during the first month after the statement of financial position date and over \$750 during the second month.

### Accrued Liabilities

Accrued liabilities are estimates of the obligation for expenses that have been incurred but for which no billing has been received. Some areas that are typically evaluated to determine the need for an accrued liability are as follows:

- Vacation pay.
- Postemployment benefits.
- Compensation.
- Payroll taxes.
- Retirement plans.
- Claims-made insurance policies.
- Environmental remediation liabilities.

In addition to those accruals, which are discussed in further detail in the following paragraphs, nonprofit organizations may have other expenses that require accrual (for example, interest expense or damages under lawsuits). The variation in the types of accrued liabilities may result in a wide range of expected payment dates. The preparer should consider the expected payment dates of the various accrued liability accounts in order to determine the sequencing of the captions on the statement of financial position.

**GAAP Measurement—General.** The accounting requirements for recording accrued expenses and the related liability are specified by FASB ASC 450-20-25-2 (formerly SFAS No. 5, *Accounting for Contingencies*). GAAP requires an accrual when both of the following conditions exist at the statement of financial position date:

- a. It is probable that a liability has been incurred.
- b. The amount can be reasonably estimated.

For most accrued expenses, the fact that a liability has been incurred at the statement of financial position date is clear, and the difficulty arises in making a reasonable estimate of the amount. When the estimate is a range rather than a specific amount, FASB ASC 450-20-30-1 (formerly FIN 14, *Reasonable Estimation of the Amount of a Loss*) provides the following guidelines:

- a. If one amount within the range is considered to be the best estimate, it should be used as the accrual.
- b. If no amount within the range is considered to be the best estimate, the lowest amount in the range should be used as the accrual.

**Accrued Vacation Pay.** FASB ASC 710-10-25-1 (formerly SFAS No. 43), requires accruing a liability for employees' compensation for future absences if *all* of the following conditions are met:

- a. The employer's obligation relating to employees' right to receive compensation for future absences is attributable to employees' services already rendered.
- b. The obligation relates to rights that vest or accumulate.
  - (1) Vested rights are those that the employer has an obligation to pay even if an employee terminates.

- (2) "Accumulate" means that the employee may carry unused vacation forward to subsequent periods, even though there may be a limit to the amount that can be carried forward.
- c. Payment of the compensation is probable.
  - d. The amount can be reasonably estimated.

If compensated absences are not accrued because the amounts cannot be reasonably estimated, employers should disclose that fact in their financial statements. GAAP does not require accrual of nonvesting rights to sick pay; thus, the statement applies primarily to vacation pay.

Although many nonprofit organizations do not have a formal vacation policy, most allow employees to take vacations under an informal arrangement. The arrangement often provides for the following:

- a. A number of days that varies with the length of service.
- b. The vacation days must be used by a certain time (typically December 31) or they are lost.
- c. If the employee quits, whether he or she will be paid for unused vacation is at the employer's discretion.
- d. If the employer lays off or fires the employee, the employee will normally be paid for unused vacation, but payment is at the employer's discretion.

Informal arrangements also should be evaluated to determine if a liability for vacation pay should be accrued. If an organization does not have formal (written) policies, factors such as the following should be considered in determining the need to accrue unused vacation pay:

- a. If the organization reports on a fiscal year and the vacation year is on a calendar year, the vacation rights begin to accumulate at the statement of financial position date.
- b. If the employer customarily pays for unused vacation pay on termination, the vacation rights are vested.
- c. If the employee may carry forward some unused days to the next year, the vacation rights accumulate.

Vacation pay to be accrued generally is calculated by preparing a schedule showing unused vacation days and salary per day for each employee as of the statement of financial position date. Although GAAP does not specify the rate to use, it implies that the accrual should be based on compensation that will actually be paid. Accordingly, the computation becomes more complicated when employees are paid a combination of salary and commissions. (Benefits such as retirement plans, insurance, and FICA taxes do not have to be considered in the accrual.) In evaluating the need for an accrual, the materiality of not providing the accrual should be determined based on the effect on accrued liabilities, total liabilities, and expenses. The effect sometimes may be estimated using a technique such as the following, particularly when vacation pay does not accumulate:

- a. Determine total salaries and wages for the year.
- b. Compute the cost per week.
- c. Multiply that amount by the estimated average number of vacation weeks allowed. As an example, if employees start with two weeks' vacation and move to three weeks after five years, an appropriate estimate of the average may be 2.5 weeks.
- d. Note that the result should be the maximum understatement, because it does not consider that some vacation days have been used.
- e. Compare the amount with accrued liabilities and total liabilities.
- f. Make a similar estimate as of the beginning of the year. The change in the estimate should be compared with total expenses.

- g. If the estimate is not material to either the statement of financial position (Step e.) or the statement of activities (Step f.), the actual understatement would not be material.

**Postemployment Benefits.** Organizations often provide benefits to former or inactive employees, their beneficiaries, and covered dependents after employment. Such postemployment benefits include cash or other consideration paid as a result of retirement, disability, layoff, death, or other specified events. The benefits frequently are paid immediately when the employee terminates employment; however, they may be paid over a specified period of time. Postemployment benefits may take the form of postretirement benefits such as pensions and health care plans, deferred compensation arrangements, and termination benefits, among others. General considerations for measurement and presentation of retirement plan contributions are discussed later in this lesson.

FASB ASC 715-60 (formerly SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*) focuses principally on postretirement health care benefits. It requires accrual, during the years that the employee renders the necessary service, of the expected cost of providing those benefits. Its provisions are similar in many respects to those in FASB ASC 715-30 (formerly SFAS No. 87).

FASB ASC 712-10-5-5 and 5-6; 712-10-15-3 and 15-4; 712-10-25-4 and 25-5; 712-10-35-1; and 712-10-50-2 (formerly SFAS No. 112, *Employers' Accounting for Postemployment Benefits*) provide guidance for accounting for employee postemployment (after employment but before retirement) benefits that are provided to former or inactive employees, their beneficiaries, and their covered dependents and on whether or not the criteria for recognition of those benefits are met. Postemployment benefits include the following (the list is not all-inclusive):

- 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.

GAAP requires employers to accrue an obligation to provide postemployment benefits if all of the following conditions are met:

- a. The obligation is attributable to employees' services already rendered.
- b. Employees' rights to those benefits accumulate or vest.
- c. Payment of the benefits is probable.
- d. The amount of the benefits can be reasonably estimated.

The accrual should be made over some period (usually the related service periods of active employees). If all of the preceding conditions are not met, employers should follow the contingency guidance and accrue postemployment benefits when it is probable that a liability has been incurred and the amount can be reasonably estimated. (If obligations are not accrued because the amounts cannot be reasonably estimated, employers should disclose that fact in their financial statements.)

**Compensation and Payroll Taxes.** Accruals for compensation and payroll taxes generally include the following:

- a. Gross compensation for the expired portion of a pay period that straddles the statement of financial position date.
- b. Bonuses.

- c. Amounts that were withheld from employees' compensation in prior pay periods but have not been remitted to the appropriate third party.
- d. Employers' taxes on compensation included on the statement of activities (for example, FICA and federal and state unemployment taxes).

Practice varies on whether separate captions are used for each of the preceding components. A good option is to group all of them into a single amount with a caption such as "Compensation" or "Compensation and related taxes." Since withholdings arise through compensation expense and are normally due at approximately the same time, there is no need to disclose them separately.

**Retirement Plans.** Measurement and presentation considerations for retirement plans are as follows:

- Nonprofit organizations organized under IRC Sec. 501(c)(3) may adopt contributory or noncontributory tax-deferred annuity plans under rules specifically provided for such organizations in IRC Sec. 403(b). Such plans involve the purchase of annuity contracts from insurance companies. IRC Sec. 403(b) specifies maximum amounts that may be contributed to the plan for each employee. Under FASB ASC 715-30 (formerly SFAS No. 87, *Employers' Accounting for Pensions*) for nonparticipating annuity contracts (contracts in which all risk and liability is transferred to the insurance company and the annuity purchaser does not participate in the investment performance or other experience of the insurance company), the cost of the contract determines the cost of the benefits currently earned (i.e., the annual pension expense and the accrued liability). More complex accounting provisions apply to participating annuity contracts and other forms of defined benefit pension plans. Certain nonprofit organizations may also adopt defined contribution plans under IRC Sec. 401(k).
- Pension expense included on the statement of activities for defined contribution plans usually will be the same as contributions related to the period. Therefore, the accrual at the statement of financial position date usually represents the remaining contributions due. Accordingly, the captions "Retirement plan contribution" or "Contribution to retirement plan" are normally appropriate for the accrual. A caption such as "Prepaid retirement plan contributions" could be used for an excess of contributions over expense related to the defined contribution plan.
- Nonprofit organizations may maintain a variety of plans, such as a tax-deferred annuity plan, defined benefit plan, and defined contribution plan. There is no need to use different accrual captions for each plan. They should be combined into a single caption such as "Contributions to retirement plans" or "Retirement plan contributions." Generally, the reader would not be helped by having separate accruals for each plan.
- An employer that sponsors one or more single-employer defined benefit plans (such as a pension or other postretirement benefit plan) is required to recognize the funded status of the plan in its statement of financial position. The funded status of a plan is calculated as the difference between the fair value of a plan's assets and the benefit obligation. If the fair value of plan assets exceeds the benefit obligation, the plan is overfunded, and the nonprofit organization should report an asset in its statement of financial position. Alternatively, a liability should be recognized if the benefit obligation is greater than the fair value of the plan's assets, which results in the plan being considered underfunded.

If a nonprofit organization sponsors more than one defined benefit plan, the organization is not permitted to aggregate all plans and report a single net asset or net liability. However, the organization should combine all of its overfunded plans and recognize the total as an asset in the statement of financial position. Likewise, it should combine all of its underfunded plans and recognize that total as a liability in the statement of financial position. If the organization presents a classified statement of financial position, the asset for an overfunded plan should always be classified as a noncurrent asset. Nevertheless, the liability for an underfunded plan must be classified as current, noncurrent, or a combination of both. The current portion should be determined individually for each plan and should be calculated as the amount by which the actuarial present value of benefits in the benefit obligation payable in the next 12 months (or, if longer, the organization's operating cycle) is greater than the fair value of plan assets.

Certain of the illustrations in FASB ASC 715-20 (formerly SFAS No. 158) use the caption "Liability for pension benefits" to recognize an underfunded pension plan in the statement of financial position.

**Claims-made Insurance Policies.** An increasing number of liability insurance policies written are claims-made policies rather than the typical occurrence policies. The claims-made coverage insures only those claims that are reported to the insurance organization during the policy period. (In contrast, occurrence policies insure claims arising from events that occur during the policy period regardless of when the claim is made.) Accordingly, with claims-made coverage, organizations have a liability for any losses incurred during the policy period that have not been reported to the insurance company.

FASB ASC 720-20-25-14 (formerly EITF Issue No. 03-8) provides that organizations should record a liability for probable losses from claims incurred but not reported during the policy period if the losses are both probable and reasonably estimable. The liability should be evaluated in subsequent periods and adjusted, if necessary. For example, if the organization purchases new coverage that insures events arising during the claims-made policy period but not reported to the insurance company or renews the claims-made coverage, an adjustment to reduce or eliminate the liability might be necessary because incurred but not reported claims would be partially or totally covered by insurance.

If it is reasonably possible that a loss has been incurred, the appropriate disclosures should be made.

**Environmental Remediation Liabilities.** Some nonprofit organizations have received donations of property that do not meet environmental safety regulations. Those organizations have potential exposure for environmental remediation liabilities. Environmental remediation liabilities can be challenging to account for. First, it is difficult to determine when a liability has been incurred because it often cannot be easily associated with a single event. Second, the amount of the liability is often difficult to reasonably estimate until long after the problem has been identified. FASB ASC 410-30 (formerly SOP 96-1, *Environmental Remediation Liabilities*) provides specific guidance for recognizing, measuring, and disclosing liabilities for legally required environmental remediation. In summary, this guidance provides that environmental remediation liabilities should:

- Be accrued on a site-by-site basis when the criteria of FASB ASC 450-20-25-2 (formerly SFAS No. 5) are met, using benchmarks specified in FASB ASC 410-30 for determining when those criteria are met.
- Include incremental direct costs, as well as compensation and benefit costs for employees who devote significant time to remediation activities.
- Include costs for the organization's allocable share of the liability for the site, as well as the organization's share of costs that will not be paid by the government or other potentially responsible parties (PRPs).
- Be estimated based on enacted laws and adopted regulations.
- Be estimated based on expected improvements in remediation technology and productivity.
- Consider discounting when appropriate.

In addition, GAAP points out that environmental remediation obligations are not unusual in nature and do not meet the criteria for classification as extraordinary items.

GAAP indicates that it is probable that an environmental remediation liability has been incurred when the following two elements are met on or before the date the financial statements are issued or are available to be issued:

- a. It has been asserted, or it is probable that it will be asserted (through litigation, claim, or regulatory assessment), that the organization is responsible for participating in an environmental process as a result of a past event (which occurred on or before the financial statement date).
- b. It is probable that the result of the litigation, claim, or assessment will be unfavorable and the organization will be held responsible.

This guidance concludes that if an assertion has been made or is probable of being made, or if the organization is associated with an identified site, there is a presumption that the outcome of the litigation, claim, or assessment will be unfavorable.

The fact that particular components of the overall environmental remediation liability may not be reasonably estimated during the early stages of the remediation process should not preclude recognizing a liability. In addition, uncertainties regarding the organization's share of an environmental remediation liability should not preclude the entity from recognizing its best estimate of its share of the liability. Therefore, the following benchmarks are provided for determining when an environmental remediation liability meets the criteria for accrual:

- Identification and verification of the organization as a PRP.
- Receipt of order or mandates to take interim corrective measures.
- Participation as a PRP in a remedial investigation or feasibility study.
- Completion of feasibility or corrective measures study.
- Issuance of Record of Decision (ROD) or approval for corrective measures study.
- Remedial design and implementation of corrective measures.

The preceding benchmarks should be considered when evaluating the probability that a loss has been incurred and the extent to which the loss is reasonably estimable. However, these benchmarks should not be applied in a way that would delay recognizing an environmental remediation liability beyond the point at which a liability would be recognized.

If the organization cannot estimate a single loss amount, the guidance in FASB ASC 450-20-30-1 (formerly FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*), which allows organizations to define a *range* of estimated losses and record the amount in the range that is the best estimate, should be used. (If no amount in the range is a better estimate than any other amount, the Interpretation requires using the lowest amount in the range.) Thus, in practice, the organization generally should define the range of an estimated environmental remediation liability and refine the estimate as activities in the remediation process occur. Subsequent changes in estimates of the organization's liability (e.g., changes in the organization's share of the liability due to identification of other PRPs) should be accounted for as changes in estimates. Consideration also should be given to the need for additional disclosures related to risks and uncertainties.

GAAP indicates that environmental remediation liabilities should provide for the following costs:

- a. Incremental direct costs, including:
  - Legal fees paid to outside law firms for work related to determining the extent of remedial actions required, the type of remedial actions to be used, or the allocation of costs among PRPs.
  - Costs related to the remedial investigation or feasibility study.
  - Engineering and consulting fees paid to outside firms for site investigations and development of remedial action plans and designs.
  - Contractors' costs for performing remedial actions (such as soil removal and disposal).
  - Government oversight costs (such as fines).
  - Costs of machinery and equipment dedicated to remedial actions.
  - PRP group assessments to cover costs incurred by the group in dealing with a contaminated site.

- Costs for operation and maintenance of the remedial action, including postremediation monitoring.
- b. Costs of compensation and benefits for employees who devote significant time to remediation activities, including:
- Technical employees involved with remediation activities.
  - Costs of internal legal staff involved with determining the extent of remediation actions required, the type of remedial action to be used, or the allocation of costs among PRPs.

Costs of compensation and benefits should be allocated based on time spent on the previous activities.

GAAP states that costs related to routine environmental compliance matters and legal costs associated with potential recoveries should not be included in remediation costs. However, GAAP does not provide guidance on whether the costs of defending against liability claims and assertions should be included in the measurement of the environmental remediation liability. Such costs could be included in the measurement of the liability to the extent they are probable and reasonably estimable.

In addition to recognizing a liability for the costs of curing violations of environmental regulations, organizations should consider whether environmental regulations impose restrictions on the future use of the property. Significant restrictions on the property’s future use could reduce the property’s fair value or its ability to generate future cash flows. In that case, the property’s carrying amount may not be recoverable, and the organization may need to recognize an impairment loss. GAAP does not address whether the recognition of environmental remediation liabilities should be considered in assessing asset impairment. FASB ASC 410-20-35-18 (formerly SFAS No. 143, *Accounting for Asset Retirement Obligations*) provides the following guidance on the treatment of certain environmental exit costs when testing a long-lived asset for impairment:

- Capitalized asset retirement costs should be included in the carrying amount of the asset being tested for impairment.
- The cash flows used to test the recoverability of the asset and to assess its fair value should exclude estimated future cash flows related to the liability for an asset retirement obligation already recognized in the financial statements.

**Statement of Financial Position Presentation of Accrued Liabilities.** The following are three examples of presenting accrued liabilities in the statement of financial position:

- a. Group all accrued expenses under a heading such as “Accrued expenses,” illustrated as follows:

	20X7	20X6
LIABILITIES		
Bank overdrafts	\$ 5,000	\$ —
Accounts payable	90,000	80,000
Accrued expenses		
Compensation	10,000	15,000
Retirement plan contributions	7,000	6,000
Other	3,000	4,000

- b. Present the components of accrued expenses as separate line items without using “accrued” in the caption as illustrated below:

	20X7	20X6
LIABILITIES		
Bank overdrafts	\$ 5,000	\$ —
Accounts payable	90,000	80,000
Compensation	10,000	15,000
Retirement plan contributions	7,000	6,000
Other	3,000	4,000

- c. Combine all accrued expenses and present as one caption. That presentation is appropriate when none of the components is individually material to total accrued expenses or to total liabilities.

	<u>20X7</u>	<u>20X6</u>
<b>LIABILITIES</b>		
Bank overdrafts	\$ 5,000	\$ —
Accounts payable	90,000	80,000
Accrued expenses	20,000	25,000

### Interfund Borrowings

Although GAAP does not prohibit or require the use of fund accounting, disaggregated reporting by fund groups is not a necessary part of external reporting. However, if an organization chooses to use fund accounting for external reporting purposes, it may have interfund borrowings. Interfund borrowings are temporary board-approved transfers between funds (e.g., a temporary borrowing from an endowment fund by a current operating fund to obtain operating cash in periods when cash receipts are slow). The governing board may decide that interest should be charged on the borrowing. If financial statements are presented by fund, the borrowing fund reports a liability to, and the lending fund reports a receivable from, the other fund. For organizations that continue to use fund accounting, interfund borrowings should be eliminated to report total assets and total liabilities. If a multicolumn reporting format is used by the organization for the statement of position, a separate column for eliminations could be used as is common in consolidating statements of commercial business enterprises. Another way to present interfund borrowings is to show receivables and payables on the same line so that they will eliminate automatically. The following is an example of that type of presentation if the organization continues to use fund accounting and a multicolumn statement of financial position is presented:

	<u>Unrestricted</u>	<u>Restricted</u>	<u>Endowment</u>	<u>Total</u>
<b>LIABILITIES</b>				
Accounts payable	\$ 90,000	\$ —	\$ —	\$ 90,000
Accrued liabilities	20,000	—	—	20,000
Interfund payables (receivables)	8,000	(5,000)	(3,000)	—

Presenting a multicolumn statement of financial position, as displayed in the preceding example, would be one way to alert readers of the financial statements to the fact that restricted or endowment funds have been borrowed to finance unrestricted operations. Multicolumn statements of financial position (either by funds or by class) do not appear to be common for external reporting. However, single-column statements of financial position can also reflect interfund borrowings as long as they are presented in such a way to not be included in total assets or total liabilities.

**Disclosure.** Although GAAP does not address disclosure of interfund borrowings, best practices indicate that certain disclosure requirements regarding loans of restricted funds should be followed. The distinction should be noted between interfund borrowings, which are temporary, and interfund transfers, which are permanent. Interfund borrowings should be considered permanent and recorded as transfers if it becomes evident that the borrowing fund does not have the resources readily available to repay the loan. If restricted donations have been used to finance unrestricted operations, the preparer should consider whether or not there are legal restrictions against borrowing restricted donations to finance unrestricted operations. It is a good idea to disclose material interfund transfers if there are legal prohibitions against such borrowings or transfers or when the liquidity of either fund is in question. In addition, if the financial statements are being prepared by an external accountant, and the accountant determines that legal restrictions have been violated, SAS No. 54, *Illegal Acts by Clients*, at AU 317 should be consulted to determine the effect on the financial statements and auditor's report.

### Agency Obligations

Agency transactions are voluntary transfers of assets to an entity in which the entity has little or no discretion over the use of the assets received. Nonprofit organizations sometimes enter into agency transactions in which a donor transfers assets to the organization as an agent for the ultimate benefit of a third-party beneficiary. It may be difficult to distinguish between an agency transaction and a contribution.

If a nonprofit organization receives financial assets in an agent capacity, the organization should record an asset and a liability. Authoritative literature defines a financial asset as “cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right (a) to receive cash or another financial instrument from a second entity or (b) to exchange other financial instruments on potentially favorable terms with the second entity” (FASB ASC Master Glossary). Nonprofit organizations may, but are not required, to recognize *nonfinancial* assets received in an agency capacity as assets and liabilities in their statement of financial position. The Statement requires the organization to apply the accounting policy consistently from period to period and disclose that accounting policy.

Agency obligations may also arise from the collection or acceptance of cash or other assets, such as sales taxes for the account of third persons. Essentially they are “wash” transactions and should have no effect on an organization’s net assets. Amounts withheld from employees’ pay for items such as income taxes, FICA, and insurance are not agency obligations because the employer acts as a disbursing agent for the employee. (As discussed previously, those amounts are accrued expenses.) Since agency obligations are “pass-through items,” best practices indicate that they should be distinguished from accounts payable and accrued expenses when they are material. The captions should be descriptive, such as the following:

- Sales taxes.
- Escrow obligations.
- Refundable deposits.

If the amounts are not material, the liabilities may be included in accounts payable.

### **Deferred Revenue**

FASB ASC 210-10-45-8 (formerly ARB No. 43) notes that collections received in advance of the delivery of goods or performance of services are intended to be included in liabilities. Those liabilities are referred to as deferred revenues and include the following examples:

- Membership dues and fees received in advance.
- Advance ticket sales.
- Advance rental payments received from lessees.

Revenue from the sale of goods or services should generally be deferred if it is received in advance. For example, a child counseling clinic that receives an advance payment from a corporation to provide services in connection with its day care program for employees should defer the revenue and recognize it as services are performed. Fees that relate to ticket sales for performances that will not take place until the next fiscal year, such as season ticket sales, should also be deferred and recognized when the performance or performances take place.

Refundable deposits, such as damage deposits from lessees, should normally be treated as agency obligations. Nonrefundable deposits would normally be recognized as revenues in the statement of activities when received. The caption used should describe the source as illustrated by the following examples:

- Membership fees received in advance.
- Deferred revenue—advance ticket sales.
- Deferred rental income.

The preparer should consider if the deferred revenue is to be earned over an extended period of time when determining the placement of the deferred revenue caption in a sequenced statement of financial position. (Further consideration of deferred revenues if the organization presents a classified statement of financial position is included later in this lesson.)

## Refundable Advances

Organizations may receive funds from a third party for which either goods or services have yet to be provided, or for which donor conditions have yet to be met. In both cases, funds received should be reported as refundable advances. Refundable advances most commonly apply to grants. Grants can be either—

- a. reciprocal exchange transactions or
- b. nonreciprocal contribution transactions.

If a grant is a reciprocal exchange transaction, the organization may receive an advance from the third party (such as the federal government or a foundation) for which the organization has not yet performed the contracted services. For example, a governmental entity might make advance payments to the organization based on the cost of providing services to constituents. Such advances should be recorded as refundable advances until the services are performed.

If an organization receives a nonreciprocal transfer of assets (such as cash or investments) that is subject to donor-imposed conditions, the transaction should be reported as a refundable advance (rather than revenue) until the donor-imposed conditions have been substantially met or explicitly waived by the donor, or unless the likelihood of not meeting the donor conditions is remote. Refundable advances should be sequenced in the liabilities based on the expected timing of when the advance will become unconditional (and therefore a contribution) or be returned to the grantor or donor. The criteria for refundable advances applies to all transfers, including grants from governmental agencies.

## Grants Payable

Nonprofit organizations may make grants to other nonprofit organizations. For example, private foundations or voluntary health and welfare organizations may award grants for research in health or education matters, or a performing arts organization may award grants to local theater groups. The grants may be one-time grants; may be routinely payable over a period of years; or may be payable over future periods, subject to periodic review, approval, and renewal. Grants or contributions made to others should be recognized as expenses in the period the contribution or grant is made.

The liability for an unconditional promise to give in the form of a grant is recognized at the grant's fair value, although grants that are due within one year may be measured at net settlement (face) value because that is a reasonable estimate of fair value. The present value of the future cash flows using a discount rate commensurate with the risks involved is one valuation technique for measuring the fair value of a grant payable; other valuation techniques are available, as described in FASB ASC 820-10 (formerly SFAS No. 157, *Fair Value Measurements*). SFAS No. 157 establishes a framework that uses marketplace inputs and valuation techniques to develop fair value measures, as described in more detail in Lesson 1.

It is likely that, with some modifications, present value calculations will continue to be the primary valuation technique used for measuring obligations for unconditional promises to give in the form of grants. Therefore, the following example assumes a present value technique is used to measure a grant payable. If Nonprofit Organization A unconditionally promises to grant Nonprofit Organization B \$1 million, payable in four equal installments over the next four years, Nonprofit Organization A would record a grant payable (and expense) equal to the present value of the future payments. Subsequent adjustments of the discount would also be recorded as grant expense, not interest expense. An organization might also choose the *fair value option* to remeasure the obligation at fair value in subsequent periods. The fair value option, as prescribed by FASB ASC 825-10 (formerly SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*) is discussed in Lesson 1.

Conditional promises to give are only recognized when the conditions on which they depend are substantially met. However, conditional promises to give or conditional grants are considered unconditional if the chances of not meeting the condition are remote. For example, a promise by an organization to give a grant to another organization contingent upon receiving the other organization's audited financial statements should be accounted for as an unconditional promise to give if the chance that the other organization will not submit the financial statements is remote. The sequencing of the caption "Grants payable" in the statement of financial position will depend on when

the grants are expected to be paid. In the preceding example, the grants payable would be sequenced closer to long-term debt in the statement of financial position because it will not be completely paid for four years.

### **Annuity Obligations**

In a split-interest agreement where the organization is trustee, the organization should record a liability for any portion of the assets that are held for the donor or other beneficiary. Preparers should also be alert to gifts that have requirements for a high rate of return to be paid to the donor or other beneficiary. The nonprofit organization may be liable for the specified amount of return to the donor even if the return on the donated assets is not enough to cover the required return to the donor.

### **Short-term Debt**

Short-term debt includes both notes (when there is a written document) and loans (when there is no written document). Short-term notes customarily require payment in a period shorter than one year (for example, 90 days or on demand). Generally, the following guidelines are appropriate for selecting captions for short-term debt and considering the order of presentation:

- a. The caption should distinguish between loans (when there is no written document) and notes (when there is a written document).
- b. Material loans from related parties should be disclosed.
- c. There is no need to name the lender (for example, First National Bank of Fort Worth).
- d. The order of presentation should be as follows:
  - (1) Notes payable to third parties.
  - (2) Notes payable to related parties.
  - (3) Loans.

Short-term debt should usually be sequenced in the statement of financial position after accounts payable and accrued liabilities, but before long-term debt. The preparer, however, should consider the unique terms of the short-term debt in determining where the caption should be placed on a sequenced statement of financial position. Applying the preceding guidelines is illustrated by the following statement of financial position presentation:

	20X7	20X6
<b>LIABILITIES</b>		
Bank overdrafts	\$ 5,000	\$ —
Accounts payable	90,000	80,000
Accrued liabilities	20,000	25,000
Short-term notes	50,000	75,000
Notes payable to affiliated entities	23,000	18,000
Loans payable	—	25,000

### Asset Retirement Obligations

FASB ASC 410-20 (formerly SFAS No. 143, *Accounting for Asset Retirement Obligations*) provides guidance on accounting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs.

### Guarantees of the Indebtedness of Others and Certain Other Guarantees

Some nonprofit organizations assist other nonprofit organizations by guaranteeing their debt without receiving compensation (called a premium) in exchange. For example, a community foundation may guarantee the debt of a local theater group without charging a premium. FASB ASC 460 (formerly FIN 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others") provides guidance about the liability associated with guarantees. Guarantees are not conditional promises to give because the guarantor has given something of value. In this example, the fact that the theater group is able to obtain financing not otherwise available, or gets a lower interest rate on its borrowing as a result of the guarantee, is evidence that something of value has been given to the theater group at the inception of the guarantee.

**Initial Recognition.** To continue the example from the previous paragraph, when the community foundation enters into a guarantee agreement, it assumes a noncontingent obligation to stand ready to perform over the term of the guarantee in the event that the theater group fails to pay. GAAP sets standards for initial recognition of guarantees by the guarantor. The guarantor (the community foundation) should recognize a liability at the inception of the guarantee even if it is *not* probable that payments will be required under the guarantee. The liability is measured at fair value.

The theater should use the fair value measurement framework of FASB ASC 820-10 (formerly SFAS No. 157) to determine the fair value of the guarantee. Ideally, the estimated fair value of the gift of a guarantee of the theater's debt could be measured by obtaining quoted market prices for the premium that would be charged by an unrelated guarantor to issue the same guarantee in a stand-alone arm's-length transaction. However it is unlikely the theater could obtain such market inputs and an income approach, such as a present value technique, would be the most likely approach for determining the fair value of the guarantee.

It is also possible to estimate fair value using the difference in the interest rate charged on the guaranteed indebtedness and the interest rate the borrower would otherwise have been charged. In many instances, the amount calculated based on the difference in interest rates would not be materially different than a typical premium charged for such a guarantee. The determination of the fair value of a guarantee using the difference in interest rates is computationally similar to calculating the contribution inherent in a below-market-interest loan. Alternatively, an organization might irrevocably elect to use fair value as the initial and subsequent measure for the guarantee, in conformity with FASB ASC 825-10 (formerly SFAS No. 159). See the discussion in Lesson 1.

Occasionally, the guarantor may conclude at the date of inception that payments under the guarantee are both probable of occurrence and reasonable of estimation. If so, then the guarantor must estimate the probable loss as required by FASB ASC 450 (formerly SFAS No. 5). That loss is compared to the fair value of the guarantee at the date of inception and the greater of the two is recognized as a liability. Only in rare circumstances should the estimated loss be greater than the fair value of the guarantee.

**Subsequent Periods.** After initial recognition, FASB ASC 460-10-35-1 through 35-4 (formerly FASB Interpretation No. 45, Paragraph 12) states that typically the liability would be reduced as the guarantor is released from risk

under the guarantee. This guidance only addresses initial measurement of the guarantee at inception. It goes on to state that, depending on the nature of the guarantee, the guarantor typically recognizes its release from risk in one of three ways. First, the liability can be written off at the expiration or settlement of the guarantee. Second, the liability can be written off (amortized) over the guarantee period. Third, the liability can be adjusted to reflect a decreasing fair value. Guarantors may not arbitrarily choose among these three methods when deciding how the liability for its obligations under the guarantee is measured subsequent to the initial recognition of that liability. The method chosen for subsequent accounting must be a method that can be justified under generally accepted accounting principles.

The authoritative literature states that typically the amount recognized due to the reduction in risk is reported as a credit to earnings (change in net assets), but does not give any further specific guidance as to the account in which the change in risk is recognized. Using an account title such as "Changes in Guarantee Risks" would clearly indicate the type of activity that generated the journal entry. Generally, the amount should be reported as either an expense or a loss. The organization would report any expense functionally based on the nature of the organization's activities and whether the guarantee was issued as part of one of the organization's programs or as part of a management and general function.

**Scope of FASB ASC 460-10.** FASB ASC 460-10 (formerly FIN 45) includes characteristic-based guidance for determining which guarantee contracts are subject to its provisions. Generally, contracts that contingently require payments based on changes in an underlying variable related to an asset, liability, or equity security; performance guarantees; indemnification agreements; and indirect guarantees of indebtedness of others are subject to FASB ASC 460-10 (formerly FASB Interpretation No. 45). The recognition, measurement, and disclosure provisions apply to guarantees, granted to a business or its owners, of a minimum revenue level over a specified period of time. For example, a nonprofit health care facility might guarantee a minimum level of gross revenues to be generated by a new nonemployee physician. Guarantees related to pension and deferred compensation plans; residual value guarantees by lessees in a capital lease; contracts accounted for as contingent rent; vendor rebates; certain subordination arrangements; and guarantees that preclude recognition of a sale are excluded from the scope of FASB ASC 460-10. Certain specific types of guarantees (including product warranties, guarantees accounted for as derivatives or as contingent consideration in a business combination, guarantees that would be reported as equity under GAAP, the secondary liability of an original lessee under a substituted lease agreement, and guarantees between parents and subsidiaries or between entities under common control) are excluded from the Interpretation's recognition and measurement provisions, but are subject to its disclosure requirements.



**SELF-STUDY QUIZ**

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

16. What type of liability commonly found on a nonprofit organization's statement of financial position is normally outstanding for the shortest amount of time?
  - a. Bank overdrafts.
  - b. Accounts payable.
  - c. Accrued liabilities.
  - d. Short-term debt.
  
17. The Starlight Group, a nonprofit organization, has liabilities on its statement of financial position that come from costs and expenses billed through a third-party invoice. What caption would the amount for these liabilities be included under?
  - a. Bank overdrafts.
  - b. Accounts payable.
  - c. Accrued liabilities.
  - d. Agency obligations.
  
18. In which of the following instances has the nonprofit organization correctly addressed accrued liabilities?
  - a. Because Meals on Us does not have a formal, written vacation policy for its employees, it does not report an accrued liability for vacation pay.
  - b. Reading Buddies accrues a liability for which the estimate is a range. The organization uses the lowest number within the range since there is not a best estimate for the accrual.
  - c. Because it is a nonprofit organization, the Ivy Foundation does not have to accrue liabilities for the postemployment benefits it provides.
  - d. Green Places accrues the liability for salary continuation benefits for former employees under compensation and payroll taxes.
  
19. Wildlife Acres, a nonprofit organization, is donated a piece of property. Later, members of the organization become aware that the property may not meet environmental safety regulations. How should this possible liability be treated?
  - a. It should be treated as an unusual or extraordinary item.
  - b. All costs for the liability for the site should be included.
  - c. Assuming all criteria are met, the liability should be accrued on a site-by-site basis.
  - d. It should be based on laws and technology in effect at the time the issue occurs.

20. The Weatherford-Stone Foundation accepts small amount of sales taxes for the account of a third person. Which of the following will occur?
- a. It will be considered an accrued liability.
  - b. The transaction's effect must be included on the statement of financial position.
  - c. It may be included in accounts payable.
  - d. The transaction is treated the same as if the foundation withheld income taxes.
21. Which of the following would be included under the short-term debt caption?
- a. Notes and loans.
  - b. Grants.
  - c. Annuities.
  - d. Bank overdrafts.
22. The Kinch Foundation, a nonprofit organization, agrees to help out the Camille Theater Group, another nonprofit organization, by guaranteeing the theater group's debt. The foundation makes this guarantee without receiving a premium or any compensation from the theater group. Which of the following would happen as a result?
- a. The theater group must recognize a liability at the inception of the foundation's guarantee.
  - b. The theater must use level 1 inputs to determine the fair value of the liability.
  - c. The foundation must estimate the probable loss of making payments under the guarantee.
  - d. During subsequent periods, the foundation's liability would be reduced.

**SELF-STUDY ANSWERS**

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

16. What type of liability commonly found on a nonprofit organization's statement of financial position is normally outstanding for the shortest amount of time? **(Page 38)**
- a. **Bank overdrafts.** [This answer is correct. Bank overdrafts are usually the result of a book overdraft that is only outstanding for a few days. The length of time a liability is outstanding can affect the position the nonprofit organization puts its caption in on the statement of financial position.]
  - b. Accounts payable. [This answer is incorrect. Most nonprofit organizations pay their accounts payable at least monthly. As a result, most balances in that account do not remain unpaid for any significant length of time. However, there is a type of liability that can be outstanding for less time than accounts payable.]
  - c. Accrued liabilities. [This answer is incorrect. Due to their nature, accrued liabilities may result in a wide range of expected payment dates. Therefore, one cannot determine a normal length of time that such liabilities will be outstanding, as one could for other liability categories.]
  - d. Short-term debt. [This answer is incorrect. Short-term notes customarily require payment in a period shorter than one year. Other liability types listed here have shorter time limits.]
17. The Starlight Group, a nonprofit organization, has liabilities on its statement of financial position that come from costs and expenses billed through a third-party invoice. What caption would the amount for these liabilities be included under? **(Page 38)**
- a. Bank overdrafts. [This answer is incorrect. Bank overdrafts result when the organization's bank statement reports and overdraft at the statement of financial position date or is positive at the statement of financial position date and an overdraft arises from "playing the float." That is not the case in this scenario.]
  - b. **Accounts payable.** [This answer is correct. The liabilities described by the Starlight Group meet the definition of those that would be categorized under the accounts payable caption. They should normally be recorded at the invoice amount.]
  - c. Accrued liabilities. [This answer is incorrect. Accrued liabilities are estimates of the obligation for expenses that have been incurred but for which no billing has been received. The liabilities described in this scenario would not be considered accrued liabilities under this definition.]
  - d. Agency obligations. [This answer is incorrect. Agency obligations are voluntary transfers of assets to an entity in which the entity has little or no discretion over the use of the assets received. Based on this definition, the liabilities described in this scenario are not agency obligations.]
18. In which of the following instances has the nonprofit organization correctly addressed accrued liabilities? **(Page 39)**
- a. Because Meals on Us does not have a formal, written vacation policy for its employees, it does not report an accrued liability for vacation pay. [This answer is incorrect. Although many nonprofit organizations do not have a formal vacation policy, most allow employees to take vacations under an informal arrangement. Informal arrangements should be evaluated to determine if a liability for vacation pay should be accrued. FAS ASC 710-10-25-1 contains information about accruing a liability for employees' compensation for future absences if certain conditions are met.]
  - b. **Reading Buddies accrues a liability for which the estimate is a range. The organization uses the lowest number within the range since there is not a best estimate for the accrual.** [This answer is correct. When an estimate is a range rather than a specific amount, FASB ASC 450-20-30-1 provides the following guidelines: (1) if one amount within the range is considered to be the best estimate,

**it should be used in the accrual; and (2) if no amount within the range is considered to be the best estimate, the lowest amount in the range should be used as the accrual.]**

- c. Because it is a nonprofit organization, the Ivy Foundation does not have to accrue liabilities for the postemployment benefits it provides. [This answer is incorrect. GAAP requires employers to accrue an obligation to provide postemployment benefits if all of the following conditions are met: (1) the obligation is attributable to the employees' services already rendered, (2) employees' rights to those benefits accumulate or vest, (3) payment of the benefits is probable, and (4) the amount of the benefits can be reasonably estimated.]
- d. Green Places accrues the liability for salary continuation benefits for former employees under compensation and payroll taxes. [This answer is incorrect. Salary continuation would be accrued as a postemployment benefit, not compensation and payroll taxes. Bonuses and employers' taxes on compensation would be accrued under compensation and payroll taxes. Postretirement benefits are covered by FASB ASC 712-10-5-5, and other areas in the FASB Codification.]
19. Wildlife Acres, a nonprofit organization, is donated a piece of property. Later, members of the organization become aware that the property may not meet environmental safety regulations. How should this possible liability be treated? **(Page 43)**
- a. It should be treated as an unusual or extraordinary item. [This answer is incorrect. GAAP points out that environmental remediation obligations are not unusual in nature and do not meet the criteria for classification as extraordinary items, so Wildlife Acres should not treat its possible liability in this manner.]
- b. All costs for the liability for the site should be included. [This answer is incorrect. According to FASB ASC 410-30, costs for the organization's allocable share of the liability for the site should be included, not all the costs in general. Also included, should be the organization's share of costs that will not be paid by the government or other potentially responsible parties.]
- c. Assuming all criteria are met, the liability should be accrued on a site-by-site basis. [This answer is correct. Per FASB ASC 410-30, this type of liability should be accrued on a site-by-site basis when the criteria of FASB ASC 450-20-25-2 are met, using benchmarks specified in FASB ASC 410-30 for determining when those criteria are met.]**
- d. It should be based on laws and technology in effect at the time the issue occurs. [This answer is incorrect. Under FASB ASC 410-30, this type of liability should be estimated based on enacted laws and adopted regulations, as well as on expected improvements in remediation technology and productivity.]
20. The Weatherford-Stone Foundation accepts small amount of sales taxes for the account of a third person. Which of the following will occur? **(Page 47)**
- a. It will be considered an accrued liability. [This answer is incorrect. This type of transaction would be considered an agency obligation.]
- b. The transaction's effect must be included on the statement of financial position. [This answer is incorrect. Essentially, this type of transaction is considered a "wash" transaction and should have no effect on an organization's net assets.]
- c. It may be included in accounts payable. [This answer is correct. If the amount is immaterial, as is the case for the Weatherford-Stone foundation, the liability may be included in accounts payable.]**
- d. The transaction is treated the same as if the foundation withheld income taxes. [This answer is incorrect. Amounts withheld from employees' pay for items such as income taxes, FICA, and insurance are not the same type of transaction because the employer acts as a disbursing agent for the employee. That is not the case in this scenario.]

21. Which of the following would be included under the short-term debt caption? **(Page 49)**
- a. **Notes and loans.** [This answer is correct. Short-term debt is one of the liability captions commonly included on nonprofit organizations' statements of financial position. This caption includes both notes (when there is a written document) and loans (when there is no written document).]
  - b. Grants. [This answer is incorrect. On the list of liability captions often used by nonprofit organizations, grants most commonly appear under either the refundable advances caption or the grants payable caption.]
  - c. Annuities. [This answer is incorrect. Annuity obligations is one of the captions commonly found on nonprofit organizations' statement of financial position; therefore, it would not need to be consolidated under a different caption.]
  - d. Bank overdrafts. [This answer is incorrect. Due to the length of time that they are outstanding, bank overdrafts would not be considered short-term debt. Also, bank overdrafts are one of the liability captions commonly used by nonprofit organizations.]
22. The Kinch Foundation, a nonprofit organization, agrees to help out the Camille Theater Group, another nonprofit organization, by guaranteeing the theater group's debt. The foundation makes this guarantee without receiving a premium or any compensation from the theater group. Which of the following would happen as a result? **(Page 50)**
- a. The theater group must recognize a liability at the inception of the foundation's guarantee. [This answer is incorrect. When the foundation enters into a guarantee agreement, it assumes a noncontingent obligation to stand ready to perform over the term of the guarantee in the event the theater group fails to pay. GAAP sets standards for initial recognition of guarantees by the guarantor. The foundation, not the theater group, should recognize a liability at the inception of the guarantee even if it is *not* probable that payments will be required under the guarantee.]
  - b. The theater must use level 1 inputs to determine the fair value of the liability. [This answer is incorrect. The theater should use the fair value measurement framework of FASB ASC 820-10 to determine the fair value of the guarantee. It is unlikely that the theater group would be able to obtain level 1 market inputs, so an income approach, such as a present value technique, would be the most likely approach for determining fair value of the guarantee.]
  - c. The foundation must estimate the probable loss of making payments under the guarantee. [This answer is incorrect. The foundation would only have to do this if, at the date of inception, it concludes that payments under the guarantee are both probable of occurrence and reasonable of estimation. If so, the estimate would be made as required by FASB ASC 450.]
  - d. **During subsequent periods, the foundation's liability would be reduced.** [This answer is correct. After initial recognition, FASB ASC 460-10-35-1 through 35-4 states that typically the liability would be reduced as the guarantor is released from risk under the guarantee. The guarantor can recognize this in one of three ways.]

# TAX CONSIDERATIONS THAT COULD AFFECT THE STATEMENT OF FINANCIAL POSITION

## Introduction

The preparer of a nonprofit organization's financial statements should be aware of the significant tax laws and regulations specifically applicable to nonprofit organizations because some tax laws and regulations relate to the organization's tax-exempt status and others may require tax provisions and liabilities in the organization's financial statements. Nonprofit organizations are subject to income tax on unrelated business income. Most private foundations are also subject to excise taxes on investment income, prohibited transactions, and excess business holdings. In addition, certain nonprofit organizations may incur a tax related to lobbying expenses paid. Also, an organization's failure to maintain its tax-exempt status by complying with tax laws and regulations would obviously have significant tax consequences. It could cause a liability that might need to be reflected in the financial statements, note disclosures, a modification of the auditor's report (if the financial statements are prepared by an external accountant), or even result in a question about the organization's ability to continue as a going concern. This discussion explains the basic taxes to which nonprofit organizations are subject and their presentation in the financial statements, but it is not intended as a substitute for the Internal Revenue Code (Code) and related regulations or for state rules and requirements. Also, this discussion is not intended as a guide to tax accounting or return preparation. However, such guidance is available in *PPC's 990 Deskbook*. In addition, *PPC's Guide to Religious Organizations* provides detailed guidance on tax issues for churches and other religious organizations. [Call (800) 431-9025 for order information or order online at [ppc.thomsonreuters.com](http://ppc.thomsonreuters.com).]

## Unrelated Business Income Taxes

Nonprofit organizations exempt from income taxes may receive unlimited amounts of income from activities substantially related to the pursuit of their exempt purposes. In contrast, nonprofit organizations are subject to taxes on income deemed to be unrelated business income. Generally, according to Code Secs. 512, 513, and 514, unrelated business income does not include income substantially generated by unpaid volunteers; income from the sale of merchandise donated to the organization; dividends, interest, royalties, and gains on the sale of property; and rents from real property. However, rents based on a percentage of the property's net income are considered unrelated business income. Also, an exempt organization's income from debt-financed property is treated as unrelated business income and is subject to tax in the same proportion as the property that remains financed by the debt. In general, debt-financed property is any property, such as rental real estate, tangible personal property, or corporate stock, that is financed by debt and held by an exempt organization to produce income, rather than for exempt purposes. Finally, although investment income is exempt from the tax on unrelated business income, private foundations must still pay an excise tax on investment income.

**Computation of Tax on Unrelated Business Income.** Unrelated business income is gross income from unrelated business activities less the deductions directly connected with the income. The organization may allocate expenses between exempt functions and the unrelated business activities; deduct charitable contributions it makes, up to a specified limit; and deduct a net operating loss carryover. The tax rates on unrelated business income are the same as the corporate tax rates (unless the organization is a trust, in which case the trust rates are used). Also, features such as general business tax credit carryovers, the alternative minimum tax, etc., apply in a manner similar to corporate income taxes. The first \$1,000 of unrelated business income is not subject to tax. The tax is computed on Form 990-T (Exempt Organization Business Income Tax Return); the return need not be filed if gross unrelated business income is less than \$1,000.

## Excise Taxes Payable

Generally, private foundations are subject to a 2% excise tax on their net investment income. The tax rate goes down to 1% if certain requirements related to distributions to charities and undistributed net income are met. An exemption is given for private operating foundations that are publicly supported and managed. A private operating foundation is a foundation that actively carries out program activities related to its exempt purpose, rather than merely acting as a conduit by making distributions to other organizations to carry out the exempt purpose. Net investment income includes dividends, interest, rents, royalties, and capital gain net income (net capital gains less net capital losses to the extent of net capital gains), less reasonable expenses. The foundation will need to keep

records of expenses allocable to investment income. In addition, a private foundation is required to make annual distributions for exempt purposes in an amount equal to its "minimum investment return" (as defined, essentially 5% of the market value of its net investment assets) or it will incur an excise tax of 30% on its undistributed income. The tax increases to 100% if the failure to distribute the income is not corrected in a specified time. Private foundations are also subject to excise taxes on prohibited transactions and excess business holdings.

### **Lobbying Tax**

Certain nonprofit organizations are required to make disclosures about lobbying expenses to its members who pay dues (or similar amounts) and on its income tax return. Instead of making the required disclosures to its members, a nonprofit organization can annually elect to pay a proxy tax equal to 35% of the lesser of its lobbying expenses or dues (and similar amounts) collected during the year. The accountant should be aware of the lobbying disclosure requirements and should determine whether the tax will be incurred and reflected in the financial statements.

### **Contribution Penalty**

Charitable contributions are only deductible to the extent the donation's value exceeds the value of any goods or services the donor receives in return. The IRS requires charities to provide donors with an estimate of the fair market value of the benefits given to the donor in return for *quid pro quo* (part donation/part purchase) donations if the total payment received for the *quid pro quo* contribution exceeds \$75. If a charity fails to comply with the disclosure rule and does not have reasonable cause for the failure, it is subject to a \$10 per contribution penalty (capped at \$5,000 per fund-raising event or mailing). The penalty applies when the organization fails to make any disclosure or when it makes a disclosure that is incomplete or inaccurate. If the organization incurs the penalty and it is not material, the amount can be included in a caption such as "Accrued expenses." If the amount is material, it could be reported as a separate line in the taxes payable section. For contributions of \$250 or more, a donor's charitable deduction is disallowed unless a written acknowledgment of the donation is obtained from the recipient organization. In those cases, *a donor's canceled check is not sufficient to substantiate a donation*. While the law puts the burden on the donor to obtain an acknowledgment, no organization that depends on public donations will survive very long if it fails to give its donors the substantiation they need. The acknowledgement must include the amount of cash and a description (but not a valuation) of any other property contributed and a statement concerning whether the organization provided any goods or services in return for the contribution. If the organization did provide something in return for the contribution, the acknowledgement must include a description and good faith estimate of the value of the item(s) provided. An acknowledgement must be received by the donor by the filing date of the donor's return for the year of the donation (or, if earlier, by the due date, including extensions, of that return), and multiple contributions may be combined into one acknowledgement letter reflecting the donor's total gifts for the year.

### **Penalties against Individuals—Intermediate Sanctions**

One of the serious issues facing tax-exempt organizations is the absolute prohibition against inurement of benefit. Inurement of benefit is the use of a tax-exempt organization's assets for the personal benefit of a control party (i.e., a person who has direct or indirect control of the organization, such as a founder, director, officer, major donor, or trustee). In the past, even the smallest amount of inurement of benefit would result in the revocation of an organization's exempt status. Before passage of the Taxpayer Bill of Rights 2 Act of 1996, the only recourse against inurement of benefit was the revocation of the tax-exempt organization's exempt status. Because this penalized the organization, its donors, and the general public, instead of the individuals who caused the organization to incur excessive expenditures that would have been better used to pursue its exempt purpose, Congress enacted the provisions known as "intermediate sanctions" in the Taxpayer Bill of Rights 2 Act of 1996. The intermediate sanctions provisions are included in IRC Sec. 4958.

The intermediate sanction provisions are designed to protect donors and tax-exempt organizations from insider dealing and excessive executive compensation. Because intermediate sanctions relate only to disqualified persons and not to the organization, the organization itself does not have any potential liability for such sanctions. However, excess benefit transactions can potentially jeopardize an organization's tax-exempt status if the excess benefit is so great that the organization is no longer operating as a charitable organization. Accountants should be alert for any transactions with a disqualified person that could potentially result in excess benefit to that person.

The following paragraphs summarize the types of excise taxes imposed by IRC Sec. 4958 and provide brief definitions of several key terms included in the intermediate sanctions provisions. Detailed guidance on the intermediate sanction provisions is available in *PPC's 990 Deskbook* and in *PPC's Guide to Religious Organizations*. [Call (800) 431-9025 for order information or order online at [ppc.thomsonreuters.com](http://ppc.thomsonreuters.com).]

**Excise Taxes.** IRC Sec. 4958 provides three types of excise tax to be imposed when an *excess benefit transaction* occurs:

- a. *Tax on Disqualified Persons.* An excise tax is imposed on the disqualified person who received economic benefits from an applicable tax-exempt organization in excess of the value of the consideration given for such benefits. This excise tax equals 25% of the value of the *excess benefit* received.
- b. *Tax on Organization Managers.* If a tax is assessed against a disqualified person, then any *organization manager* who participated in, or knew of, the excess benefit transaction is subject to an excise tax equal to 10% of the value of the excess benefit, unless such participation "is not willful and is due to reasonable cause." The maximum tax that will be imposed on all organization managers for each excess benefit transaction is \$10,000. For years beginning after August 17, 2006, this maximum tax is increased to \$20,000. If more than one manager participates in a transaction, all are jointly and severally liable. An organization manager who also receives an excess benefit from an excess benefit transaction can be liable for both the 25% and 10% taxes.
- c. *Additional Tax on Disqualified Persons.* An additional excise tax is imposed on the disqualified person if the excess benefit transaction is not corrected within the taxable period. This tax equals 200% of the excess benefit.

**Disqualified Person.** A *disqualified person* is anyone who was, at any time during the five-year period ending on the date of the *excess benefit transaction*, in a position to exercise substantial influence over the affairs of an organization. To be a disqualified person, it is not necessary that the person actually exercise substantial influence, only that the person be in a position to exercise substantial influence. Also included are a member of such person's family and any entity (corporation, partnership, LLC, trust, or estate) in which the disqualified person and members of his family have more than 35% ownership interest. The members of a person's family are his spouse, siblings (whether by whole or half blood) and their spouses, ancestors, direct descendants through great-grandchildren, and spouses of such descendants.

Certain individuals are automatically deemed to have the requisite substantial influence. These include:

- a. Voting members of the organization's governing body.
- b. The president, chief executive officer, or chief operating officer and anyone who, regardless of title, has or shares ultimate responsibility for implementing the decisions of the governing body or for supervising the organization's management, administration, or operation.
- c. The treasurer or chief financial officer and anyone who, regardless of title, has or shares ultimate responsibility for managing the organization's finances.

However, any of the officers referred to in the previous paragraph can avoid disqualified person status by demonstrating that he does not, in fact, have the requisite responsibility. Moreover, a person who has the authority to sign or direct the signing of bank drafts (checks) or to authorize electronic wire transfers of funds will not be deemed to have ultimate responsibility for managing the organization's finances simply because of such limited authority.

The term *person* includes entities as well as individuals. For example, a management company that has ultimate responsibility for managing the affairs of an applicable organization is a disqualified person because it is in a position to exercise substantial influence over the organization's affairs.

**Excess Benefit Transactions.** The definition of excess benefit transaction is broad. An *excess benefit transaction* occurs when the economic benefit provided, either directly or indirectly, by an applicable tax-exempt organization to or for the use of a disqualified person exceeds the value of the consideration received. To determine whether an

excess benefit transaction has occurred, all consideration and benefits exchanged between a disqualified person and the applicable tax-exempt organization, and all entities it controls, are taken into account. In determining the value of economic benefits, the value of property received (including the right to the use of property) is its fair market value on the date of receipt. Common examples of an excess benefit transaction include: the payment of unreasonable compensation to a disqualified person; a sale of property by an applicable tax-exempt organization to a disqualified person for less than fair market value; a sale of property by a disqualified person to an applicable tax-exempt organization for more than fair market value; an expense reimbursement under a nonaccountable plan [within the meaning of Reg. 1.62-2(c)(3)] that is not treated as compensation; and the payment of the personal expenses of a disqualified person.

An economic benefit is provided by an organization even if the transfer of the benefit was not authorized under the organization's regular procedures (i.e., embezzlement by a disqualified person is an excess benefit transaction). The statutory inclusion of indirectly provided benefits is intended to prevent circumvention of the rules through a controlled entity (i.e., where there is more than 50% ownership, actually or constructively) or through an intermediary.

### **For-profit Subsidiaries**

The Taxpayer Relief Act of 1997 made it harder for nonprofit organizations to avoid unrelated business income taxes on income from subsidiaries. If a nonprofit organization has for-profit subsidiaries, the organization may encounter the same tax issues as those of for-profit entities. Some of the more complex issues related to accounting for income taxes of for-profit subsidiaries are beyond the scope of this course. However, such guidance is available in *PPC's Guide to Accounting for Income Taxes*.

### **Accrued Taxes Payable**

Taxes currently payable are the amount that would have been due on the organization's tax return as of the statement of financial position date. The amount of taxes currently payable may differ from the liability on the tax return actually filed because of the following:

- a. Payments were made subsequent to the statement of financial position date.
- b. The provision was estimated for the financial statements before the returns were prepared.

### **Deferred Income Tax Assets and Liabilities**

Although nonprofit organizations are generally tax-exempt, some may be subject to federal and state income taxes, such as unrelated business income taxes or federal excise taxes on investment income. Organizations should follow the guidance in FASB ASC 740-10 (formerly SFAS No. 109, *Accounting for Income Taxes*) for recognizing current and deferred taxes payable or refundable. It is important for accountants to note that nonprofit organizations are *not* excluded from the scope of FASB ASC 740-10 (formerly SFAS No. 109).

Computing the provision for income taxes is discussed in *PPC's Guide to Preparing Nonprofit Financial Statements*. The deferred tax liability or asset is generally computed by multiplying the applicable tax rate by identified taxable temporary differences. Temporary differences are differences between income tax and financial reporting that have future tax consequences. Specifically, they are differences between the financial and tax bases of assets and liabilities that will result in future taxable income or future tax deductions.

Because income taxes incurred by a nonprofit organization often represent unrelated business income taxes, the types of temporary differences that arise may be as varied as those of a for-profit entity. Although not all-inclusive, the following list contains some of the more common types of temporary differences a nonprofit organization may experience:

- Depreciation on assets used in unrelated business activities determined for financial reporting using estimated useful lives or methods that differ from tax reporting.
- Bad debts from unrelated business activities that are recognized using the allowance method for financial reporting and the direct charge-off method for tax reporting.

- Unrealized gains or losses on investments that are recognized for financial reporting but not recognized for tax reporting until realized.
- Inventories used in unrelated business activities that are recorded at the lower of cost or market for financial reporting and at cost for tax reporting.
- Inventory-related costs that are expensed for financial reporting and capitalized for tax reporting.
- Investments representing unrelated business activities that are accounted for by the equity method for financial reporting and the cost method for tax reporting.
- Expenses from unrelated business activities that are accrued for financial reporting but deductible for tax reporting only when actually paid (for example, vacation pay, certain loss contingencies, and losses on discontinued operations).

**Valuation Allowance.** If a nonprofit organization has recorded deferred tax assets, a valuation allowance should be provided for those assets if it is more likely than not that all or a portion of the asset will not be realized. In other words, a deferred tax asset should be recognized only if there is more than a 50% chance that it will be realized. The need for a valuation allowance should be reevaluated each year based on current circumstances. Changes in the valuation allowance from year to year should be included in the deferred tax provision in the year of the change.

Whether a deferred tax asset should be realized requires considerable judgment. The potential effects of both positive and negative evidence should be weighed. If negative evidence exists, it may be difficult to conclude that a valuation allowance is not needed for at least a portion of the deferred tax asset. The existence of negative evidence does not always indicate that a valuation allowance is necessary, however. In some cases, positive evidence may exist that outweighs the negative evidence, and a conclusion can be reached that a valuation allowance is not needed.

### Accounting for 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. A tax position might also include:

- a. How income is characterized or the decision to exclude income in a tax return.
- b. Decisions to classify transactions, entities, or other positions as tax exempt.
- c. Allocations or shifts of income between jurisdictions.
- d. Decisions not to file a return.
- e. Status as a pass-through entity or a tax-exempt not-for-profit entity.

According to FASB ASC 740-10-55-223 through 55-228, tax-exempt nonprofit entities and pass-through entities may have tax positions that require evaluation of uncertainty. For example, a tax position might be the entity's status as tax exempt. In addition, a tax position might involve unrelated business income subject to income taxes. Another tax position could be the determination of whether a pass-through entity has nexus in jurisdictions where it has income. For such entities, accounting for uncertainty depends on whether the laws and regulations of the tax jurisdiction attribute income taxes to the entity or its owners (i.e., that consideration affects whether related tax effects should be treated as taxes of the entity or transactions with owners).

The financial statement effect of a tax position should be recognized when it is more likely than not that the position will be sustained upon examination by a taxing authority, including the resolution of related appeals or litigation. For this purpose, the phrase "more likely than not" means that there is greater than a 50% chance that a tax position

would be sustained. The Audit Guide, at Paragraph 15.02, provides examples of tax positions that might be taken by nonprofit organizations:

- a. Deciding whether a tax return needs to be filed; for example, a decision that Form 990T need not be filed.
- b. Deciding whether a transaction, entity or other position is tax-exempt or subject to a lower rate of tax.
- c. Determining the characterization of income; for example, deciding to characterize some income as passive or deciding not to report taxable income.
- d. Deciding on an allocation to shift income between jurisdictions (federal, state, local, or foreign).

**Recognition and Measurement of Tax Benefits.** GAAP requires a two-step approach to recognizing tax benefits: determining whether a tax benefit should be recognized and determining how to measure a tax benefit that is recognized.

Determining whether a tax benefit should be recognized depends on whether the benefit is, or will be, derived from a tax position that meets the “more likely than not” criterion. A tax benefit should only be recognized if the tax position meets the criterion. The nonprofit organization must assess the likelihood that a tax position would be sustained by assuming that the taxing authority will examine the return in which the position is, or will be, taken, and that the taxing authority will examine the position. That is, GAAP prohibits considering the possibility that a return may not be examined or that, even if a return is examined, the position may not be examined. The recognized tax benefit should be measured as the largest amount of tax benefit for which there is greater than a 50% chance of realization after an assumed examination by a taxing authority with complete knowledge of all relevant information related to the tax position. The largest amount of tax benefit should be determined using facts and circumstances available and should also consider likely outcomes.

The portion of the deduction expected to be accepted by the taxing authority can be determined qualitatively or quantitatively.

- a. A qualitative assessment could be made in a variety of ways. For example, it could be made based on the accountant's experience with comparable situations or based on the accountant's understanding of the recent trend of rulings by the taxing authority.
- b. A quantitative assessment could be made based on different probability scenarios under which the amount recognized is the largest amount above a cumulative probability greater than 50%.

To help focus discussions on the effects of FASB ASC 740-10 (formerly FIN 48), the illustrations in this section use simple facts and circumstances and a 15% tax rate imposed by a single taxing authority. Each illustration assumes that the nonprofit organization did not make estimated tax payments during the year, and therefore, the carrying amount of the current tax liability at year-end equals the amount of tax reported in the tax return. To avoid inferences that a particular tax position always has a certain level of uncertainty, the illustrations describe the uncertainty in income taxes in general terms. The uncertainty of a tax position and the amount of tax benefit that ultimately will be realized depends on the facts and circumstances.

**The Effect on Current Tax Provisions.** To illustrate applying this guidance to the computation of current tax provisions, assume that the nonprofit organization:

- a. receives rental income from an activity considered an unrelated trade or business;
- b. has no temporary differences;
- c. reports taxable income of \$6,000, consisting of revenue of \$10,000 and expense of \$4,000; and
- d. reports tax of \$900 in its tax return, computed by applying the 15% tax rate to taxable income of \$6,000.

If the nonprofit organization believes there is greater than a 50% chance that, upon examination, the tax position for deducting the \$4,000 expense in the current-year return would be sustained and that there is greater than a 50%

chance the full amount of the deduction would be allowed, the organization would recognize a current tax provision of \$900 and a \$900 liability for the tax reported in the return as illustrated by the following entry:

Current tax provision	900	
Income tax due currently		900

However, if the nonprofit organization believes there is no greater than a 50% chance the tax position would be sustained, GAAP would prohibit recognizing any tax benefit from the \$4,000 deduction. Instead, the current provision would be computed on a pro forma basis ignoring the deduction.

- Pro forma unrelated business income would be \$10,000, consisting solely of the revenue because none of the deduction for the expense could be considered.
- The pro forma tax would be \$1,500, computed by applying the 15% tax rate to the \$10,000 pro forma taxable income.

The \$1,500 pro forma tax exceeds by \$600 the \$900 tax reported in the return. The excess is the tax benefit of the deduction claimed in the return that must be deferred (the \$4,000 deduction by the 15% tax rate). The nonprofit organization would recognize a \$1,500 current provision for the pro forma tax and a \$900 liability for the tax reported in the return. The \$600 difference between those two amounts would be recognized as a liability as illustrated by the following entry:

Current tax provision	1,500	
Income tax due currently		900
Liability for unrecognized tax benefit		600

Therefore, even though the \$600 tax benefit was realized by claiming the \$4,000 deduction in the current-year return, it was not recognized in the statement of activities as a reduction of the current tax provision, but was accrued as a liability. FASB ASC 740-10-25-16 (formerly Paragraph 17 of FASB Interpretation No. 48) describes the liability as the entity's "potential future obligation to the taxing authority for a tax position that was not recognized pursuant to this Interpretation." The liability can be viewed as the organization's obligation to return the realized tax benefit to the taxing authority in the event it disallows the tax position. Therefore, the liability would be the estimated additional tax that would be assessed if the tax position is disallowed.

The liability can also be viewed as a deferral of the tax benefit that was realized by claiming the deduction in the current-year tax return. (As such, the deferral is not a deferred tax liability but a deferral of a current tax benefit.) Recognition of the realized tax benefit in the statement of activities is being deferred until the uncertainty is eliminated or reduced to less than 50%. The liability should be classified based on whether settlement is anticipated within one year (or the operating cycle). The Interpretation also prohibits including the liability for unrecognized tax benefits with deferred tax liabilities or offsetting it against deferred tax assets.

Consistent with the deferral notion, the liability for the unrecognized tax benefit generally would be written off, or derecognized, only when:

- New information, such as additional authoritative support, causes the nonprofit organization to change its assessment of the likelihood the position would be sustained to more likely than not.
- The taxing authority examines, but does not accept, the position, and the organization pays the additional tax assessed.
- The taxing authority examines and accepts the position.
- The statute of limitations for the taxing authority to examine the position expires.

To illustrate, assume that the taxing authority does not examine the tax position in the previous illustration before the statute of limitations expires. In the year the statute expires, the nonprofit organization would eliminate the \$600 liability and recognize an offsetting tax benefit as illustrated by the following entry:

Liability for unrecognized tax benefit	600	
Current tax provision		600

Therefore, in this set of facts and circumstances, the \$600 tax benefit of the \$4,000 deduction would be recognized when the uncertainty is eliminated rather than when the tax benefit is realized by deducting it in the tax return.

**The Effect on Deferred Tax Provisions.** As discussed previously, a taxable or deductible temporary difference is a difference between the tax basis of an asset or liability and its carrying amount in the financial statements. Once the guidance on accounting for uncertainty in income taxes is implemented, the tax basis of an asset or liability will no longer be determined solely based on positions taken, or expected to be taken, in tax returns. Instead, only tax positions that meet the “more likely than not” criterion will be considered in determining the tax basis of an asset or liability.

**Other Considerations.** FASB ASC 740-10 (formerly FIN 48) requires providing for the effect of penalties and interest on the liability for tax benefits that have been realized but have not been recognized. The Interpretation notes that some entities include penalties and interest related to income taxes in the tax provision and other entities include them in expenses; the Interpretation permits either approach but requires disclosure of the approach used. It also requires certain other disclosures. More information on this topic is available in *PPC’s Guide to Preparing Nonprofit Financial Statements*.

ASU No. 2009-06 exempts nonpublic entities from two of the disclosure requirements of FASB ASC 740-10-50 (formerly FIN 48):

- a. the requirement to provide a tabular reconciliation of the total amount of unrecognized tax benefits at the beginning and end of the years presented (FASB ASC 740-10-50-15a), and
- b. the requirement to disclose the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate (FASB ASC 740-10-50-15b).

**Initial Application of FASB ASC 740-10 (formerly FIN 48).** Although the FASB requires applying the guidance in the Interpretation retrospectively, it only permits determining the cumulative effect of retrospective application as of the beginning of the year the Interpretation is first applied. Therefore, in the year this guidance is first applied—

- a. The nonprofit organization should determine whether changes would have been needed to the statement of financial position as of the end of the prior year if this guidance had always been applied.
- b. Those adjustments should be made as of the beginning of the year this guidance is first applied.
- c. The nonprofit organization should not revise any prior-year financial statements that are presented in comparison with those of the year in which this guidance is first applied.

GAAP does not prescribe how the adjustment of beginning unrestricted net assets should be reported. A variety of approaches for reporting the cumulative effect adjustment could be acceptable. For example, beginning unrestricted net assets as originally reported could be shown, followed by the cumulative effect adjustment, with a revised beginning unrestricted net assets amount shown. An equally acceptable approach would be to show the amount of beginning unrestricted net assets, followed by the cumulative effect adjustment, but without showing a revised beginning unrestricted net assets amount.

A nonprofit organization might describe the accounting change as illustrated in the following note to the financial statements:

## NOTE X—ACCOUNTING CHANGE

Generally accepted accounting principles have been changed to impose a threshold for determining when an income tax benefit can be recognized. The threshold now imposed for financial statement reporting generally is higher than the threshold imposed for claiming deductions in income tax returns. The change in generally accepted accounting principles was first effective for the Organization in 2007 and was applied retrospectively as of the beginning of 2007. To comply with the new requirements, tax benefits totaling \$13,000 that were realized through deductions in prior-year returns through 2006 have been deferred as of the beginning of 2007. The effect of this change is to reduce unrestricted net assets by \$13,000 and to recognize an offsetting liability for deferral of the benefits.

**Some Observations.** The following observations may be helpful when evaluating the tax positions of nonprofit organizations.

- The measurement and disclosure principles of FASB ASC 740-10 normally cannot affect the financial statements of a nonprofit organization unless the organization is potentially subject to income taxes (because of unrelated business taxable income or a taxable subsidiary). However, ASU No. 2009-06 clarifies that management's determination of the taxable status of the entity, including its status as a tax-exempt nonprofit organization, is a tax position that is subject to the accounting for uncertainty in income tax requirements.
- The Interpretation will have no effect on a nonprofit organization's financial statements if there is greater than a 50% chance that all tax positions would be sustained upon examination and if there is greater than a 50% chance the full amount of the tax benefits of those positions would be realized upon settlement.
- If there are one or more tax positions for which there is no greater than a 50% chance of being sustained, no tax benefit from those tax positions can be recognized.
- If there are one or more tax positions for which there is greater than a 50% chance they would be sustained, only the portion of the benefit from the position for which there is greater than a 50% chance of realization upon examination should be recognized.
- The assessment as to whether a tax position is more likely than not to be sustained can be made qualitatively or quantitatively.
- Depending on the risk in the tax positions, the guidance may have no impact on current and deferred income taxes and related current and deferred tax assets and liabilities.

### Statement of Financial Position Presentation

When presenting a sequenced statement of financial position, taxes payable or receivable should be sequenced based on when they are due or expected to be received. The preparer should consider the original due date for the nonprofit organization's tax return when determining the sequencing of the current tax payable caption. That is the case even if an extension is granted, since the liability is payable by the original due date. Deferred tax assets and liabilities are typically presented with other long-term assets and liabilities unless they are expected to be substantially realized sooner. For a sequenced statement of financial position, there is no need to classify deferred taxes as current and long-term. The placement and grouping of current and deferred tax liabilities on a sequenced statement of financial position can vary, as shown in the following alternative presentations:

- a. Group taxes payable under headings such as "Taxes payable" and "Deferred tax liabilities" for the components as illustrated by the following:

	<u>20X7</u>	<u>20X6</u>
<b>LIABILITIES</b>		
Accounts payable	90,000	80,000
Accrued expenses		
Compensation	10,000	15,000
Retirement plan contributions	7,000	6,000
Taxes payable		
Excise	1,050	1,400
Unrelated business income	1,450	2,900
Unrecognized tax benefit	600	200
Deferred tax liabilities		
Excise	14,000	15,000
Unrelated business income	22,000	28,500
Long-term debt	<u>115,000</u>	<u>117,000</u>
<b>TOTAL LIABILITIES</b>	261,100	266,000

b. Present taxes payable as separate line items as illustrated below:

	<u>20X7</u>	<u>20X6</u>
<b>LIABILITIES</b>		
Accounts payable	90,000	80,000
Compensation	10,000	15,000
Retirement plan contributions	7,000	6,000
Excise taxes	1,050	1,400
Unrelated business income taxes	1,450	2,900
Unrecognized tax benefit	600	200
Deferred tax liabilities	14,000	15,000
Deferred unrelated business income taxes	22,000	28,500
Long-term debt	<u>115,000</u>	<u>117,000</u>
<b>TOTAL LIABILITIES</b>	261,100	266,000

If taxes payable are not material, the amounts can be included in the accounts payable caption rather than being reflected as separate line items.



**SELF-STUDY QUIZ**

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

23. Which of the following nonprofit organizations would be subject to unrelated business income taxes?
- a. The Trinity Group earns income from activities deemed to be related to pursuit of its exempt purpose.
  - b. Community Outreach earns income from the work of its unpaid volunteers.
  - c. Thrift Town earns income by selling items that were donated by members of the community.
  - d. Mission House earns income from rents based on a percentage of the net income of the property.
24. Jacob, founder of the Island Foundation, a nonprofit organization, was found to have been using some of the organization's assets for his personal benefit. What punishment will be invoked in this scenario?
- a. The foundation must comply with the disclosure rule and pay a \$10 per contribution penalty.
  - b. The foundation's tax-exempt status will be immediately revoked.
  - c. Intermediate sanctions will be imposed against Jacob, and the foundation will not have liability.
25. The Cloud Foundation has a piece of property for sale. If the property were sold to a disqualified person for less than fair market value, an excess benefit transaction would occur. All of the following would be considered *disqualified persons* with respect to the Cloud Foundation, **except**:
- a. Anna is the founder's spouse.
  - b. Bonnie is a volunteer of the Cloud Foundation.
  - c. Cal is a voting member of the foundation's governing body.
  - d. Dave is the chief financial officer of the foundation.
26. Clean Water, a nonprofit organization, claims a tax benefit; however, it is unsure if the tax benefit would meet the "more likely than not" test. After considering the slim likelihood that its return will be examined by the taxing authority, and, even if it were, the chance that the taxing authority would examine that particular position, the organization decides to recognize the tax benefit. Has the right decision been made?
- a. Yes.
  - b. No.
27. Under which of the following circumstances can Clean Water write off or derecognize a liability for an unrecognized tax benefit?
- a. New information confirms the fact that the position would be unlikely to be sustained.
  - b. The organization pays additional tax assessed by the taxing authority.
  - c. The taxing authority examines the position.
  - d. The statute of limitations for the position begins.

**SELF-STUDY ANSWERS**

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

23. Which of the following nonprofit organizations would be subject to unrelated business income taxes? **(Page 58)**
- a. The Trinity Group earns income from activities deemed to be related to pursuit of its exempt purpose. [This answer is incorrect. Under the Internal Revenue Code, nonprofit organizations exempt from income taxes may receive unlimited amounts of income from activities substantially related to the pursuit of their exempt purposes.]
  - b. Community Outreach earns income from the work of its unpaid volunteers. [This answer is incorrect. According to the Code, unrelated business income does not include income substantially generated by unpaid volunteers.]
  - c. Thrift Town earns income by selling items that were donated by members of the community. [This answer is incorrect. Income earned from selling merchandise donated to the organization does not qualify as unrelated business income, per the Code.]
  - d. Mission House earns income from rents based on a percentage of the net income of the property. [This answer is correct. According to the Internal Revenue Code, Mission House's rental income would be considered unrelated business income and, thus, would be taxed.]**
24. Jacob, founder of the Island Foundation, a nonprofit organization, was found to have been using some of the organization's assets for his personal benefit. What punishment will be invoked in this scenario? **(Page 59)**
- a. The foundation must comply with the disclosure rule and pay a \$10 per contribution penalty. [This answer is incorrect. Contribution penalties only apply when a nonprofit organization fails to provide donors with an estimate of the fair market value of the benefits given to the donor in return for *quid pro quo* donations if the total payment received for the *quid pro quo* contribution exceeds \$75. That is not the problem in this scenario.]
  - b. The foundation's tax-exempt status will be immediately revoked. [This answer is incorrect. Before passage of the Taxpayer Bill of Rights 2 Act of 1996, the only recourse against inurement of benefit was the revocation of the tax-exempt organization's exempt status. However, there is now a better option.]
  - c. Intermediate sanctions will be imposed against Jacob, and the foundation will not have liability. [This answer is correct. Congress enacted provisions known as "intermediate sanctions" in the Taxpayer Bill of Rights 2 Act of 1996. The intermediate sanctions provisions are included in IRC Sec. 4958. They relate only to disqualified persons and not to the organization, so the organization does not have any potential liability for such sanctions.]**
25. The Cloud Foundation has a piece of property for sale. If the property were sold to a disqualified person for less than fair market value, an excess benefit transaction would occur. All of the following would be considered *disqualified persons* with respect to the Cloud Foundation, **except: (Page 60)**
- a. Anna is the founder's spouse. [This answer is incorrect. Under the Code, the definition of a disqualified person includes members of the person's family, such as his spouse, siblings (whether by whole or half blood) and their spouses, ancestors, direct descendants through great-grandchildren, and spouses of such descendants.]
  - b. Bonnie is a volunteer of the Cloud Foundation. [This answer is correct. Per the Code, the definition of a qualified person is anyone who was, at any time during the five-year period ending on the date of the excess benefit transaction, in a position to exercise substantial influence over the affairs of an organization. As a mere volunteer, Bonnie would not be in a position to influence the Cloud Foundation or the excess benefit transaction.]**

- c. Cal is a voting member of the foundation's governing body. [This answer is incorrect. Under the Code, Cal's position as a voting member automatically means he has the requisite substantial influence to be a disqualified person.]
  - d. Dave is the chief financial officer of the foundation. [This answer is incorrect. Under the Code, the treasurer or chief financial officer and anyone who, regardless of title, has or shares ultimate responsibility for managing the organization's finances is automatically deemed to have the influence to be a disqualified person.]
26. Clean Water, a nonprofit organization, claims a tax benefit; however, it is unsure if the tax benefit would meet the "more likely than not" test. After considering the slim likelihood that its return will be examined by the taxing authority, and, even if it were, the chance that the taxing authority would examine that particular position, the organization decides to recognize the tax benefit. Has the right decision been made? **(Page 63)**
- a. Yes. [This answer is incorrect. GAAP prohibits an organization from considering the possibility that a return may not be examined or that, even if a return is examined, the position may not be examined. Therefore, Clean Water should not have recognized this tax position without clarifying if it met the "more likely than not" test.]
  - b. No. [This answer is correct. Under GAAP, the organization must decide whether a position meets the "more likely than not" test by assuming that the taxing authority will examine the return in which the position is, or will be, taken, and that the taxing authority will examine the position. Therefore, the decision made by Clean Water above is not in accordance with GAAP.]**
27. Under which of the following circumstances can Clean Water write off or derecognize a liability for an unrecognized tax benefit? **(Page 64)**
- a. New information confirms the fact that the position would be unlikely to be sustained. [This answer is incorrect. If new information, such as additional authoritative support, causes the organization to change its assessment of the likelihood the position would be sustained to more likely than not, then it could write off or derecognize the benefit.]
  - b. The organization pays additional tax assessed by the taxing authority. [This answer is correct. If the taxing authority examines, but does not accept, the position, and the organization pays the additional tax assessed, the organization can then write off or derecognize the liability, according to the Code.]**
  - c. The taxing authority examines the position. [This answer is incorrect. If the taxing authority examines and accepts the position, then it can write off or derecognize the benefit. Examination of the position alone is not enough for the organization to take that step.]
  - d. The statute of limitations for the position begins. [This answer is incorrect. Once the statute of limitations for the taxing authority to examine the position expires, the organization can write off or derecognize the liability.]

## LONG-TERM DEBT AND THE STATEMENT OF FINANCIAL POSITION

Similar to business enterprises, nonprofit organizations may incur unsecured or secured debt, such as long-term debt secured by a mortgage on property or equipment. Long-term debt consists of the following:

- a. Notes that provide for repayment over a term longer than one year.
- b. Notes or loans whose form is short-term but that are treated as long-term.
- c. Obligations under capital leases due over a term longer than one year.

Conceptually, the principal balance of any debt represents the present value of future payments discounted over the repayment period using the interest rate stated in the agreement. The present value computation varies with the payment arrangement. Financing arrangements are becoming more creative, even in nonprofit organizations. However, the GAAP concept of discounting for the "time value of money" is unaffected. This discussion of long-term debt refers to fair value measurement in several instances. Lesson 1 discusses fair value measurement and the related authoritative literature in more depth.

### Maturities of Long-term Debt

FASB ASC 210-10-45-5 (formerly ARB No. 43) requires that principal reductions of long-term debt scheduled during the next year be classified as a current liability in a classified statement of financial position. However, even if a nonprofit organization is preparing a sequenced statement of financial position, the entity will need to know the maturities of long-term debt for disclosure in the notes to the financial statements. Normally, the maturities may be quickly computed by adding the principal portion of each year's 12 payments on the amortization schedule for the five years following the statement of financial position date. However, the computation is complicated somewhat by situations such as the following:

- There is no amortization schedule.
- Payments are in arrears.
- The interest rate floats (for example, prime plus 2%).

Each of those may be solved through present value computations using a computer amortization program or an inexpensive present value calculator, but the preparer will need to know payment amounts (including balloon payments), interest rates, and the number of payments remaining. Preparers should normally obtain a copy of the debt agreement because it provides information about payment arrangements as well as collateral arrangements, both of which are necessary for preparation of financial statements.

Maturities represent the difference between the present value of payments outstanding (including balloon payments) computed as of the statement of financial position date and 12-month increments after the statement of financial position date. If the interest rate floats, the rate in effect at the statement of financial position date can be used. The current rate may be determined in either of the following ways:

- a. The lender may provide it.
- b. It may be derived through present value computations.

If the nonprofit organization is preparing a classified statement of financial position, the current maturities should be included on a separate line in the current liabilities section. (Additional consideration needed if a classified statement of financial position is being prepared is discussed later in this lesson.)

### Accounting for Violations of Debt Covenants

Most nonprofit organizations do not have debt with significant covenants. If, however, the organization's debt agreement has covenants, the organization is in violation of the agreement, and the debt is callable, the preparer

should sequence the debt accordingly in the statement of financial position. (See additional consideration on accounting for violations of debt covenants for classified statements of financial position later in this lesson.)

### Problems of GAAP Measurement for Debt

**Determining the Effective Interest Rate.** The *interest method* is defined in FASB ASC 835-30-20 (formerly APB Opinion No. 12, Omnibus Opinion—1967) as a method of arriving “at a periodic interest cost (including amortization) that will represent a level effective rate on the sum of the face amount of the debt and (plus or minus) the unamortized premium or discount and expense.” In other words, interest costs should include amortization of premium or discount and costs incurred in obtaining the debt. Present value computations should be made using the interest method. It is specifically required in the following cases:

- a. FASB ASC 310-10 and 835-30 (formerly APB Opinion No. 21, *Interest on Receivables and Payables*) requires its use when interest has been imputed.
- b. FASB ASC 840-30-35-6 (formerly SFAS No. 13, *Accounting for Leases*) requires its use for obligations under capital leases.
- c. FASB ASC 470-30-35-1 (formerly SFAS No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*) requires its use for certain modification of terms.

In addition, SFAC No. 6, *Elements of Financial Statements*, indicates a preference for that method for all debt. The Audit Guide, Paragraph 10.13, states that the interest method should be used to amortize discounts on unconditional promises to give.

**Rule of 78s.** Some debt agreements provide for interest amortization using the “Rule of 78s” method, which amortizes interest using the sum-of-the-years’ digits method and, therefore, amortizes interest faster in the early periods. (Note that the sum of the numbers 1 through 12 is 78.) The results are normally not materially different from the interest method when the term is five years or less. However, a straight-line method normally would vary materially from the interest method.

**Financing Arrangements with Low Stated Interest.** Some financing arrangements state a low interest rate but require a lump-sum payment at the end of the debt term. For example, some loan agreements provide for terms that appear to yield a low interest rate. However, they also contain an option to purchase the financed asset at a specified amount. At the inception of the loan, the lender requires the borrower to sign an agreement to exercise the option. The “option” then becomes a guaranteed residual payment to the lender. When that is considered in the present value computations, the effective rate typically approximates current market rates. In applying the interest method to those arrangements, the effective interest rate should be used throughout the debt term. The effective rate may be determined from present value computations, even if a trial and error method is used to “ballpark” the rate.

**Imputing an Interest Rate.** When a note is exchanged for property, goods, or services, FASB ASC 835-30-25-6 (formerly APB Opinion No. 21) requires consideration of whether the interest rate stated in the agreement is reasonable in comparison with prevailing market conditions. When a note is exchanged solely for cash, this guidance does not apply because the present value of the debt service (i.e., principal and interest) is presumed to equal the cash received. When this guidance applies, the following decision process is required:

- a. The property, goods, or services received should preferably be recorded at whichever of the following is more clearly determinable:
  - (1) Fair value of the items received.
  - (2) Market value of the note.
- b. In the absence of established exchange prices for the items or evidence of the market value of the note, the items received should be recorded at the present value of future payments under the note discounted, using an *appropriate interest rate*.

The following summarizes the two-step process, in the absence of an established exchange price, used to discount a \$1 million note to its present value at December 31, 20X7.

Information required for calculation:

- Payment amount                      \$ 25,000 per quarter
- Terms                                      No payments for first 3 years  
\$ 25,000 due on 1/1/Y1  
\$ 25,000 due over next 39 quarters
- Interest rate                              16% per annum (or 4% per quarter)

Calculate present value of the \$25,000 annuity as of January 1, 20Y1 (PV of 39 payments of \$25,000 at 4% plus \$25,000)	\$	514,612
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Calculate the present value of the \$514,612 as of December 31, 20X7 (PV of the \$514,612 future value at 4% for 12 quarters)	\$	321,425
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The calculation results in a discount of \$678,575 (\$1,000,000 – \$321,425).

An “appropriate interest rate” should be determined at the inception of the note, and subsequent changes in market conditions should not be considered. FASB ASC 835-30-25-12 (formerly APB Opinion No. 21) offers the following guidance on determining an appropriate interest rate:

- a. Prevailing rates for similar instruments of issuers (borrowers) with similar credit ratings will normally help determine the appropriate discount rate.
- b. The discount rate used should be the rate at which the debtor could obtain financing of a similar nature from other sources at the date of the transaction. (That is the same as the “incremental borrowing rate.”)
- c. The objective is to approximate the rate that would have resulted if an independent borrower and an independent lender had negotiated a similar transaction under comparable terms and conditions, with the option to pay the cash price upon purchase or to give a note for the amount of the purchase that bears the prevailing rate of interest to maturity.

**Changes in Debt Terms.** Debt terms for a nonprofit organization may be changed in the following ways:

- a. Forgiveness of principal.
- b. Transfer of assets in full settlement.
- c. Modification of terms.

Accounting by debtors for changes in debt terms is prescribed by the following:

- FASB ASC 470-60 (formerly SFAS No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*) applies if the creditor grants a concession to the debtor, for economic or legal reasons related to the debtor’s financial difficulties, that it would not otherwise consider.
- FASB ASC 470-50-40-2 and 40-4 (formerly APB Opinion No. 26, *Early Extinguishment of Debt*) deal with all other situations.

When assets or equity interests are transferred in settlement of debt, the borrower should recognize a gain equal to the excess of the debt’s carrying amount over the fair value of assets transferred to the creditor. Any difference between the fair value and the carrying amount of assets transferred is a gain or loss on transfer of assets. If the debt is forgiven and no consideration is required, the entire principal reduction is included in the statement of

activities as a gain. FASB ASC 470-50-45-1 (formerly SFAS No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*) permits the recognition of an extraordinary gain or loss from debt extinguishment only when it meets the criteria of FASB ASC 225-20 (formerly APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*).

Normally, a modification of terms should be accounted for prospectively and does not affect the borrower's change in net assets in the year of modification. If the carrying amount of the debt exceeds the total future cash payments specified by the new terms, however, the borrower should reduce the debt's carrying amount to the total future cash payments specified by the new terms and recognize a gain on debt restructuring for the amount of the reduction. Subsequently, all cash payments under the terms of the debt should be accounted for as principal reductions, and no interest expense should be recognized on the debt.

FASB ASC 470-60 (formerly SFAS No. 15) only applies to changes in debt terms associated with a troubled debt restructuring. A substantial modification in terms of existing debt other than in a troubled debt restructuring or an exchange of existing debt for new debt with substantially different terms should be accounted for in accordance with FASB ASC 470-50 (formerly EITF Issue No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments"), which is discussed later in this lesson. FASB ASC 470-60-55-4 through 55-14 (formerly EITF Issue No. 02-4, "Determining Whether a Debtor's Modification or Exchange of Debt Instruments Is within the Scope of FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*") clarify that if a debtor is experiencing financial difficulty and the creditor grants the debtor a concession, FASB ASC 470-60 (formerly SFAS No. 15) applies. However, if the debtor is not experiencing financial difficulty or the creditor has not extended any concession in response to the debtor's financial difficulty, FASB ASC 470-50 (formerly EITF Issue No. 96-19) applies. FASB ASC 470-60-55 (formerly EITF Issue No. 02-4) provides guidance for determining whether a debtor is experiencing financial difficulty and whether a creditor has granted a concession.

FASB ASC 470-50-40-6 through 40-10 (formerly EITF Issue No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments") address how a debtor should account for (a) an exchange of existing debt for new debt with substantially different terms and (b) a substantial modification in terms of existing debt *other than in a troubled debt restructuring*. The guidance concluded that:

- a. An exchange of debt with substantially different terms is a debt extinguishment and should be accounted for in accordance with FASB ASC 405-20-40-1 (formerly SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*).
- b. A substantial modification of terms also should be accounted for as an extinguishment.
- c. An exchange of debt or modification of debt terms is considered "substantial" if the present value of the cash flows under the terms of the new debt differs by at least 10% from the present value of the remaining cash flows under the terms of the original debt. Otherwise, the exchange of debt or modification of terms is not considered to be substantially different.
- d. The following guidance should be used when applying the 10% cash flows test:
  - (1) The new cash flows include all cash flows specified by the new debt agreement plus amounts paid by the debtor to the creditor and less amounts received by the debtor from the creditor.
  - (2) The present value calculations should use the effective interest rate, for accounting purposes, of the original debt instrument.
  - (3) The rate in effect at the date of the debt exchange or modification should be used to calculate cash flows if the old or new debt has a floating interest rate.
  - (4) If there is a call or put option related to either the old or the new debt, cash flows should be calculated separately assuming exercise and nonexercise of the options. The assumption that results in the smaller change in cash flows should be used to determine whether the 10% test is met.

- (5) Judgment should be used in calculating cash flows based on contingent payment terms or unusual interest rate terms.
- (6) If the debt was exchanged or modified within a year of the current debt exchange or modification without being deemed to be substantially different, then the debt terms that existed a year earlier should be used to determine whether the current exchange or modification is substantially different.

**Credit Line or Revolving Debt Arrangements.** A credit line or revolving debt arrangement allows the borrower to make multiple borrowings up to a specified maximum amount, repay portions of prior borrowings, and then reborrow under the same contract. The arrangements may include both amounts drawn by the debtor and loan commitments. The debtor generally defers and amortizes the costs incurred to establish the arrangement over the term of the arrangement. Although FASB ASC 470-50 (formerly EITF Issue No. 96-19) provides guidance for debt modifications and exchanges, it does not specifically address credit line or revolving debt arrangements or how to apply the 10% cash flows tests to such arrangements.

FASB ASC 470-50-40-21 (formerly EITF Issue No. 98-14, "Debtor's Accounting for Changes in Line-of-Credit or Revolving-Debt Arrangements") states that credit line or revolving debt modifications or exchanges that result in either a new credit line or revolving debt arrangement or in traditional term debt should be assessed as follows:

- a. The debtor should compare the borrowing capacity of the old arrangement to that of the new arrangement. Borrowing capacity is calculated by multiplying the remaining term by the maximum available credit. (For example, the borrowing capacity of a \$100,000 loan commitment with two years remaining equals \$200,000.)
- b. If the new arrangement's borrowing capacity is at least equal to that of the old arrangement, the debtor should defer and amortize any unamortized deferred costs relating to the old arrangement, any fees paid to the creditor, and any third-party costs over the term of the new arrangement.

To illustrate, assume that a \$1,000,000 loan commitment with two years remaining and unamortized loan costs of \$40,000 is refinanced as a \$1,200,000 commitment for three years at a cost of \$60,000. The borrowing capacity is \$2,000,000 (\$1,000,000 commitment × 2 years remaining) under the old arrangement and \$3,600,000 (\$1,200,000 commitment × 3 years) under the new arrangement. Since the new arrangement's borrowing capacity exceeds that of the old arrangement, the \$100,000 total of the \$40,000 loan costs remaining under the old commitment and the \$60,000 cost of obtaining the new commitment should be amortized over the three-year term of the new commitment.

- c. If the new arrangement's borrowing capacity is less than that of the old arrangement, the debtor should defer and amortize any fees paid to the creditor and any third-party costs over the term of the new arrangement. Any unamortized deferred costs relating to the old arrangement should be written off in proportion to the decrease in borrowing capacity. The remaining unamortized deferred costs should then be deferred and amortized over the term of the new arrangement.

To illustrate, assume that a \$2,000,000 loan commitment with three years remaining and unamortized loan costs of \$90,000 is refinanced as a two-year \$1,800,000 commitment at a cost of \$70,000. The borrowing capacity is \$6,000,000 (\$2,000,000 commitment × 3 years remaining) under the old arrangement and \$3,600,000 (\$1,800,000 commitment × 2 years) under the new arrangement. The borrowing capacity has therefore been reduced by \$2,400,000, which is 40% of the \$6,000,000 capacity under the old arrangement. Accordingly, 40% (\$36,000) of the \$90,000 unamortized loan costs remaining under the old commitment should be written off. The \$54,000 remaining balance (\$90,000 – \$36,000) should be added to the \$70,000 cost of obtaining the new commitment, and the \$124,000 total should be amortized over the two-year term of the new commitment.

Any write-off of unamortized deferred costs relating to the old arrangement should not be classified as extraordinary in the statement of activities.

Classification of revolving debt agreements can also be an issue. FASB ASC 470-10-45-3 through 45-6 (formerly EITF Issue No. 95-22, "Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements that Include both a Subjective Acceleration Clause and a Lock-Box Arrangement") apply to any revolving line

of credit that (a) contains a subjective acceleration clause and (b) requires customer payments to be made directly to a lock-box account, which is then applied directly to the outstanding balance of the line of credit. If a line of credit includes these features, it must be classified as a current liability even though the agreement may not expire until more than one year after the statement of financial position date.

**Installment Loans.** Installment loans are sometimes recorded on a gross basis by charging an *asset* account for the interest portion of installments outstanding and crediting a *liability* account for the total of installments (principal and interest) outstanding. That method arose when the “Rule of 78s” method was more prevalent and it was necessary to keep track of unamortized interest charges. The unamortized amount is not an asset and, instead, should be offset against total installments outstanding. The net amount would be reported as a liability.

**Costs of Obtaining Financing or Refinancing.** Organizations incur costs in obtaining financing or refinancing. For nonprofit organizations, those costs can include bank fees, accounting fees, and legal fees. FASB ASC 310-20 (formerly SFAS No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*) generally requires *lenders* to account for their fees as an adjustment of yield. Therefore, the bank fees are, in substance, discounts on the debt. The other costs of obtaining financing, which usually are not material to significant subtotals in the statement of financial position, are similar in concept to bank fees. Accordingly, those costs could also be offset against the debt and amortized to interest expense using the interest method described previously unless the loan is payable on demand or under a revolving line of credit or similar arrangement with no scheduled payments.

SFAC No. 6, *Elements of Financial Statements*, views discount and debt issue costs the same. Neither has substance apart from the debt, and neither is an asset. Both should be offset against the debt and amortized to interest expense using the interest method. As described previously, the interest method produces a periodic interest cost that reflects a level effective rate on the net loan proceeds. By offsetting discounts and debt issue costs against the debt, interest expense relates directly to the amount reported as a liability.

This guidance differs from GAAP in one respect: the costs that are not in substance discount should be reported as a deferred charge. FASB ASC 835-30-45 (formerly APB Opinion No. 21, *Interest on Receivables and Payables*) requires offsetting the discount against the face amount of the debt, but it requires reporting debt issue costs as a deferred charge. A FASB Statement of Financial Accounting Concepts is not authoritative, so the conclusion in FASB ASC 835-30-45 (formerly APB Opinion No. 21) takes precedence over the conclusion in SFAC No. 6. [However, the position in FASB ASC 835-30-45 (formerly APB Opinion No. 21) is inconsistent with the definition of carrying amount of debt in FASB ASC 470-50-20 (formerly APB Opinion No. 26, *Early Extinguishment of Debt*) and FASB ASC 470-60-20 (formerly SFAS No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*). Each defines the *carrying amount of the debt* as the face amount adjusted for unamortized premium, discount, and cost of issuance.] The effect of the GAAP departure, however, is limited to the statement of financial position (that is, it understates assets and liabilities) and is rarely material.

FASB ASC 310-20-20 and 310-20-35-18 through 35-24 (formerly SFAS No. 91) provide guidance on how lenders should calculate the yield adjustment. Although that guidance does not specifically apply to nonprofit organizations as borrowers, its view of bank fees as yield adjustments of interest provides useful guidance for borrowers. The following definitions are provided:

- **Origination Fees.** Fees charged to the borrower in connection with the process of originating, refinancing, or restructuring a loan. The term includes, but is not limited to, points, management, arrangement, placement, application, underwriting, and other fees pursuant to a lending or leasing transaction and also includes syndication and participation fees to the extent they are associated with the portion of the loan retained by the lender.
- **Commitment Fees.** Fees charged for entering into an agreement that obligates the entity to make or acquire a loan or to satisfy an obligation of the other party under a specified condition. *Commitment fees* include fees for letters of credit and obligations to purchase a loan or group of loans and pass-through certificates.

These provisions were used to develop the following guidance for nonprofit organization borrowers to use in amortizing fees charged by lending institutions:

- If the loan is payable on demand, the fees should be amortized using the straight-line method over a period consistent with the understanding between the borrower and lender. If no such understanding exists, the fees should be amortized over the borrower's estimate of the period that the loan will be outstanding. Any unamortized amount should be charged to interest expense when the loan is paid in full.
- If the loan is a revolving line of credit or similar arrangement with no scheduled payments, the fees should be amortized using the straight-line method over the period the line is active, assuming that borrowings are outstanding for the maximum term provided in the loan contract. Any unamortized amount should be charged to interest expense when the line is paid.
- If a loan commitment expires unexercised, fees should be charged to interest expense in the period of expiration.
- Fees for all other arrangements should be charged to interest expense using the interest method described previously. If the loan's stated interest rate varies based on future changes in an independent factor (for example, prime plus 1%), the calculation of the constant effective yield should be based either on the factor that is in effect at the inception of the loan or on the factor as it changes over the life of the loan.

These provisions were used to provide the following guidance on how nonprofit organization borrowers should account for debt issue costs when the issue is subsequently refinanced or restructured:

- If the refinancing or restructuring is a troubled debt restructuring so that the lender is economically or legally compelled to grant concessions, FASB ASC 470-60 (formerly SFAS No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*) applies.
- If only minor modifications are made to the original loan contract, the unamortized issue costs should be carried forward and amortized over the term of the new loan following the guidance in paragraph .
- If the terms of the refinanced or restructured loan are comparable to those of other organizations with similar collection risks, unamortized issue costs associated with the original loan should be charged to interest expense when the new loan is granted.
- If the terms are not comparable, the unamortized costs associated with the original issue should be amortized over the term of the new loan following the guidance in the previous paragraph.

**Extinguishments of Liabilities.** FASB ASC 405-20-40-1 (formerly SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*) specifies that a liability is considered extinguished if either of the following conditions is met:

- a. The debtor pays the creditor and is relieved of its obligation for the liability.
- b. The debtor is legally released from primary obligation under the liability.

A liability that is considered extinguished should be removed from the debtor's statement of financial position.

If a creditor releases a debtor from primary obligation on the condition that a third party assumes the debt and the original debtor becomes secondarily liable, the release extinguishes the original debtor's liability. However, in that case, the original debtor becomes a guarantor, and should recognize a guarantee obligation at fair value if it is likely that the third party will not pay the debt. The guarantee obligation reduces the debtor's gain (or increases the loss) recognized on extinguishment of the debt.

FASB ASC 405-20-55 [formerly the FASB Implementation Guide (Q&A) titled *A Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*] provides the following guidance on debt extinguishment issues:

- a. A legal defeasance generally is accounted for as an extinguishment since the creditor legally releases the debtor from being the primary obligor. In contrast, an “in-substance” defeasance in which the debtor places assets in a trust to satisfy the debt is not accounted for as an extinguishment.
- b. If old debt is exchanged for new debt with substantially different terms or if existing debt terms are substantially modified, the guidance in FASB ASC 470-50-40 and 50-55 (formerly EITF Issue No. 96-19, “Debtor’s Accounting for a Modification or Exchange of Debt Instruments”) should be followed.
- c. If an entity is released from being the primary obligor but becomes a secondary obligor through a guarantee, the guarantee obligation should be recognized at its fair value through a charge that reduces the gain, or increases the loss, on extinguishment.

**In-substance Defeasance of Debt.** In certain “in-substance” defeasances of debt, the debtor irrevocably places cash or other risk-free monetary assets in a trust solely for satisfying the debt; however, the creditor does not relieve the debtor of primary obligation under the debt (although the possibility that the debtor will be required to make further payments may be remote). The debtor’s liability in such an “in-substance” defeasance is not considered extinguished because it would not meet either condition. Therefore, the debtor could not remove the liability from its statement of financial position. However, disclosure is required of the nature of restrictions placed on assets set aside after December 31, 1996, solely for satisfying scheduled payments of a specific obligation.

**Secured Borrowings.** A debtor may grant a security interest in assets to a lender to serve as collateral for its debt, and the lender may be allowed to sell or repledge the collateral. The accounting for noncash collateral depends on whether the lender has the right to sell or repledge the collateral and if the debtor has defaulted on the loan, as follows:

- a. If the lender is allowed (by contract or custom) to sell or repledge the collateral—
  - (1) the debtor should separately report the collateral as a restricted asset in its statement of financial position, and
  - (2) the lender should not recognize the pledged collateral on its statement of financial position.
- b. If the lender sells the collateral, the lender should recognize the proceeds from the sale of the collateral and its liability for returning the collateral.
- c. A debtor that defaults under the terms of the secured borrowing and is no longer entitled to redeem the collateral should remove the collateral from its statement of financial position. The lender should—
  - (1) record the collateral as its asset at fair value; or
  - (2) if it has already sold the collateral, remove the liability to return the collateral.

### Statement of Financial Position Presentation

Long-term debt can be presented in one of two ways in the statement of financial position. It can be presented as one caption, with information about significant categories and maturities disclosed in the notes to the financial statements. Alternatively, the significant categories (such as notes to banks, mortgage notes, or obligations under capital leases) can be included as separate captions in the statement of financial position with information about maturities disclosed in the notes to the financial statements. Best practices indicate that long-term debt should be the last caption or captions in the liabilities section unless the debt has features that may cause it to be callable at an earlier date (for example, the organization is in violation of certain debt covenants). The preparer should consider all of the circumstances when determining the placement of long-term debt captions in a sequenced statement of financial position. If there are no factors that could cause the debt to be callable, the following is an appropriate presentation:

	<u>20X7</u>	<u>20X6</u>
<b>LIABILITIES</b>		
Accounts payable	\$ 90,000	\$ 80,000
Accrued expenses	15,000	10,000
Short-term notes	50,000	75,000
Notes payable to affiliated entities	20,000	18,000
Loans payable	—	25,000
Long-term debt	<u>500,000</u>	<u>400,000</u>
<b>TOTAL LIABILITIES</b>	675,000	608,000

**SELF-STUDY QUIZ**

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

28. Define the *interest method*.
- A method used to arrive at a periodic interest cost (including amortization) that represents a level effective rate on the sum of the debt's face amount (plus or minus) the unamortized premium or discount and expense.
  - The difference between the present value of outstanding payments (including balloon payments) that are computed as of the date of the statement of financial position and in 12-month increments after that date.
  - A method provided for in some debt agreements in which interest is amortized using the sum-of-the-years' digits method. This method amortizes interest faster in early periods.
  - A method for exchanging a note for property, goods, or services.
29. Baker's Dozen, a nonprofit organization, has a long-term note payable. The organization has financial difficulties due to economic reasons, and the creditor grants a concession by modifying the terms of the debt agreement in a way that will help Baker's Dozen meet its payments. What piece of authoritative guidance governs how Baker's Dozen should account for the changes in debt terms under these circumstances?
- FASB ASC 310-10 and 835-30.
  - FASB ASC 470-50-40-2 and 40-4.
  - FASB ASC 470-60.
  - FASB ASC 840-30-35-6.
30. A nonprofit organization has an arrangement allowing it to make multiple borrowings until a specified maximum amount is reached. Then the organization can repay portions of those borrowings, and it can reborrow under the same contract. What is the term for this scenario?
- An installment loan.
  - Forgiveness of principal.
  - A financing arrangement with low stated interest.
  - A revolving debt arrangement.
31. Fees related to which of the following would be considered commitment fees?
- Points.
  - Letters of credit.
  - Underwriting.
  - Syndication.

32. The Mellman Group is a nonprofit organization. Its debt is not considered extinguished in which of the following scenarios?
- a. The creditor releases the Mellman Group from primary obligation because a third party assumes the debt.
  - b. The organization takes the funds it would use to pay off the debt and puts them in a trust.
  - c. The organization pays off its creditor for its long-term debt.
33. Tiny Footprints, a nonprofit organization, grants a security interest to its lender as collateral for a debt. Under the contract, the lender is allowed to sell the collateral, but it has not done so at the current time. How should the organization report the collateral on its statement of financial position?
- a. It should be reported as a restricted asset.
  - b. It should not be recognized at all.
  - c. Proceeds from sale of the collateral should be recognized.
  - d. It should be removed from the statement.

## 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.)**

28. Define the *interest method*. **(Page 73)**

- a. **A method used to arrive at a periodic interest cost (including amortization) that represents a level effective rate on the sum of the debt's face amount (plus or minus) the unamortized premium or discount and expense. [This answer is correct. This is the definition of the *interest method* found in FASB ASC 835-30-20. In other words, under the interest method, interest costs should include amortization of premium or discount and costs incurred in obtaining the debt.]**
- b. The difference between the present value of outstanding payments (including balloon payments) that are computed as of the date of the statement of financial position and in 12-month increments after that date. [This answer is incorrect. This is the definition of *maturities*.]
- c. A method provided for in some debt agreements in which interest is amortized using the sum-of-the-years' digits method. This method amortizes interest faster in early periods. [This answer is incorrect. This is the definition of the *rule of 78s*. However, the results are not materially different from the interest method when the term is five years or less.]
- d. A method for exchanging a note for property, goods, or services. [This answer is incorrect. When this is done, FASB ASC 835-30-25-6 requires consideration of whether the interest rate stated in the agreement is reasonable in comparison with prevailing market conditions. Making this consideration is called imputing an interest rate and requires a step-by-step decision-making process.]

29. Baker's Dozen, a nonprofit organization, has a long-term note payable. The organization has financial difficulties due to economic reasons, and the creditor grants a concession by modifying the terms of the debt agreement in a way that will help Baker's Dozen meet its payments. What piece of authoritative guidance governs how Baker's Dozen should account for the changes in debt terms under these circumstances? **(Page 74)**

- a. FASB ASC 310-10 and 835-30. [This answer is incorrect. This piece of authoritative guidance requires that the interest method, as defined in FASB ASC 835-30-20, be used when interest has been imputed.]
- b. FASB ASC 470-50-40-2 and 40-4. [This answer is incorrect. This piece of authoritative literature deals with all situations related to accounting by debtors for changes in debt terms, except for the one described in the scenario above.]
- c. **FASB ASC 470-60. [This answer is correct. This piece of authoritative guidance governs accounting by debtors for changes in debt terms when the creditor grants a concession to the debtor, for economic or legal reasons related to the debtor's financial difficulties, that it would not otherwise consider. Based on the information provided in the scenario above, this piece of authoritative guidance will apply to Baker's Dozen.]**
- d. FASB ASC 840-30-35-6. [This answer is incorrect. This piece of authoritative guidance requires that the interest method, as defined in FASB ASC 835-30-20, be used for obligations under capital leases.]

30. A nonprofit organization has an arrangement allowing it to make multiple borrowings until a specified maximum amount is reached. Then the organization can repay portions of those borrowings, and it can reborrow under the same contract. What is the term for this scenario? **(Page 76)**

- a. An installment loan. [This answer is incorrect. The nonprofit organization described above is not using an installment loan. Installment loans are sometimes recorded on a gross basis by charging an *asset* account for the interest portion of installments outstanding and crediting a *liability* account for the total of installments (principals and interest) outstanding.]

- b. Forgiveness of principal. [This answer is incorrect. This is an example of one way a nonprofit organization's debt terms may be changed. The nonprofit organization in the scenario above did not experience a change in debt terms. Accounting for changes in debt terms is discussed by authoritative guidance in the FASB Codification.]
  - c. A financing arrangement with low stated interest. [This answer is incorrect. This type of arrangement is characterized by a financing arrangement that states a low interest rate but requires a lump-sum payment at the end of the debt term.]
  - d. **A revolving debt arrangement. [This answer is correct. Also known as a line of credit, this is the type of arrangement being used by the nonprofit organization described above. These arrangements may include both amounts drawn by the debtor and loan commitments. FASB ASC 470-50-40-21 discusses this type of arrangement.]**
31. Fees related to which of the following would be considered commitment fees? (Page 77)
- a. Points. [This answer is incorrect. According to FASB ASC 310-20-20 and 310-20-35-18 through 35-24, fees related to points would be considered origination fees.]
  - b. **Letters of credit. [This answer is correct. According to FASB ASC 310-20-20 and 310-20-35-18 through 35-24, fees charged for entering into an agreement that obligates the entity to make or acquire a loan to satisfy an obligation of the other party under a specified condition are called commitment fees. Examples of commitment fees include fees for letters of credit and obligations to purchase a loan or group of loans and pass-through certificates.]**
  - c. Underwriting. [This answer is incorrect. Fees associated with underwriting would be considered origination fees under FASB ASC 310-20-20 and 310-20-35-18 through 35-24.]
  - d. Syndication. [This answer is incorrect. Under FASB ASC 310-20-20 and 310-20-35-18 through 35-24, syndication and participation fees are considered origination fees to the extent they are associated with the portion of the loan retained by the lender.]
32. The Mellman Group is a nonprofit organization. Its debt is **not** considered extinguished in which of the following scenarios? (Page 78)
- a. The creditor releases the Mellman Group from primary obligation because a third party assumes the debt. [This answer is incorrect. The debt would be considered extinguished if the creditor released the organization from primary obligation to pay the liability on the condition that a third party assumed the debt and the original debtor becomes secondarily liable, per FASB ASC 405-20-40-1.]
  - b. **The organization takes the funds it would use to pay off the debt and puts them in a trust. [This answer is correct. This is done for an in-substance defeasance of debt. The Mellman Group's liability is not considered extinguished, because the creditor does not relieve the debtor of primary obligation under the debt.]**
  - c. The organization pays off its creditor for its long-term debt. [This answer is incorrect. Under FASB ASC 405-20-40-1, the Mellman Group's liability is considered extinguished after the events in this scenario.]
33. Tiny Footprints, a nonprofit organization, grants a security interest to its lender as collateral for a debt. Under the contract, the lender is allowed to sell the collateral, but it has not done so at the current time. How should the organization report the collateral on its statement of financial position? (Page 79)
- a. **It should be reported as a restricted asset. [This answer is correct. Because the lender is allowed (by contract or custom) to sell the collateral, the debtor should separately report the collateral as a restricted asset in its statement of financial position.]**
  - b. It should not be recognized at all. [This answer is incorrect. This is what the lender, not the organization, should do in the scenario described above.]

- c. Proceeds from sale of the collateral should be recognized. [This answer is incorrect. If the lender sold the collateral, it would recognize the proceeds from the sale and its liability for returning the collateral. However, as the lender has not sold the collateral in this scenario, it would not have to recognize proceeds at this point. Also, if the sale were made, this would be an action taken by the lender, not the organization.]
- d. It should be removed from the statement. [This answer is incorrect. If the organization defaulted under the terms of the secured borrowing and is no longer entitled to redeem the collateral, it would remove the collateral from its statement of financial position. However, that is not the case in this scenario.]

## PRESENTING A CLASSIFIED STATEMENT OF FINANCIAL POSITION—LIABILITIES

As previously discussed, organizations are not required to present a classified statement of financial position. However, in some situations the organization may elect to present a classified statement of financial position, such as when a bank loan requires it or the loan has covenants relating to current ratios or working capital levels. If an organization elects to present a classified statement of financial position, the following paragraphs present additional items that should be considered in the preparation of the financial statements. Those matters might also need to be considered in the sequencing of liabilities on an unclassified statement of financial position or for disclosure in the notes to the financial statements. The current liability classification includes obligations that, by their terms, are due on demand or will be due on demand within one year (or operating cycle, if longer) from the statement of financial position date, even though liquidation may not be expected within that period.

### Grants Payable

Grants payable that the organization has made to others may be paid over a period of several years. As a result, the amount of the grants payable should be allocated between current and noncurrent portions. For example, an organization that has awarded grants amounting to \$200,000 that are payable evenly over the next four years should reflect a current grant payable of \$50,000 on a classified statement of financial position and a noncurrent grant payable of \$150,000. (For simplicity, discounts that may have been recorded if a present value technique was used to measure the fair value of the grants payable have not been considered in this example.)

### Deferred Revenues

As previously discussed, receipts collected in advance of the delivery of goods or performance of services are included in liabilities and are referred to as deferred revenues. Classification of the deferred revenues on a classified statement of financial position as current or noncurrent depends on when the revenues will be earned. If the revenue will be earned within the next 12 months, the deferred revenue should be classified as a current liability. If the deferred revenue will be recognized on the statement of activities over a period longer than one year (for example, membership dues under a three-year plan), it should be divided into current and noncurrent portions.

### Annuity Obligations

As discussed previously, an organization should record a liability for the portion of assets held for other beneficiaries in accordance with a split-interest agreement in which the organization is trustee. Classification of the obligation to other beneficiaries on the statement of financial position is often divided between current and noncurrent. The amount estimated to be paid to other beneficiaries within the next 12 months should generally be classified as a current liability. The remainder of the obligation should then be classified as noncurrent.

### Deferred Tax Assets and Liabilities

FASB ASC 740-10-45-4 through 45-10 (formerly SFAS No. 109, *Accounting for Income Taxes*) state that when classified statements of financial position are presented, deferred tax assets and liabilities should be segregated into current and noncurrent components. The method used to classify deferred tax assets and liabilities depends on whether they relate to assets and liabilities for financial reporting as follows:

- a. *Deferred Tax Assets and Liabilities Associated with Particular Assets and Liabilities for Financial Reporting.* Deferred tax assets and liabilities that can be identified with particular assets and liabilities for financial reporting should be classified the same as those assets and liabilities. For example, a deferred tax asset related to trade accounts receivable would be classified as current since it relates to a current asset. On the other hand, a deferred tax asset related to property and equipment would be classified as noncurrent since it relates to a noncurrent asset.
- b. *Deferred Tax Assets and Liabilities Not Associated with Particular Assets or Liabilities for Financial Reporting.* Some temporary differences are associated with deferred taxable income or deductions and only appear on tax basis statements of financial position. Those differences, as well as loss and tax credit

carryforwards, cannot be easily identified with a particular asset or liability for financial reporting. Deferred tax assets or liabilities that are not associated with an asset or liability for financial reporting should be classified as current or noncurrent according to the reversal dates of the temporary differences or carryforwards. In other words, the portion of those deferred tax assets and liabilities that will reverse during the next year should be classified as current, and the portion that will reverse after the next year should be classified as noncurrent.

Any deferred tax asset valuation allowance should be allocated ratably between current and noncurrent deferred tax assets. Accordingly, if there is only one deferred tax asset, the valuation allowance would be classified the same as that asset. If there is more than one deferred tax asset, the valuation allowance would be allocated ratably between all deferred tax assets.

All current deferred tax assets and liabilities should be offset and presented as a single amount, and all noncurrent deferred tax assets and liabilities should be offset and presented as a single amount. FASB ASC 740-10-45-6 (formerly SFAS No. 109), however, states that current tax assets and current tax liabilities or noncurrent tax assets and noncurrent tax liabilities should only be offset if they relate to the same tax jurisdictions (e.g., federal taxes) and to the same taxpaying entity. However, if materiality is considered when applying this principle, best practices indicate that tax deferred assets and liabilities of different tax jurisdictions may be offset if doing so does not significantly distort the statement of financial position.

### **Unrecognized Tax Benefits of a Tax Position**

As previously discussed, an organization may have a liability for unrecognized tax benefits of a tax position. The liability should be classified based on whether settlement is anticipated within one year (or the operating cycle). A recognized tax position may affect the tax bases of assets and liabilities and the resulting temporary differences. A liability for unrecognized tax benefits of a tax position should not offset deferred tax assets nor should it be included with deferred tax liabilities.

### **Refinancing of Short-term Debt**

**Practice Problems in Classification of Short-term Debt.** Because lenders tend to emphasize working capital levels, nonprofit organizations sometimes attempt to exclude short-term debt from current liabilities unless it clearly will be repaid within one year. The following are examples of those situations:

- a. Interim construction financing; for example, bridge loans for construction of a building that will be converted to long-term financing when construction is complete.
- b. Demand notes that are being repaid in installments over a period longer than one year in either of the following cases:
  - (1) The note is strictly a demand note but the lender orally agreed to accept payment in installments.
  - (2) The note specifies the installments but also allows the lender to call the note at its option.
- c. The organization is in default on a long-term obligation because it violated one of the following types of covenants of the loan agreement:
  - (1) Transaction default. (For example, the organization bought equipment without the prior approval of the lender.)
  - (2) Condition default. (For example, the organization's net assets are less than levels prescribed by the agreement.)

**Criteria for Classification as Current or Noncurrent.** FASB ASC 210-10-20 (formerly SFAS No. 6, *Classification of Short-Term Obligations Expected to Be Refinanced*) refers to *short-term obligations* as those scheduled to mature within one year after the statement of financial position date. Short-term obligations are normally classified as

current liabilities. However, FASB ASC 470-10-45-13 and 45-14 (formerly SFAS No. 6) indicate short-term obligations should be included with noncurrent liabilities if both of the following conditions are met:

- a. *Intent to Refinance.* The organization intends to refinance the obligation on a long-term basis.
- b. *Ability to Consummate the Refinancing.* The organization's ability to refinance the obligation may be demonstrated in either of the following ways:
  - (1) *Issuance of a Long-term Obligation after the Statement of Financial Position Date.* A long-term obligation has been issued for the refinancing after the statement of financial position date but before the financial statements are issued or available to be issued.
  - (2) *Financing Agreement.* Before the financial statements are issued or available to be issued, the organization has entered into a financing agreement that clearly permits refinancing on terms that are readily determinable. In addition, all of the following conditions are met:
    - (a) The agreement does not expire within one year (or within the operating cycle) from the statement of financial position date and the agreement cannot be cancelled by the lender (or called) except for violation of a provision in the agreement with which compliance is objectively determinable or measurable.
    - (b) No violation of any provision in the agreement exists at the statement of financial position date, and no available information indicates that a violation has occurred after that date but prior to the date the financial statements are issued or available to be issued. If there has been a violation, a waiver has been obtained.
    - (c) The lender is expected to be financially capable of honoring the agreement.

**Suggested Guidelines—Bridge Loans.** Bridge loans are often with a bank, but the borrower intends to refinance with some other financing institution. In reality, the debt has to be refinanced and, normally, negotiations have progressed to the point that commitment letters have been obtained for the long-term financing. If letters have been obtained, generally the requirements will be considered met, and the debt should be classified as noncurrent. However, if completion is anticipated within one year, and commitment letters have not been obtained, the preparer has no real basis for excluding the note from current liabilities. Also, common sense dictates that classification as current is the more economically realistic approach, since the lack of commitment letters may indicate that there is some problem obtaining long-term financing.

**Accounting for Demand Loans.** FASB ASC 210-10-20 (formerly SFAS No. 6) defines *short-term obligation* as one *scheduled to mature* within one year. Should *scheduled* be interpreted based on form (if so, all demand notes would be classified as current) or on substance (if so, some demand notes would be classified as noncurrent)? Some preparers have attempted to overcome the problem by requesting that the lender waive its right to call the note during the next year. However, they are normally unsuccessful. Instead, the lender will at best say that the loan will not be called "provided there are no adverse shifts in changes in net assets." Therefore, preparers should be alert for "due on demand" clauses that are included in many standard commercial bank notes and, at first glance, may appear to be long-term notes. An example of a typical \$30,000 note that contains both a due on demand clause and a maturity schedule is as follows:

The note is due on demand, but if no demand is made, is payable as follows:

January 1, 20X8	\$	10,000
January 1, 20X9		10,000
January 1, 20Y0		10,000

In FASB ASC 470-10-45-9 and 45-10 (formerly EITF Issue No. 86-5, "Classifying Demand Notes with Repayment Terms"), an obligation that, by its terms, is due on demand should be considered a current liability in accordance with FASB ASC 470-10-45-12 (formerly SFAS No. 78, *Classification of Obligations That Are Callable by the Creditor*).

Factors such as an assessment of the likelihood that the creditor actually will call the notes do not affect the classification decision. Demand notes that specify or permit installments and lines of credit are current liabilities unless the creditor has specifically waived the right to demand payment for more than one year from the statement of financial position date. GAAP requires an unconditional waiver, however, before short-term debt may be classified as noncurrent. A waiver stating that the loan will not be called provided there are no adverse shifts in changes in net assets or using similar language is not sufficient.

### Accounting for Violations of Debt Covenants

Most nonprofit organizations do not have debt with significant covenants. If the debt agreement has covenants, they are usually basic covenants such as providing the bank with financial statements within a certain time period after year end. The preparer should consider the following information if the nonprofit organization has covenants that could make the debt callable.

If violations of long-term debt agreements exist that make the debt callable within one year from the statement of financial position date (or callable within one year from the statement of financial position date if not cured within a specified grace period), the long-term debt should be classified as a current liability unless one of the following has occurred:

- a. The creditor has specifically waived (or lost) the right to demand payment for more than one year from the statement of financial position date.
- b. The violation is cured after the statement of financial position date but before financial statements are issued or available to be issued.
- c. The organization demonstrates that it is probable it will be able to cure the violation within the grace period.

The preceding criteria apply to all violations of debt agreements, including violations that the debtor believes are merely technical. In reaching that conclusion, the FASB believed that the debtor would be able to obtain a waiver for violations considered insignificant by the creditor.

A subjective acceleration clause allows a creditor to accelerate the maturity of long-term debt based on subjective criteria such as "occurrence of material adverse changes" or "failure to maintain satisfactory operations." FASB ASC 470-10-45-2 (formerly FASB Technical Bulletin 79-3, *Subjective Acceleration Clauses in Long-term Debt Agreements*) indicates that an evaluation of all of the facts and circumstances is necessary in deciding whether (a) the long-term debt should be classified as current, (b) the subjective acceleration clause should be disclosed, or (c) neither disclosure nor reclassification is necessary because the likelihood of acceleration is remote. (For example, the organization is in good financial condition, and the lender has historically not accelerated due dates.)

**Subjective Acceleration Clauses.** Banks often use a standard note agreement that contains a subjective acceleration clause. In many cases, the clause is included with boilerplate language about conditions of default and is easy to overlook. The following is an example of a subjective acceleration clause:

#### DEFAULT, ACCELERATION AND SETOFF

Any one of the following shall constitute an event of default under the terms of this Note: . . . (5) a determination by the Bank that it deems itself insecure or that a material adverse change in the financial condition of any Party or decline or depreciation in the value or market value of any Collateral has occurred since the date of this Note or is reasonably anticipated; . . . If an event of default occurs, . . . the entire unpaid balance of this Note, shall, at the option of the Bank, become immediately due and payable, without notice or demand . . . . To the extent permitted by law, upon default, the Bank will have the right . . . to set off the amount due under this Note or due under any other obligation of the Bank against any and all accounts . . . or other security . . . held by the Bank . . . to the credit of any Party, without notice or consent . . . .

Subjective acceleration clauses often are found in bank commitment letters, too, as the following example illustrates:

**MATERIAL ADVERSE CHANGE:**

This commitment may be terminated, at the sole discretion of the Bank, upon the occurrence of a material adverse change in the financial condition of the Borrower or any other person liable to the Bank for the repayment of this loan.

In both of the preceding examples, a change in the financial condition of either the debtor or guarantors triggers the clause. The clause in the first example is also triggered by declines in the value of the collateral, whether the debtor or some other entity owns the collateral. Neither example requires the bank to call the loan; the clause only gives it the option of calling the loan. But the existence of the option raises measurement and disclosure questions, such as the following:

- a. When does a subjective acceleration clause require reporting all of the balance of a long-term note as a current liability?
- b. What should the financial statements say about such clauses?

Subjective acceleration clauses are addressed by FASB ASC 470-10-45-2 (formerly FASB Technical Bulletin 79-3) and FASB ASC 470-10-45-12 and 45-13 (formerly SFAS No. 6). FASB ASC 470-10-45-2 addresses such a clause in an existing long-term note. It appears that this guidance only requires classifying the outstanding principal as current if default under the clause within a year of the statement of financial position date is probable. FASB ASC 470-10-45-12 and 45-13 address a subjective acceleration clause in an agreement to refinance a short-term note on a long-term basis. It prohibits reclassifying the present debt when the refinancing agreement—either a new note or a commitment letter—has a subjective acceleration clause. It does not allow probability assessments.

Assessing the likelihood that an existing note will be called requires considering the likelihood of a default event occurring and the likelihood the bank will call the loan if such an event is probable. The following steps are examples of best practices accountants can use in this situation:

- a. Identify the events that would trigger the clause.
- b. Based on information available prior to issuing the financial statements, consider the likelihood of one of those events occurring within one year from the statement of financial position date. That may require inquiries about the financial condition of guarantors and the value of collateral. Some practical considerations in making the assessment follow:
  - (1) Concluding that an event is *probable* is often justified only if it is a continuation of an existing condition, such as continuing decreases in net assets, or an event has occurred, such as a fire or other casualty.
  - (2) If a significant change in a market condition either has occurred or is probable, such as the introduction of a competing nonprofit theater, evaluating the likelihood of a material adverse effect requires an assessment of how long it will take the condition to affect the entity and whether the entity will be able to develop a compensating strategy. Often, a material adverse effect within a year of the statement of financial position date is not probable.
- c. If a default condition is probable, consider the likelihood that the bank will call the loan. If that is probable, the debt should be reclassified. Often a loan is called only if the situation represents a deterioration of already existing conditions.

Generally, the need to disclose the existence of a subjective acceleration clause depends on the likelihood that the bank will call the loan. Disclosure of subjective acceleration clauses should be addressed in the following ways:

- a. If a long-term note is reclassified as current because of a subjective acceleration clause, the financial statements should disclose the reasons.
- b. If calling the note is at least reasonably possible and it would have a material effect on the financial statements within the near term, the provisions of FASB ASC 275-10 (formerly SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*) could apply.

- c. If there is only a remote chance the loan will be called, no disclosure is necessary. Disclosing a subjective acceleration clause in that circumstance may unnecessarily alarm the reader.

Demand loans can also include subjective acceleration clauses. However, since demand loans are already classified as current liabilities, the clause has no additional effect in those cases.

Questions have arisen about whether the statement of financial position classification of debt is affected by (a) violations that occur subsequent to the statement of financial position date or (b) violations that have not occurred but are probable. The following paragraphs discuss those issues, and Exhibit 2-1 summarizes the accounting for covenant violations.

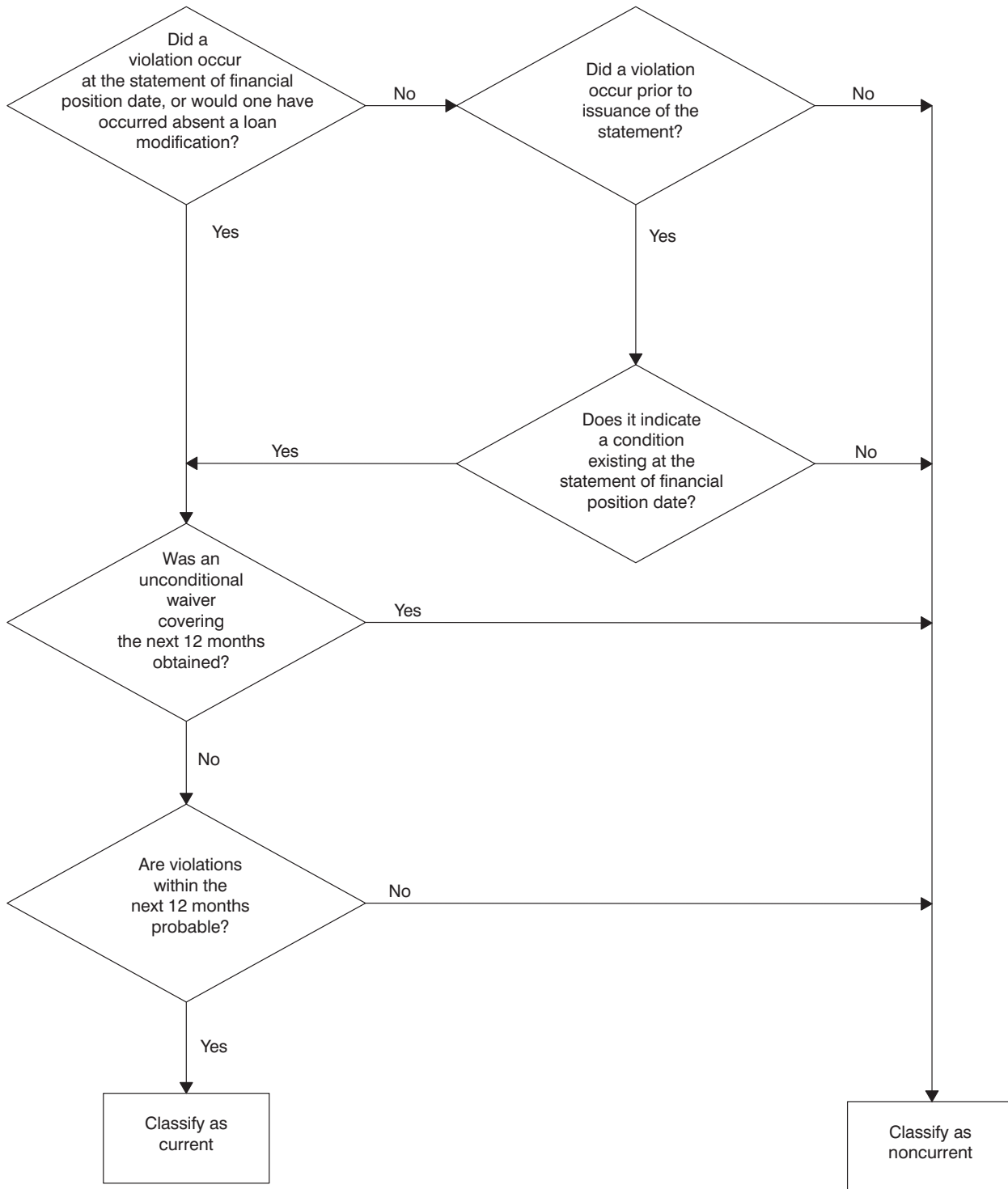
**Subsequent Violations.** Although GAAP provides guidance on classifying long-term debt when covenant violations have occurred at the statement of financial position date, it does not address whether classification is affected when violations occur after the statement of financial position date but before the financial statements are issued or available to be issued. The issue is particularly relevant for nonprofit organizations because, although accountants only have a responsibility to consider subsequent events that occur between the statement of financial position date and the date the financial statements are issued or available to be issued, nonprofit organizations tend to have longer intervals between those dates.

In deciding how subsequent covenant violations affect the financial statements, the guidance on subsequent events in FASB ASC 855 (formerly SFAS No. 165, *Subsequent Events*) can be consulted. GAAP 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). As the names imply, recognized subsequent events are recognized in an entity's financial statements, and nonrecognized subsequent events should not be recognized in an entity's financial statements. However, some nonrecognized subsequent events may be of such a nature that disclosure would be required to keep the financial statements from being misleading. In most cases, covenant violations may be classified as follows:

Covenant Violation	Subsequent Event Classification	Effect on Financial Statements
<i>Technical Covenants</i> (i.e., those that prohibit a borrower from doing something such as buying equipment over a prescribed dollar limit without prior approval).	Nonrecognized	Possible disclosure
<i>Condition Covenants</i> (i.e., those that require certain conditions to exist such as prescribed debt-to-net assets ratio or working capital level).	Recognized or nonrecognized depending on whether the violation is indicative of conditions existing at the statement of financial position date	Measurement or possible disclosure

Violations of condition covenants generally would be recognized subsequent events. (Such violations could be nonrecognized subsequent events, however, if the violation results from a discrete event that occurs after the statement of financial position date, such as failure to meet prescribed increase in net asset levels as a result of a fire or flood.) Thus, if the violation makes long-term debt callable by the lender, the debt should be classified as a current liability.

**Exhibit 2-1  
Accounting for Covenant Violations**



\* \* \*

**Probable Violations.** Questions have been raised about whether long-term debt should be classified as current when covenant violations have neither occurred at the statement of financial position date nor the date the financial statements are issued or available to be issued, but the accountant believes that it is probable that covenant

violations will occur within the next 12 months (or operating cycle, if longer). For example, consider the following scenario:

- An organization has a long-term debt that requires compliance with certain condition covenants, such as a minimum level of net assets on a quarterly or semi-annual basis.
- At the statement of financial position date, the organization is in violation of the covenant, thus giving the lender the ability to call the debt, but the lender waives its rights resulting from that violation for a period greater than one year.
- The lender retains the future covenant compliance requirements.

Does the lender's waiver constitute a grace period since the organization must meet the same or a similar test at the next quarterly or semi-annual compliance date? If the waiver is viewed as a grace period, and it is not probable that the organization will be able to comply with the covenant at the end of the grace period, GAAP would require the debt to be classified as current.

FASB ASC 470-10-45-1 (formerly EITF Issue No. 86-30, "Classification of Obligations When a Violation is Waived by the Creditor") concludes that such long-term obligations should be classified as *noncurrent* unless *both* of the following conditions exist:

- A covenant violation has occurred at the statement of financial position date or would have occurred absent a modification.
- It is probable that the borrower will not be able to cure the default (or comply with the covenant) at measurement dates that are within the next 12 months (or operating cycle, if longer).

A violation must have occurred before classification becomes an issue. However, if a violation would have occurred, but the loan agreement is modified to postpone the compliance requirement, the substance of the situation is considered to be the same as a violation occurring.

Some general observations about applying FASB ASC 470-10-55 when a violation has occurred at the statement of financial position date are as follows:

- If the covenant requires annual measurement and the lender waives its right to call the loan for the next year, the debt normally should be classified as *noncurrent*.
- If the covenant requires interim measurement and the lender waives its right to call the loan for the next year, it also generally would be appropriate to classify the debt as *noncurrent*.
- However, if the covenant requires interim measurement and the lender reserves its rights to reconsider compliance at any future measurement date within the next 12 months (or operating cycle, if longer), the debt should be classified as *current* if noncompliance during the period is probable and *noncurrent* if noncompliance is not probable.
- Even if a waiver is obtained for the proper period, it would be necessary to reconsider the appropriate classification when the next interim statements are prepared because the new 12-month period will extend beyond the original waiver period.

The focus of the guidance is only on whether long-term debt should be classified as current or noncurrent in the preceding circumstances. Regardless of how the debt is classified, entities may need to disclose the potential adverse consequences of its failure to satisfy future covenants.

### **Current Maturities of Long-term Debt**

If the long-term debt is classified as noncurrent in the statement of financial position, FASB ASC 210-10-45-9 (formerly ARB No. 43) requires that principal reductions of the debt scheduled during the next year be classified as a current liability in classified statements of financial position.

### Statement of Financial Position Presentation

If the organization presents a classified statement of financial position, the statement should include a captioned subtotal for total current liabilities. A good presentation method would place the current portion of long-term debt immediately after short-term notes and loans and the noncurrent portion immediately after total current liabilities, as follows:

	<u>20X7</u>	<u>20X6</u>
<b>CURRENT LIABILITIES</b>		
Accounts payable	\$ 90,000	\$ 80,000
Accrued expenses	15,000	10,000
Short-term notes	50,000	75,000
Loans payable	—	25,000
Current portion of long-term debt	<u>10,000</u>	<u>9,000</u>
<b>TOTAL CURRENT LIABILITIES</b>	165,000	199,000
LONG-TERM DEBT, less current portion	<u>500,000</u>	<u>400,000</u>
<b>TOTAL LIABILITIES</b>	665,000	599,000

It would generally not be appropriate to combine short-term notes and the current portion of long-term debt into a single caption because they have different characteristics.

Many preparers include the current portion of long-term debt as either the first or last item of current liabilities.

**SELF-STUDY QUIZ**

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

34. Which of the following nonprofit organizations has correctly reported information on a classified statement of financial position?
- a. Alpha Organization collected receipts 24 months in advance of when services will be rendered. It classifies all the deferred revenue as a current liability.
  - b. Beta Organization serves as the trustee for annuity obligations. It is obligated to make payments every month for three years. It classifies the obligation as a noncurrent liability.
  - c. Gamma Organization has a deferred tax asset that is related to its trade accounts receivable. It classifies this asset as current.
  - d. Delta Organization has a deferred tax liability that is not associated with a particular liability for financial reporting. It classifies this liability as noncurrent.
35. City Streets, a nonprofit organization, has a short-term debt obligation scheduled to mature within a year of the date of the organization's classified statement of financial position. The organization has decided to refinance the obligation on a long-term basis, and a long-term obligation was issued for the refinancing before the financial statements were issued but after the statement of financial position date. How should the organization classify this obligation?
- a. Current.
  - b. Noncurrent.
36. Which of the following statements most accurately describes a subjective acceleration clause and/or their effect on the statement of financial position?
- a. Subjective acceleration clauses are not discussed by any authoritative guidance, so accounting for them is a matter of professional judgment.
  - b. A short-term debt refinanced as long-term can be reclassified as noncurrent if a subjective acceleration clause is in the agreement.
  - c. If a subjective acceleration clause is included, it must always be disclosed in the financial statements.
  - d. It is possible for a demand loan to contain a subjected acceleration clause without affecting the statement of financial position.
37. Brain Boosters, a nonprofit organization, has a long-term debt covenant. As of its statement of financial position date and the date of the accountant's report, the organization is not in violation of the covenant, and no modifications were needed for the organization to keep from violating the covenant. However, due to the terms of the covenant and the economic status of the organization's industry, the accountant realizes that it is very likely the organization will violate the covenant before the next set of financial statements are prepared. The organization presents a classified statement of financial position. How should this debt be classified on the current statement of financial position?
- a. Current.
  - b. Noncurrent.

## 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.)**

34. Which of the following nonprofit organizations has correctly reported information on a classified statement of financial position? **(Page 86)**
- a. Alpha Organization collected receipts 24 months in advance of when services will be rendered. It classifies all the deferred revenue as a current liability. [This answer is incorrect. If the revenue would be earned within 12 months, this would be the correct accounting treatment on a classified statement of financial position. Because it will take longer than one year for Alpha Organization to earn the revenue, it should divide the deferred revenue into current and noncurrent portions.]
  - b. Beta Organization serves as the trustee for annuity obligations. It is obligated to make payments every month for three years. It classifies the obligation as a noncurrent liability. [This answer is incorrect. The amount estimated to be paid to other beneficiaries within the next 12 months should generally be classified as a current liability. The remainder of the obligation should then be classified as noncurrent.]
  - c. **Gamma Organization has a deferred tax asset that is related to its trade accounts receivable. It classifies this asset as current. [This answer is correct. FASB ASC 740-10-45-4 through 45-10 state that when classified statements of financial position are presented, deferred tax assets and liabilities should be segregated into current and noncurrent components. Those that can be identified with particular assets and liabilities for financial reporting (such as the ones held by Gamma Organization) should be classified the same as those assets and liabilities. In this scenario, Gamma Organization would classify this deferred tax asset as current because it relates to a current asset.]**
  - d. Delta Organization has a deferred tax liability that is not associated with a particular liability for financial reporting. It classifies this liability as noncurrent. [This answer is incorrect. Before making the current/noncurrent determination, Delta Organization needs to know what the reversal dates are for the temporary differences or carryforwards. The portion of the liability that will reverse during the next year should be classified as current, and the portion that will reverse after the next year should be classified as noncurrent.]
35. City Streets, a nonprofit organization, has a short-term debt obligation scheduled to mature within a year of the date of the organization's classified statement of financial position. The organization has decided to refinance the obligation on a long-term basis, and a long-term obligation was issued for the refinancing before the financial statements were issued but after the statement of financial position date. How should the organization classify this obligation? **(Page 87)**
- a. Current. [This answer is incorrect. Because the organization has both an intent to refinance and the ability to consummate the refinancing, under GAAP, it can classify this short-term obligation as noncurrent.]
  - b. **Noncurrent. [This answer is correct. Normally, short-term obligations are included with current liabilities, but in the scenario above, City Streets met both of the applicable conditions (as discussed in FASB ASC 470-10-45-13 and 45-14) that allow the organization to classify the debt as noncurrent.]**
36. Which of the following statements most accurately describes a subjective acceleration clause and/or their effect on the statement of financial position? **(Page 90)**
- a. Subjective acceleration clauses are not discussed by any authoritative guidance, so accounting for them is a matter of professional judgment. [This answer is incorrect. Subjective acceleration clauses are addressed by FASB ASC 470-10-45-2 and FASB ASC 470-10-45-12 and 13.]
  - b. A short-term debt refinanced as long-term can be reclassified as noncurrent if a subjective acceleration clause is in the agreement. [This answer is incorrect. FASB ASC 470-10-45-12 and 13 address a subjective

acceleration clause in an agreement to refinance a short-term note on a long-term basis. It prohibits reclassifying the present debt when the refinancing agreement—either a new note or a commitment letter—has a subjective acceleration clause.]

- c. If a subjective acceleration clause is included, it must always be disclosed in the financial statements. [This answer is incorrect. Best practices indicate that if there is only a remote chance the loan will be called, no disclosure is necessary. Disclosing a subjective acceleration clause in that circumstance may unnecessarily alarm the reader.]
  - d. It is possible for a demand loan to contain a subjected acceleration clause without affecting the statement of financial position. [This answer is correct. Since demand loans are already classified as current liabilities, the clause has no affect in those cases.]**
37. Brain Boosters, a nonprofit organization, has a long-term debt covenant. As of its statement of financial position date and the date of the accountant's report, the organization is not in violation of the covenant, and no modifications were needed for the organization to keep from violating the covenant. However, due to the terms of the covenant and the economic status of the organization's industry, the accountant realizes that it is very likely the organization will violate the covenant before the next set of financial statements are prepared. The organization presents a classified statement of financial position. How should this debt be classified on the current statement of financial position? **(Page 93)**
- a. Current. [This answer is incorrect. According to FASB ASC 470-10-45-1, a violation must have occurred before classification becomes an issue. Since it has not occurred in this scenario, Brain Boosters would not have to classify this long-term debt as current.]
  - b. Noncurrent. [This answer is correct. In FASB ASC 470-10-45-1, the EITF concluded that long-term obligations should be classified as *noncurrent* unless *both* of the following conditions exist: (1) a covenant violation has occurred at the statement of financial position date or would have occurred absent a modification and (2) it is probable that the borrower will not be able to cure the default (or comply with the covenant) at measurement dates that are within the next 12 months (or operating cycle), if longer. According to the information provided above, Brain Boosters does not meet both of these conditions, so the debt should be classified as noncurrent.]**

## NET ASSETS AND THE STATEMENT OF FINANCIAL POSITION

Net assets represent the difference between a nonprofit organization's assets and liabilities. Net assets are classified into one of the following three categories depending on the absence or presence and nature of donor-imposed restrictions:

- a. *Unrestricted Net Assets*, which are not restricted either by donors or by law.
- b. *Temporarily Restricted Net Assets*, whose use has been limited by donor-imposed time restrictions or purpose restrictions.
- c. *Permanently Restricted Net Assets*, which have been restricted by donor or by law to be maintained by the organization in perpetuity.

Authoritative literature does not specifically require the use of the terms "unrestricted," "temporarily restricted," and "permanently restricted" net assets. Other terms may be used, for example "equity" may be used for "net assets," and "other" or "not donor-restricted" could be used for "unrestricted net assets." Although the terms are not required, use of the terms "unrestricted," "temporarily restricted," and "permanently restricted," except in unusual situations, should avoid any confusion as to their meaning or the nature of the restrictions.

The amounts for each of the three classes of net assets and total net assets are required to be reported on the face of the statement of financial position. Additional information is required to be reported for temporarily restricted and permanently restricted net assets. That information includes a description and dollar amount of the different types of permanent restrictions and the different types of temporary restrictions. For example, permanent restrictions may exist with regard to property that may not be sold and to assets required to be invested to provide a permanent source of income. Similarly, temporary restrictions may exist with regard to support for a particular project or for a future period. This information about the nature and amounts of temporarily restricted and permanently restricted net assets may be presented either on the face of the statement of financial position as secondary captions of those classes of net assets or in the notes to the financial statements. Nonprofit organizations with donor-restricted or board-designated endowment funds are required to disclose information about the net asset classification, composition, and changes in the net asset composition of the endowment funds, as well as the spending and related investment policies for those funds. Organizations with donor-restricted endowment funds are also required to describe their interpretation of the laws underlying the net asset classification of those funds.

### Presentation of Net Assets

**Designations.** Designations, including board-designated endowments, are voluntary board-approved segregations of unrestricted net assets for specific purposes, projects, or investments. The governing board of the nonprofit organization may approve designations as an aid in planning future expenditures, but designations are not expenses and should not be reported in the statement of activities. Since designations are voluntary and may be reversed by the governing board at any time, designated portions of net assets are not considered restricted. Designations may be reported as classifications of unrestricted net assets on the statement of financial position or may be disclosed in the notes to the financial statements.

**Contractual or Other Limitations.** Organizations may have certain contractual or other limitations placed on the use of net assets other than those resulting from donor-imposed restrictions. If the limitations or restrictions on net assets *do not* relate to donor stipulations, corresponding net assets are *not* restricted. For example, certain government grants that are exchange transactions may have restrictions limiting the use of the organization's use of the funds. In such cases, the associated net assets are *unrestricted* because the restrictions are imposed by the other party to the exchange transaction, not by a donor. Organizations are permitted to disclose contractual or other limitations on net assets either on the face of the financial statements or in the notes, as long as they are presented as components of unrestricted net assets.

**Statement of Financial Position Presentation.** The following example illustrates a presentation of net assets that includes board and trustee designations, temporarily restricted net assets, and permanently restricted net assets. The information, other than the total amounts for the three classes of net assets and the total net assets, can be presented in the notes to the financial statements instead of on the face of the statement of financial position.

Unrestricted net assets	
Designated by the Board for endowment purposes	250,000
Designated by the trustees for	
Equipment	10,000
Plant expansion	40,000
Long-term investment	150,000
Undesignated	<u>150,000</u>
Unrestricted net assets	600,000
Temporarily restricted net assets	
Restricted for	
Purchase of property and equipment	40,000
Subsequent year’s operations	35,000
Educational publications	12,000
Term endowments	<u>60,000</u>
Temporarily restricted net assets	147,000
Permanently restricted net assets	
Restricted for	
Permanent endowments	200,000
Land required to be permanently used in programs	<u>45,000</u>
Permanently restricted net assets	<u>245,000</u>
Total net assets	<u>992,000</u>

If the organization presents the additional disclosures on designations and restrictions in the notes to the financial statements rather than on the face of the statement of financial position, the net assets section would appear as follows:

Net assets	
Unrestricted net assets	600,000
Temporarily restricted net assets	147,000
Permanently restricted net assets	<u>245,000</u>
Total net assets	<u>992,000</u>

**Negative Net Assets.** If liabilities exceed assets, a negative net asset or equity balance will be reported. One of the following captions can be used under these circumstances:

- a. Negative net assets shown in all periods—“net deficiency in assets” or “net deficit.”
- b. Negative net assets shown in one period and positive net assets shown in another period—“net equity (deficiency in assets),” “net equity (deficit),” or “net assets (deficit).”

**Changes in Net Assets**

The amount of the change in each net asset class for the period is reported in the statement of activities. Changes in the various classes of net assets are generally limited to:

- a. Revenues, expenses, gains, and losses for the period. (Expenses can only represent a decrease in *unrestricted* net assets.)
- b. Reclassifications between net assets, primarily due to expirations of donor-imposed restrictions during the period or board appropriations of temporarily restricted net assets.

- c. Adjustments to the opening balances. The opening balances in net assets may be adjusted as a result of:
- (1) Certain changes in accounting principles.
  - (2) Prior-period adjustments.

The change in net assets in the statement of activities should reconcile between net assets at the beginning of the year and net assets at the end of the year. The amounts reported for net assets should agree to the net assets reported in the statement of financial position.

**Reclassifications.** Reclassifications generally occur and are reported simultaneously with the expiration of either donor-imposed time or purpose restrictions. They typically occur between temporarily restricted net assets and unrestricted net assets as donor restrictions are satisfied. For example, if a cash donation of \$20,000 is made for the purpose of purchasing inventory, when the inventory is purchased, temporarily restricted net assets are reduced with an offsetting increase in unrestricted net assets as follows:

Net assets released from temporary restrictions (temporarily restricted)	20,000	
Net assets released from temporary restrictions (unrestricted)		20,000

FASB ASC 958-225-45-13 permits donors to place restrictions on unrestricted net assets. For example, a donor might give a contribution of \$100,000 to establish an endowment with the stipulation that the organization match the contribution with \$100,000 of unrestricted net assets. Unrestricted net assets in the amount of \$100,000 should be reclassified to permanently restricted net assets, and the organization would have no discretion about releasing those permanent restrictions. In addition, although rare, there can be circumstances where temporarily restricted net assets are reclassified to permanently restricted net assets as a result of donor-imposed restrictions.

Reclassifications have no net effect on the total net assets of a nonprofit organization as a whole. Reclassifications should be presented as separate line items on the statement of activities and typically will be reported as increases in unrestricted net assets, separate from revenues, gains, and other support, with offsetting decreases in temporarily restricted net assets.

**Adjustments to Opening Net Assets for Accounting Changes.** FASB ASC 250-10-05-02 (formerly SFAS No. 154, *Accounting Changes and Error Corrections*) establishes retrospective application as the required method for reporting a change in accounting principle unless it is impracticable to do so or the newly adopted accounting principle contains explicit transition requirements. Retrospective application may require an adjustment to the opening balance of net assets. Accounting changes are discussed further later in this lesson.

**Prior-period Adjustments.** The balance of net assets at the beginning of the period should be restated for the effects of prior-period adjustments. FASB ASC 250-10-45-23 and 45-24 (formerly SFAS No. 16, *Prior Period Adjustments*) state that adjustment of previously issued financial statements should only be made for the correction of an error in the financial statements of a prior period.

FASB ASC 250-10 (formerly SFAS No. 154) defines an error in previously issued financial statements as “an error in recognition, measurement, presentation, or disclosure in financial statements resulting from mathematical mistakes, mistakes in the application of GAAP, or oversight or misuse of facts that existed at the time the financial statements were prepared. A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error.”

### Use of Fund Accounting

While GAAP does not preclude the use of fund accounting for external reporting, it no longer provides guidance for organizations that choose to use it. Accordingly, any guidance on the use of fund accounting is based on the AICPA Audit and Accounting Guide, *Not-for-Profit Entities*, which is nonauthoritative. The financial reporting model specified by FASB ASC 958 (formerly SFAS No. 117) focuses on the nonprofit organization as a whole, with net assets

classified solely on the absence or presence and nature of donor-imposed restrictions. Even if fund accounting is presented, organizations are still required to present net assets by classification. Thus, fund balances must be classified on the statement of financial position as unrestricted, temporarily restricted, or permanently restricted net assets based on the absence or existence and type of donor restrictions. Nonprofit organizations using fund accounting can evaluate whether it is both cost-effective and meaningful for financial statement users to present statements reflecting both fund accounting and net asset classifications.

**Presentation Using Fund Accounting.** If the organization uses fund accounting for external financial reporting, the fund balances of the respective funds must be allocated between the appropriate classes of net assets in order to report total amounts for the three classes of net assets as required by FASB ASC 958 (formerly SFAS No. 117). The following example is one possible way to continue using fund accounting, while still reporting the required information on the statement of financial position:

	<u>Unrestricted</u>	<u>Restricted</u>	<u>Plant</u>	<u>Endowment</u>	<u>Total</u>
Net assets					
Unrestricted	50,000	10,000	16,000	19,000	95,000
Temporarily restricted	—	45,000	14,000	2,000	61,000
Permanently restricted	—	—	25,000	245,000	270,000
	50,000	55,000	55,000	266,000	426,000

## ACCOUNTING CHANGES AND THE STATEMENT OF FINANCIAL POSITION

### What are Accounting Changes?

According to FASB ASC 250-10-05-01 and 05-4 (formerly SFAS No. 154, *Accounting Changes and Error Corrections*), the term *accounting changes* includes changes in an accounting estimate, changes in the reporting entity, and changes in an accounting principle. The term does not include correction of errors.

**Change in Accounting Estimate.** A change in accounting estimate results from new information. Examples of accounting estimates that periodically change are allowances for bad debts, useful lives or salvage values of depreciable assets, and inventory obsolescence. The effects of changes in estimates should be reported in the period of change and subsequent periods. Restatement or retrospective adjustment of amounts reported in prior period financial statements or the presentation of pro forma prior period amounts is not permitted. For example, a change in the estimated useful lives of assets would be accounted for by adjusting depreciation expense in the current and future periods to depreciate the carrying value of assets over their remaining (new) useful lives.

Changes that are inseparable from changes in accounting principle, such as a change in depreciation, amortization, or depletion method for long-lived nonfinancial assets, should be accounted for as a change in accounting estimate effected by a change in accounting principle. Such changes are accounted for as a change in an estimate. However, a change in accounting estimate effected by a change in accounting principle is permitted only if the reporting entity can justify the new principle on the basis that it is preferable. See further discussion of justifying changes in accounting principles later in this lesson. Changing from certain depreciation methods, for example, an accelerated depreciation method, to the straight-line method at a specified point in the life of an asset to fully depreciate the asset’s cost over its estimated life is not a change in accounting principle if the change had been planned when the asset was placed in service and the policy is applied consistently.

### Change in Reporting Entity

A change in reporting entity refers to a change that results in financial statements that are, in effect, the statements of a different reporting entity. Typically, such changes are limited to changes in the organizations or subsidiaries that are included in combined or consolidated financial statements. Changes in the reporting entity are accounted for by retrospectively applying the change to the financial statements of all previous periods presented to show the financial information for the new reporting entity for the previous periods.

## Change in Accounting Principle

A change in accounting principle is generally defined as a change from one acceptable principle to another or a change in the method of applying an acceptable accounting principle. A change from an unacceptable principle to an acceptable principle is a correction of an error and not a change in accounting principle as defined by GAAP.

The following events or circumstances are *not* considered to be accounting changes for the purpose of applying this guidance:

- a. Initial adoption of a new accounting principle for new events or transactions or for material events or transactions that were previously immaterial.
- b. Adoption or modification of an accounting principle due to substantially different events or transactions than those previously occurring.

**Justifying Changes in Accounting Principles.** GAAP permits a change in accounting principle only if an entity justifies the use of an alternative acceptable accounting principle on the basis that it is preferable or a newly issued accounting pronouncement requires the change.

## Accounting for and Reporting a Change in Accounting Principle

This guidance applies to all voluntary changes in accounting principle as well as to changes required by an accounting pronouncement when that pronouncement does not include explicit transition provisions. If a pronouncement includes explicit transition provisions, those provisions should be applied.

A change in accounting principle should be reported by retrospective application of the new principle to the financial statements of all prior periods, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. Retrospective application is the application of a different accounting principle to previous accounting periods as if it had always been used. The following steps are required to retrospectively apply a new accounting principle:

- a. Determine the cumulative effect of the change to the new accounting principle on periods before the periods presented. Apply the cumulative effect of the change to the carrying amounts of assets and liabilities as of the beginning of the first period presented.
- b. If necessary, record an offsetting adjustment to the opening balance of net assets for that period.
- c. Adjust the financial statements for each individual prior period presented to reflect the period-specific effects of applying the new accounting principle.

If the cumulative effect of applying the change to all prior periods can be determined, but it is impracticable to determine the period-specific effects of the change on all prior periods presented, the cumulative effect of the change should be applied to the balances of assets and liabilities as of the beginning of the earliest period to which the new principle can be applied. In those situations, an offsetting adjustment to the opening balance of net assets for that period may be necessary. If it is impracticable to determine the cumulative effect of applying a change in accounting principle to any prior period, the new principle should be applied as if it were adopted prospectively from the earliest date practicable.

When applying a new accounting principle retrospectively, an entity should include only the direct effects of the change and the related income tax effects, if any. The retrospective application should not include any indirect effects that would have been recognized if the new principle had been used in previous periods. Indirect effects of the change that are actually incurred and recognized should be reported in the period the change is made. An example of an indirect effect is a change in a royalty payment that is based on a reported amount of revenue.

**SELF-STUDY QUIZ**

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

38. The Harmonic Conservatory, a nonprofit organization, must disclose net assets whose use is limited by time restrictions imposed by the donor on its statement of financial position. What term is used to describe this type of net asset?
- a. Unrestricted net assets.
  - b. Temporarily restricted net assets.
  - c. Permanently restricted net assets.
39. Can a nonprofit organization use fund accounting on the statement of financial position?
- a. Yes.
  - b. No.
40. Which of the following would be considered a change in accounting principle?
- a. Changing the allowance for salvage values of depreciable assets.
  - b. Changes in the organizations included in combined financial statements.
  - c. Changing the method used to apply an acceptable accounting principle.
  - d. Changing from an unacceptable accounting principle to an acceptable one.

**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.)**

38. The Harmonic Conservatory, a nonprofit organization, must disclose net assets whose use is limited by time restrictions imposed by the donor on its statement of financial position. What term is used to describe this type of net asset? **(Page 98)**
- Unrestricted net assets. [This answer is incorrect. Unrestricted net assets are not restricted either by donors or law. Because the assets described in this scenario are restricted, they would not fall into this category.]
  - Temporarily restricted net assets. [This answer is correct. Net assets represent the difference between a nonprofit organization's assets and liabilities. Net assets are classified into one of three categories depending on the absence or presence and nature of donor-imposed restrictions. Temporarily restricted net assets are classified as those whose use has been limited by donor-imposed time restrictions or purpose restrictions, which is the case in this scenario.]**
  - Permanently restricted net assets. [This answer is incorrect. Permanently restricted net assets have been restricted by donor or by law to be maintained by the organization in perpetuity. That is not the case for the assets described in this scenario.]
39. Can a nonprofit organization use fund accounting on the statement of financial position? **(Page 100)**
- Yes. [This answer is correct. GAAP does not preclude the use of fund accounting, so a nonprofit organization is allowed to use it. However, even if fund accounting is presented, organizations are still required to present net assets by classification. Thus, fund balances must be classified on the statement of financial position as unrestricted, temporarily restricted, or permanently restricted net assets based on the absence or existence and type of donor restrictions.]**
  - No. [This answer is incorrect. According to GAAP, the use of fund accounting is neither prohibited nor required; therefore, it is allowed. However, the financial reporting model specified by FASB ASC 958 focuses on the nonprofit organization as a whole, with net assets classified solely on the absence or presence and nature of donor-imposed restrictions. It might be worthwhile for a nonprofit organization using fund account to evaluate whether it is both cost-effective and meaningful for financial statement users to present statements reflecting both fund accounting and net asset classifications.]
40. Which of the following would be considered a change in accounting principle? **(Page 102)**
- Changing the allowance for salvage values of depreciable assets. [This answer is incorrect. This is an example of a change in an accounting estimate. FASB ASC 250-10-05-01 and 05-4 defines the term *accounting changes*, and changes in an accounting estimate are considered an accounting change.]
  - Changes in the organizations included in combined financial statements. [This answer is incorrect. This is a change in reporting entity. The term *accounting changes* is defined by FASB ASC 250-10-05-01 and 05-4, and changes in the reporting entity are considered an accounting change.]
  - Changing the method used to apply an acceptable accounting principle. [This answer is correct. As defined by GAAP, a change in accounting principle is generally a change from one acceptable accounting principle to another or a change in the method of applying an acceptable accounting principle.]**
  - Changing from an unacceptable accounting principle to an acceptable one. [This answer is incorrect. This type of change is considered a correction of an error and not a change in accounting principle as defined by GAAP.]

**EXAMINATION FOR CPE CREDIT****Lesson 2 (NFSTG101)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

16. Sharing Hands, a nonprofit organization, has two over drafted bank accounts at its statement of financial position date. One account has a real overdraft, and the other has a book overdraft. What caption should the organization use for the overdrafts on its statement of financial position?
  - a. Real Overdrafts.
  - b. Book Overdrafts.
  - c. Real and Book Overdrafts.
  - d. Bank Overdrafts.
  
17. Sharing Hands holds open cash disbursements for a few days after its year end. What type of liability would be affected?
  - a. Accounts payable.
  - b. Accrued vacation pay.
  - c. Interfund borrowings.
  - d. Deferred revenue.
  
18. Sharing Hands has expense obligations for payroll taxes, compensation, and vacation pay. These expenses would be classified as what type of liability?
  - a. Accounts payable.
  - b. Accrued liabilities.
  - c. Agency obligations.
  - d. Refundable advances.
  
19. Sharing Hands has liability insurance through a claims-made insurance policy. What type of liability would it accrue in this situation?
  - a. A liability for all claims made against the insurance policy.
  - b. A liability for losses incurred during the policy period that were not reported to the insurance company.
  - c. A liability for probable losses that are not reasonably estimable.
  - d. Do not select this answer choice.

20. How are interfund borrowings by a nonprofit organization treated by GAAP?
- The use of fund accounting is required by GAAP, so nonprofit organizations will have interfund borrowings on their statements of financial position.
  - GAAP neither requires nor prohibits fund accounting, so nonprofit organizations may have interfund borrowings on their statements of financial position under certain circumstances.
  - The use of fund accounting is prohibited by GAAP, so nonprofit organizations will not address interfund borrowings on their statements of financial position.
  - Do not select this answer choice.
21. Stage East, a nonprofit organization, sells season tickets for performances that will not take place until the next fiscal year. Under what caption should these revenues be categorized?
- Refundable advances.
  - Accrued liabilities.
  - Agency obligations.
  - Deferred revenue.
22. Which of the following is a difference between a refundable advance and a grant payable?
- A refundable advance is typically a grant received by a nonprofit organization, while a grant payable occurs if the organization makes a grant to another nonprofit organization.
  - A refundable advance must be a reciprocal exchange transaction, while a grant payable will be a nonreciprocal contribution transaction.
  - A refundable advance should be recognized at fair value, while a grant payable should be measured at net settlement value.
  - A refundable advance should be listed close to long-term debt on a statement of financial position, while a grant payable should be sequenced based on when it become unconditional or be returned.
23. The Round Tree Foundation, a private foundation that is a nonprofit organization, has \$10,000 of net investment income. What tax would this income be subject to, and what amount would be affected?
- Unrelated business income taxes; \$9,000 would be subject to taxation at the corporate tax rate.
  - Excise taxes; the tax would be \$200 (2%).
  - Lobbying tax; the tax would be \$3,500 (35%).
  - The contribution penalty applies; the penalty is capped at \$5,000.

24. If an excess benefit transaction occurs, three types of excise tax can be imposed. Match the following taxes with the appropriate tax amount.

**Taxes**

1. Tax on disqualified persons
2. Tax on organization managers
3. Additional tax on disqualified persons

**Amounts**

- i. 25% of the value of the excess benefit received.
- ii. 200% of the excess benefit.
- iii. 10% of the value of the excess benefit, with a \$10,000 maximum.

- a. 1., i.; 2., ii.; 3., iii.
  - b. 1., i.; 2., iii.; 3., ii.
  - c. 1., ii.; 2., iii.; 3., i.
  - d. 1., iii.; 2., i., 3., ii.
25. Learning Tree, a nonprofit organization, has bad debts from unrelated business activities. These debts must be recognized using the direct charge-off method for tax reporting and the allowance method for financial reporting. Which of the following will arise as the result of Learning Tree's situation?
- a. Accrued taxes payable.
  - b. Excess benefit transaction.
  - c. Temporary difference.
  - d. Valuation allowance.
26. For it to be considered that a nonprofit organization's tax position will "more likely than not" be sustained, the chance that the taxing authority will sustain the position must be at least what percent?
- a. 25%.
  - b. 30%.
  - c. 51%.
  - d. 76%.
27. The Summers Group, a nonprofit organization, presents a sequenced statement of financial position. Which of the following statements best describes the way taxes should be presented on its statement of financial position?
- a. Taxes payable and receivable should be sequenced based on their due dates or when they are expected to be received.
  - b. If the organization is granted an extension on its tax return, that is the date that should be used to determine the sequencing.
  - c. Deferred tax assets and liabilities should always be presented with short-term assets and liabilities.
  - d. The placement of current and deferred tax liabilities must be done according to specific guidelines in the Internal Revenue Code.

28. The Double Ring Foundation, a nonprofit organization, has long-term debt to include on its statement of financial position. However, its payments on the debt are in arrears. How should it compute the long-term debt's maturities for disclosure in the notes to the financial statements?
- For five years after the financial position date, add the principal portion of the 12 payments for each year on an amortization schedule.
  - Perform present value computations using a present value calculator or a computer amortization program.
  - Multiply the monthly payment due by 12 months and record the amount as the long-term debt due each year.
  - Do not select this answer choice.
29. The Double Ring Foundation decides to purchase property that will be financed with debt. Assuming all of the following information is clearly determinable, what should the organization use to value the property?
- The future value of all payments due.
  - The present value of future payments under the note discounted.
  - The appropriate interest rate that applied at the note's inception.
  - Either the property's fair value or the market value of the note.
30. K-Force, a nonprofit organization, is exchanging an existing debt for a new debt with terms that are different. The present value of the cash flow of the new terms is 15% different than under the previous terms. This is not a troubled debt restructuring. Which of the following correctly describes an aspect of how K-Force should account for this change?
- The exchange should be treated as a debt extinguishment under FASB ASC 405-20-40-1.
  - The exchange will not be considered substantial because cash flows did not change at least 20%.
  - If the debt was previously exchanged within the past year, it will not qualify for treatment under FASB ASC 470-50-40-6 through 40-10.
  - Present value calculations to determine if cash flows are substantial should use the effective interest rate of the new debt instrument.
31. Giving with a Smile, a nonprofit organization, has a revolving debt arrangement. The loan commitment is for \$100,000. There are two years remaining in the arrangement and \$4,000 of unamortized loan costs. The arrangement is refinanced, and now the organization has a \$120,000 commitment for three years at a cost of \$6,000. What is the total borrowing capacity of the new agreement?
- \$100,000.
  - \$120,000.
  - \$200,000.
  - \$360,000.

32. Assume the same facts as in the previous question. How should Giving with a Smile account for the loan costs in this revolving debt arrangement?
- All \$10,000 of loan costs should be amortized over the two-year term of the original arrangement.
  - All \$10,000 of loan costs should be amortized over the three-year term of the new arrangement.
  - \$4,000 should be amortized over two years; \$6,000 should be amortized over three years.
  - \$6,000 should be amortized over two years; \$4,000 should be amortized over three years.
33. Giving with a Smile has long-term debt to recognize on its sequenced statement of financial position. Last year, it presented the information in a single caption and disclose information about significant categories and maturities in the notes to the financial statements. This year, the organization decides it would prefer to present the information in a different way. Which other presentation method would be appropriate?
- The organization includes significant categories as separate captions and includes information about maturities in the notes.
  - To present with more detail, the organization would have to change to a classified statement of financial position.
  - The organization can include long-term debt amounts in accounts payable instead of making them separate line items.
  - There is only one acceptable method for an organization to use to report long-term debt on its statement of financial position, so it must use the same method as used in the previous year.
34. The Raven Foundation, a nonprofit organization, has awarded grants totaling \$500,000 that are payable evenly over the next five years. How should this be allocated on a classified statement of financial position?
- \$500,000 should be allocated for the current year, and nothing in subsequent years.
  - \$500,000 will be allocated on the statement the year the last payment is made.
  - \$400,000 should be allocated as a current grant payable, and \$100,000 should be allocated as a noncurrent grant payable.
  - \$100,000 should be allocated as a current grant payable, and \$400,000 should be allocated as a noncurrent grant payable.
35. The Raven Foundation has a demand note that it is repaying in installments over a period that is longer than one year. Under what circumstances could the foundation classify this note as noncurrent on its classified statement of financial position?
- If the lender grants the foundation an unconditional waiver that it will not call in the demand note before it has been paid off in installments, the foundation can classify it as noncurrent.
  - If the lender agrees with the noncurrent classification, the foundation can make the classification in its financial statements.
  - If it is not likely that the lender will request a demand payment, the foundation can classify the note as noncurrent.
  - All demand notes could be requested to be paid at any time, so they are considered short-term debt and will always be classified as current.

36. The Raven Foundation has a note agreement that allows a creditor to accelerate the maturity of a long-term debt if any material adverse changes occur. What is the correct term for this situation?
- A violation of a debt covenant.
  - A subjective acceleration clause.
  - Refinancing of short-term debt.
  - A demand loan.
37. Phone Counselors, a nonprofit organization, has a long-term debt covenant that prohibits them from buying equipment over a certain dollar limit without getting prior approval from the lender. After their statement of financial position date but before the auditor's report on the financial statements, the organization violates this covenant. What kind of violation is this and what effect will it have on the financial statements?
- Recognized; possible disclosure.
  - Nonrecognized; possible disclosure.
  - Recognized; measurement or possible disclosure.
  - Nonrecognized; measurement or possible disclosure.
38. Which of the following nonprofit organizations has correctly presented its net assets?
- Nonprofit One has a government grant that is an exchange transaction with restrictions limiting what the organization can do with the funds. It reports the net assets as unrestricted and discloses the limitation in the notes.
  - Nonprofit Two has funds designated for a certain project. The organization indicates that these funds are restricted and reports them on the statement of activities.
  - Nonprofit Three reports its total net assets on the face of the statement of financial position, and discloses its unrestricted, temporarily restricted, and permanently restricted net assets in the notes.
  - Nonprofit Four has liabilities that exceed its assets; therefore, it does not report any net assets on its statement of financial position.
39. Safe Haven, a nonprofit organization, is preparing its statement of financial position and its statement of net assets. Which of the following correctly describes how net assets would be reported on one of these statements?
- Expenses would be reported as a decrease in permanently restricted net assets.
  - Net assets reported on the statement of activities can differ from the statement of financial position.
  - If donor-imposed restrictions have expired, net assets are reclassified.
  - Changes in accounting principles should not be reflected in net assets.
40. GAAP prohibits which of the following types of accounting changes from being retroactively applied to the financial statements?
- Change in accounting estimate.
  - Change in reporting entity.
  - Change in accounting principle.
  - Do not select this answer choice.

## GLOSSARY

**Account form:** Also known as the side-by-side format, this is one of two ways a statement of financial position can be arranged. In this format, assets are listed on the left-hand side and totaled to equal the sum of liabilities and net assets on the right-hand side.

**Accounting changes:** Changes in accounting estimate, changes in the reporting entity, and changes in accounting principle. The correction of errors is not included.

**Book overdraft:** The bank statement at the statement of financial position date reports a positive balance, and the overdraft, in essence, arises from "playing the float."

**Captions:** Headings within the statement that designate major groups of accounts to be totaled or subtotaled. They are also used to identify major totals or subtotals.

**Change in accounting principle:** A change from one acceptable principle to another or a change in the method of applying an acceptable accounting principle. A change from an unacceptable principle to an acceptable principle is a correction of an error and not a change in accounting principle as defined by GAAP.

**Classified statement:** Assets and liabilities are classified as current and noncurrent following the requirements of FASB ASC 210-10-45-1 through 45-12.

**Commitment fees:** Fees charged for entering into an agreement that obligates the enterprise to make or acquire a loan or to satisfy an obligation of the other party under a specified condition.

**Condition covenants:** A covenant that requires certain conditions to exist, such as prescribed debt-to-net assets ratio or working capital level. Violation of this covenant can be classified as type I or type II, depending on whether it is indicative of conditions that exist at the statement of financial position date.

**Cost approach:** A category of approach used by valuation techniques. This approach is based on the amount that currently would be required to replace the service capacity of an asset (i.e., the current replacement cost).

**Derecognition:** The removal of a recognized asset or liability.

**Disqualified person:** Anyone who was, at any time during the five-year period ending on the date of the excess benefit transaction, in a position to exercise substantial influence over the affairs of an organization.

**Excess benefit transaction:** This type of transaction occurs when the economic benefit provided, either directly or indirectly, by an applicable tax-exempt organization to or for the use of a disqualified person exceeds the value of the consideration received.

**Fair value:** 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.

**Financial asset:** A financial instrument that conveys a right to the entity.

**Financial flexibility:** The ability to take effective actions to alter amounts and timing of cash flows to respond to unexpected needs and opportunities.

**Financial liability:** A contract that imposes an obligation on the entity.

**Income approach:** A category of approach used by valuation techniques. This approach converts future amounts, such as cash flows or earnings, to a single present amount based on current market expectations about those future amounts.

**Interest method:** A method of arriving at a periodic interest cost (including amortization) which will represent a level effective rate on the sum of the face amount of the debt and (plus or minus) the unamortized premium or discount and expense.

**Inurement of benefit:** The use of a tax-exempt organization's assets for the personal benefit of a control party (i.e., a person who has direct or indirect control of the organization).

**Liquidity:** The nearness of an asset or liability to cash.

**Market approach:** A category of approach used by valuation techniques. This approach uses prices or relevant information derived from market transactions for identical or comparable assets or liabilities.

**Nonrecognition:** Not recognizing assets or liabilities (commonly known as off-balance-sheet financing), which, therefore, results in no gain or loss.

**Observable inputs:** Assumptions used in fair value measurements that are based on market data obtained from independent sources.

**Origination fees:** Fees charged to the borrower in connection with the process of originating, refinancing, or restructuring a loan.

**Other format statement:** The statement groups assets and liabilities, in no required format, with information about liquidity (including restrictions on the use of particular assets) disclosed in the notes to the financial statements.

**Permanently restricted net assets:** Net assets that have been restricted by donor or by law to be maintained by the organization in perpetuity.

**Real overdraft:** The bank statement at the end of the statement of financial position date reports an overdraft.

**Report form:** Also known as the running format, this is one of two ways that a statement of financial position can be arranged. In this format, assets are listed at the top of the page followed by liabilities and net assets. Sometimes, total liabilities are deducted from total assets to equal net assets.

**Right of setoff:** A debtor's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor. Certain conditions must be met for a right of setoff to exist.

**Rule of 78s:** A method of amortizing interest using the sum-of-the-years' digits, which amortizes interest faster in the early periods.

**Sequenced statement:** Assets are sequenced according to their nearness of conversion to cash, and liabilities are sequenced according to the nearness of their maturity and resulting use of cash.

**Subjective acceleration clause:** This type of clause allows a creditor to accelerate the maturity of a long-term debt based on subjective language such as "occurrence of material adverse changes" or "failure to maintain satisfactory operations."

**Technical covenants:** A covenant that prohibits a borrower from doing something, such as buying equipment over a prescribed dollar limit without prior approval. Violation of this type of covenant is generally classified as type II.

**Temporarily restricted net assets:** Net assets whose use has been limited by donor-imposed time restrictions or purpose restrictions.

**Temporary differences:** Differences between income tax and financial reporting that have future tax consequences.

**Unobservable inputs:** Assumptions used in fair value measurements that are the organization's own assumptions about what market participants would assume based on the best information available in the circumstances.

**Unrelated business income:** Gross income from unrelated business activities less the deductions directly connected with the income.

**Unrestricted net assets:** Net assets that are not restricted either by donors or law.

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## COMPANION TO PPC'S GUIDE TO PREPARING NONPROFIT FINANCIAL STATEMENTS

### COURSE 2

#### NOTES TO THE FINANCIAL STATEMENTS (NFSTG102)

##### OVERVIEW

**COURSE DESCRIPTION:** This interactive self-study course takes an in-depth look at how nonprofit organizations should prepare the notes to their financial statements. Lesson 1 discusses the relevant authoritative literature, form and style, necessary disclosures, and the summary of significant accounting policies. Lesson 2 provides guidance for common problems nonprofit organizations face when preparing frequent disclosures, general disclosures, and other disclosures. Lesson 3 examines the disclosures of information about financial instruments and risks and uncertainties.

**PUBLICATION/REVISION DATE:** April 2010

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

**PREREQUISITE/ADVANCE PREPARATION:** Basic knowledge of accounting.

**CPE CREDIT:** 7 QAS Hours, 7 Registry Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at [www.nasba.org](http://www.nasba.org) for a listing of states that accept QAS hours.

**FIELD OF STUDY:** Accounting

**EXPIRATION DATE:** Postmark by **April 30, 2011**

**KNOWLEDGE LEVEL:** Basic

##### Learning Objectives:

##### **Lesson 1—Authoritative Literature, Form and Style, Necessary Disclosures, and the Summary of Significant Accounting Policies**

Completion of this lesson will enable you to:

- Identify the authoritative literature and form and style considerations that are relevant to a nonprofit organization's notes to the financial statements.
- Recognize how nonprofit organizations should determine necessary disclosures and how they should deal with the summary of significant accounting policies in the notes to the financial statements.

##### **Lesson 2—Common Problems Encountered When Preparing Financial Statement Notes**

Completion of this lesson will enable you to:

- Identify common problems that nonprofit organizations can encounter when preparing frequent disclosures for their financial statement notes and best practices for dealing with those problems.
- Recognize possible methods nonprofit organizations can use to deal with common problems that may arise when preparing general disclosures for the notes to the financial statements.
- Identify common problems nonprofit organizations may encounter when preparing other disclosures (such as those related to accounting changes and income taxes) for the notes to their financial statements.

### **Lesson 3—Disclosing Information about Financial Instruments and Risks and Uncertainties in Financial Statement Notes**

Completion of this lesson will enable you to:

- Compare and contrast different types of financial instruments, and determine the disclosure requirements for financial instruments in a nonprofit organization's financial statement notes.
- Assess issues that nonprofit organizations might have with disclosing information about risks and uncertainties in the notes to their financial statements.

#### **TO COMPLETE THIS LEARNING PROCESS:**

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation**, and payment to:

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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: Authoritative Literature, Form and Style, Necessary Disclosures, and the Summary of Significant Accounting Policies

## INTRODUCTION

This lesson takes a beginning look at how nonprofit organizations prepare their financial statement notes. It discusses the authoritative literature that provides the basis for such notes and gives an overview of how the course is organized. Next, the lesson takes a look at form and style considerations that affect notes to the financial statements. The lesson then briefly discusses how to determine what disclosures are necessary in the notes to the financial statements under GAAP. Finally, the lesson discusses the summary of significant accounting policies and how it affects a nonprofit organization's notes to the financial statements.

### Learning Objectives:

Completion of this lesson will enable you to:

- Identify the authoritative literature and form and style considerations that are relevant to a nonprofit organization's notes to the financial statements.
- Recognize how nonprofit organizations should determine necessary disclosures and how they should deal with the summary of significant accounting policies in the notes to the financial statements.

## AUTHORITATIVE LITERATURE

### Authoritative Basis for Notes

Authoritative pronouncements 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. Descriptions of accounting policies and notes to financial statements are recognized in SAS No. 29 (AU 551), *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, as components of the "basic financial statements" necessary for a fair presentation in accordance with generally accepted accounting principles. Thus, 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 in the statements, that is, on the face of the statements.

### Referencing Accounting Standards after the Effective Date of the FASB Accounting Standards Codification

Previously, many of the illustrative note disclosures cited specific Statements of Financial Accounting Standards (SFAS), especially in the case of significant accounting policies. For example, when disclosing a nonprofit organization's accounting policy for the presentation of its financial statements, the policy might have said: "Under Statement of Financial Accounting Standards (SFAS) No. 117, *Financial Statements of Not-for-Profit Organizations*, the Organization is required to report information regarding its financial position and activities according to three classes of net assets: unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets." However, FASB Accounting Standards Codification (ASC) Topic 105, *Generally Accepted Accounting Principles* (formerly SFAS No. 168), established the FASB Accounting Standards Codification (FASB ASC or the Codification) as the single source of authoritative accounting principles for nongovernmental entities that prepare financial statements in accordance with U.S. GAAP. FASB ASC 105 was effective for financial statements issued for interim and annual periods ending after September 15, 2009.

Upon the effective date of FASB ASC 105 (formerly SFAS No. 168), the existing sources of accounting and reporting standards were superseded (except for certain grandfathered guidance). Thus, FASB ASC 105 reduced the GAAP hierarchy to two levels: authoritative and nonauthoritative. Authoritative GAAP is contained in the Codification. Accounting literature that is not contained in the Codification is considered nonauthoritative.

Since the individual Statements of Financial Accounting Standards are no longer authoritative, they generally should not be cited in the notes to financial statements for periods ending after September 15, 2009. Further, FASB ASC 105-10-05-5 (formerly SFAS No. 168) states that Accounting Standards Updates (ASUs), which are issued by the FASB to update the FASB ASC with new or amended guidance, are not considered authoritative in their own right. Since individual ASUs are not authoritative, citing them in disclosures to financial statements would not be considered a best practice. Thus, the illustrative notes in this course follow this guideline.

### Organization of This Course

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 not discussed in this course. This course explains disclosures for nonprofit organizations commonly made in the notes. However, this course does not attempt to describe all possible disclosures. For those reasons, the course 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 Course

This course should be taken to gain practical guidance on drafting notes. As noted previously, this course does not discuss all disclosures required by GAAP. The guidance given includes both form and style considerations as well as technical requirements for common problem areas. More information can be found in *PPC's Guide to Preparing Nonprofit Financial Statements*.

## FORM AND STYLE

### Title and Format

**Title.** When the notes are presented on separate pages, the pages 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. Many accountants use the caption "Notes to Financial Statements" without a date because notes relate to the accompanying statements, each of which is dated. However, other preparers use the date of the statement of financial position in the caption.

**Arrangement.** Generally, notes are presented on a separate page or pages after the basic financial statements. The notes should be arranged in the same order as the financial statement captions to which they relate, and each note should bear a descriptive caption corresponding to the related financial statement caption. The following additional guidelines relate to use of that approach:

- 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 contingent liabilities notes would be placed between liabilities and net assets.
- A subsequent events note would be the last note.

**Heading Individual Note Captions.** The following style can be used for heading of individual notes within the "Notes to Financial Statements" section:

NOTE C—PROPERTY AND EQUIPMENT

## Wording

The notes, as an integral part of the financial statements, are the responsibility of the nonprofit organization even though the accountant may assist with, or totally prepare, the statements and notes. The wording of the notes should follow that principle, and words such as “we,” “us,” “client,” and “our” should not be used to avoid any implication of reference to the CPA. Use of “the Organization” or “Management” is a more appropriate way of referring to the nonprofit organization.

## Comparative Financial Statements

**Disclosures for Prior Years Repeated.** When comparative financial statements are issued, FASB ASC 205-10-45-4 (formerly ARB No. 43) 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. In the following situations, authoritative literature determines the required disclosures.

- An authoritative pronouncement requires disclosures only for the current period or future periods in comparative presentations. For example, FASB ASC 470-10-50-1 (formerly SFAS No. 47, *Disclosure of Long-Term Obligations*) requires disclosure of maturities of long-term debt for the five years following the current statement of financial position.
- An authoritative pronouncement requires disclosures for all periods presented. For example, FASB ASC 958-320-50 (formerly SFAS No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*) requires, among other things, disclosure of the composition of investment return for each period that a statement of activities is presented.

**Summarized Prior-year Information.** 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 in financial statements only summarized information (in a single column) for the prior period. 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). If only summarized prior-year information is presented in the financial statements, it would be a best practice for the note disclosures to only include information for the current year. The notes to the financial statements are considered an integral part of the financial statements, and a two-year presentation of note information could confuse the presentation if the financial statements only include summarized prior-year information. FASB ASC 958-205-45-8 and 958-205-50-4 (formerly 2008 Audit Guide, Paragraphs 3.20–3.21) 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.

## 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. Since that only involves eliminating some items from the notes for the full set, it should not be costly or time-consuming. 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 statement,” such as:

ABC ORGANIZATION  
NOTES TO STATEMENT OF FINANCIAL POSITION

**Intermediate Measure of Operations on the Statement of Activities**

FASB ASC 958 (formerly SFAS No. 117) allows organizations a great deal of flexibility in arranging the statement of activities. FASB ASC 958-225-45-9 through 45-12 (formerly SFAS No. 117, Paragraph 23) 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.

**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 best describes the notes to the financial statements under the authoritative literature?
  - a. They are part of the basic financial statements.
  - b. They are used to restate important information from the face of the financial statements.
  - c. They have a specifically mandated format.
  
2. Helping Hands, a nonprofit organization, issues comparative financial statements. Should it also repeat note disclosures from the prior period?
  - a. Yes.
  - b. No.
  
3. Joe, a CPA, is engaged by Helping Hands to prepare its basic financial statements. The organization also requests that Joe prepare only a statement of financial position for a small number of people. How will this special request affect the notes to the financial statements?
  - a. Joe should only include note disclosures with information related to the current year.
  - b. Joe should only include disclosures related to the statement of financial position.
  - c. Joe must ensure that the notes describe how Helping Hands uses the term "operations."
  - d. There is no effect to the notes; Joe must include all notes with the single statement.

## 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 best describes the notes to the financial statements under the authoritative literature? **(Page 117)**
  - a. **They are part of the basic financial statements. [This answer is correct. Descriptions of accounting policies and notes to financial statements are recognized in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, as components of the “basic financial statements” necessary for a fair presentation in accordance with generally accepted accounting principles (GAAP).]**
  - b. They are used to restate important information from the face of the financial statements. [This answer is incorrect. Financial statement notes should be used to present material disclosures required by GAAP that are not otherwise presented in the statements, that is, on the face of the statements.]
  - c. They have a specifically mandated format. [This answer is incorrect. Authoritative pronouncements mandate many types of disclosures, but generally do not mandate the manner of presentation.]
2. Helping Hands, a nonprofit organization, issues comparative financial statements. Should it also repeat note disclosures from the prior period? **(Page 119)**
  - a. **Yes. [This answer is correct. 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.]**
  - b. No. [This answer is incorrect. Under FASB ASC 205-10-45-4, significant prior-period disclosures should be repeated. 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.]
3. Joe, a CPA, is engaged by Helping Hands to prepare its basic financial statements. The organization also requests that Joe prepare only a statement of financial position for a small number of people. How will this special request affect the notes to the financial statements? **(Page 119)**
  - a. Joe should only include note disclosures with information related to the current year. [This answer is incorrect. Joe would need to do this if Helping Hands requested that he prepare financial statements with summarized prior-year information.]
  - b. **Joe should only include disclosures related to the statement of financial position. [This answer is correct. In this situation, Joe must prepare a different set of notes than those he prepared to go with the full set of basic financial statements. Since that should only involve eliminating some items from the notes for the full set, it should not be costly or time consuming.]**
  - c. Joe must ensure that the notes describe how Helping Hands uses the term “operations.” [This answer is incorrect. FASB ASC 958-225-45-9 notes that a nonprofit organization may divide the statement of activities between operating and nonoperating activities. The 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. However, though required, this is not relevant to the scenario presented in this question.]
  - d. There is no effect to the notes; Joe must include all notes with the single statement. [This answer is incorrect. Joe should not include notes with the single financial statement that do not apply to that financial statement. For example, notes related to the statement of activities or the statement of cash flows, would not be applicable to the presentation of only a statement of financial position.]

## NECESSARY DISCLOSURES

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. *PPC's Guide to Preparing Nonprofit Financial Statements* includes a checklist of disclosures that are ordinarily necessary for nonprofit organizations. For determining other disclosures that may be necessary in specific circumstances, the following general advice can be considered:

- 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.

## PROVIDING A SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

According to FASB ASC 235-10-50-1 (formerly APB Opinion No. 22, *Disclosure of Accounting Policies*), 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 (formerly SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*) requires disclosure of the nature of an organization's activities and is discussed further in Lesson 3.

### Caption and Format

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 capitalization and underlining of the subcaptions as follows:

#### NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Activities

Use of Estimates

Investments

Property and Equipment

Income Tax Status

### 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 (formerly APB Opinion No. 22), 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 (formerly APB Opinion No. 12, *Disclosure of Depreciable Assets and Depreciation*) 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. (Additional discussion of the application of the criteria for disclosure of accounting policies is provided later in this lesson.)

### Practice Problems

**Methods That Approximate GAAP.** If an accounting method approximates a generally accepted principle or method, the GAAP description can be used. 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 could 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 pronouncements 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) (formerly ARB No. 43, Ch. 4).
- *Long-lived Asset (Property and Equipment) Capitalization.* The policy for capitalizing long-lived assets (FASB ASC 958-360-50-1) (formerly 2008 Audit Guide, Paragraph 9.13).
- *Depreciation.* A general description of the methods used in computing depreciation for major classes of depreciable assets (FASB ASC 360-10-50-1) (formerly APB Opinion No. 12, Paragraph 5).
- *Environmental Remediation Liabilities.* The policy for measuring environmental remediation liabilities either on a discounted or undiscounted basis (FASB ASC 410-30-50-4) (formerly SOP 96-1, Paragraph 7.11).
- *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) (formerly SFAS No. 95, Paragraph 10).
- *Trade Receivables and Other Financing Activities.* The basis for accounting for receivables and accounting policies for uncollectible accounts (FASB ASC 310-10-50-2 through 50-8) (formerly SOP 01-6, Paragraph 13).
- *Notes Receivable or Loans.* The policy for recognizing interest income on impaired loans, including how cash receipts are recorded (FASB ASC 310-10-50-15) (formerly SFAS No. 114).
- *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; 958-205-50-3; 958-320-50; 958-325-50) (formerly SFAS No. 107, Paragraph 10, and SFAS No. 124, Paragraph 15).
- *Intangibles Amortization.* The method and period of amortization (APB Opinion No. 17, Paragraph 30).
- *Contributions.* The policy for recording restricted contributions when those restrictions are met during the period and for implying time restrictions on gifts of long-lived assets (FASB ASC 958-605-50-2; 958-360-50-1) (formerly SFAS No. 116, Paragraphs 14 and 16).
- *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 revenue (FASB ASC 958-320-45-3) (formerly SFAS No. 124, Paragraph 10).
- *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 958-205-50-1) formerly (FSP FAS 117-1, Paragraph 11).
- *Collection Items.* Whether the organization recognizes and capitalizes contributions of collection items (FASB ASC 958-360-45-3) (formerly SFAS No. 116, Paragraph 27).
- *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) (formerly SOP 93-7).
- *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) (formerly SFAS No. 136, Paragraph 11).

- *Sales and Similar Taxes.* The policy regarding the presentation of sales and similar taxes (for instance, use, value added and certain excise taxes), that is, whether such taxes are presented on a gross or net basis (FASB ASC 605-45-50-3) (formerly EITF Issue No. 06-3).
- *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) (formerly EITF Issue No. 00-10).
- *Uncertain Tax Positions.* If applicable, an organization that elects to defer the application of FASB ASC 740-10-65-1 (formerly FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes"), should disclose that fact and disclose its accounting policy for evaluating uncertain tax positions for each set of financial statements where the deferral applies.

In addition to the examples listed above, FASB ASC 235-10-50-4 (formerly APB Opinion No. 22) requires that the consolidation policy be disclosed, if applicable.

**Required Disclosure Regarding Subsequent Events.** FASB ASC 855-10-50-1 (formerly Paragraph 12 of SFAS No. 165, *Subsequent Events*) 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 will make this disclosure as part of the summary of significant accounting policies note. Other accountants, however, may 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.

### **Recommended Accounting Policy Disclosures**

As previously mentioned, GAAP requires disclosure of all significant accounting policies. In addition to disclosures required by specific pronouncements, organizations should consider disclosing the accounting methods prescribed by authoritative literature 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.

4. Heart Felt, a nonprofit organization, is preparing the notes to its financial statements for the current year. It ensures that all the specific disclosures required by authoritative literature are included in the presentation. Has the organization included all the necessary disclosures to be in conformity with GAAP?
  - a. Yes.
  - b. No.
5. Heart Felt uses both the straight-line and the declining balance methods of depreciation; however, only the declining-balance method has a significant effect on the organization's financial statements. How will Heart Felt's accounting policy note be affected?
  - a. Only the straight-line method should be included.
  - b. Only the declining-balance method should be included.
  - c. Both depreciation methods should be included.
6. Heart Felt's summary of significant accounting policies is required by authoritative literature to include all of the following disclosures, **except**:
  - a. The policy the organization uses to classify costs related to shipping and handling.
  - b. The policy the organization uses to determine what short-term investments are treated as cash equivalents on its statement of cash flows.
  - c. The basis the organization uses to capitalize its long-lived assets.
  - d. The basis the organization uses to allocate expenses among its program and supporting services.

## 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. Heart Felt, a nonprofit organization, is preparing the notes to its financial statements for the current year. It ensures that all the specific disclosures required by authoritative literature are included in the presentation. Has the organization included all the necessary disclosures to be in conformity with GAAP? **(Page 123)**
  - a. Yes. [This answer is incorrect. Determining the disclosures that are necessary in specific circumstances may be complex and requires seasoned professional judgment. 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. Disclosures other than those specified by authoritative pronouncements must be considered.]
  - b. No. [This answer is correct. Determining what is required for a fair presentation in conformity with GAAP involves consideration of both of the following: (1) specific disclosures required by authoritative pronouncements and (2) disclosures not specifically required by authoritative pronouncements but that are necessary to keep the financial statements from being misleading. Therefore, though Heart Felt includes all of the disclosures mentioned in the authoritative pronouncements, it might need to make more disclosures to insure that the statements are not misleading to readers.]**
5. Heart Felt uses both the straight-line and the declining balance methods of depreciation; however, only the declining-balance method has a significant effect on the organization's financial statements. How will Heart Felt's accounting policy note be affected? **(Page 124)**
  - a. Only the straight-line method should be included. [This answer is incorrect. According to this scenario, the straight-line method does not have a significant effect on Heart Felt's financial statements; therefore, it would not be the sole depreciation method listed in the organization's accounting policy note.]
  - b. Only the declining-balance method should be included. [This answer is correct. 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, and in the scenario above, that would be the declining-balance method.]**
  - c. Both depreciation methods should be included. [This answer is incorrect. If both methods had a significant effect on the financial statements, it would be appropriate for Heart Felt to include both methods in its summary of significant accounting policies. However, in this scenario, one method accounts for most of the effect on the financial statements, so both depreciation methods should not be included in Heart Felt's accounting policy note.]
6. Heart Felt's summary of significant accounting policies is required by authoritative literature to include all of the following disclosures, **except: (Page 125)**
  - a. The policy the organization uses to classify costs related to shipping and handling. [This answer is incorrect. This disclosure is required by FASB ASC 605-45-25-2. Heart Felt should disclose whether shipping and handling costs are included in the cost of sales.]
  - b. The policy the organization uses to determine what short-term investments are treated as cash equivalents on its statement of cash flows. [This answer is incorrect. This disclosure is required by FASB ASC 230-10-50-1.]
  - c. The basis the organization uses to capitalize its long-lived assets. [This answer is incorrect. This disclosure is required by FASB ASC 958-360-50-1, and applies to property and equipment.]

- d. The basis the organization uses to allocate expenses among its program and supporting services. [This answer is correct. This is not a disclosure required by authoritative literature; however, if Heart Felt chooses, it can include this disclosure in its accounting policies note. Doing so might be a best practice, especially if it keeps the financial statements from being misleading.]**

**EXAMINATION FOR CPE CREDIT****Lesson 1 (NFSTG102)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Which of the following is currently the single source of authoritative accounting principles for nongovernmental entities?
  - a. Statements of Financial Accounting Standards.
  - b. U.S. GAAP.
  - c. FASB Accounting Standards Codification.
  - d. Do not select this answer choice.
2. Which of the following nonprofit organizations has correctly formatted its financial statement notes?
  - a. Alpha Organization uses different formatting and capitalization for the title of its financial statement notes to distinguish those pages from the rest of the financial statements.
  - b. Beta Organization includes a subsequent events note in the notes section of its financial statements. It places this note as the first note in the section.
  - c. Gamma Organization presents its notes on a separate page and arranges them in the same order as the financial statement captions to which they apply.
  - d. Delta Organization uses language in its notes that reference the CPA who prepared the notes.
3. The Food Cupboard, a nonprofit organization, presents comparative financial statements. Which of the following note disclosures should **not** be included in the organization's presentation?
  - a. Disclosure of maturities of long-term debt for five years after the date of the current statement of financial position.
  - b. Disclosure of information about the organization's commitments and contingent liabilities from the prior year.
  - c. Disclosure of the composition of investment return for each period that the organization presents a statement of activities.
  - d. Disclosure of a summary of the organization's significant accounting policies.
4. The Bryant Foundation, a nonprofit organization, is preparing its summary of significant accounting policies to include in its financial statements. Based on the guidance in FASB ASC 235-10-50-1, how should this disclosure be formatted?
  - a. It must be presented as a separate summary.
  - b. It must be included in the first note to the financial statements.
  - c. It must be presented on the face of the financial statements.
  - d. The disclosure's format, including its location, is flexible.

5. The Bryant Foundation uses straight-line depreciation and discloses this fact in its summary of significant accounting policies. Why is this disclosure necessary under FASB ASC 235-10-50-3?
- The foundation is choosing from existing acceptable depreciation methods.
  - Use of this depreciation method would qualify as an industry peculiarity.
  - Use of this depreciation method would be considered an innovative or unusual application of GAAP.
  - Use of this method approximates GAAP.
6. Accounting policies for which of the following are required by authoritative literature to be disclosed in a nonprofit organization's summary of significant accounting policies? (List all that apply.)
- |                    |                             |  |
|--------------------|-----------------------------|--|
| i. Inventories.    | iii. Advertising.           | v. The Internal Revenue Code section exempting the organization from federal income taxes. |
| ii. Contributions. | iv. Use of fund accounting. | vi. Investment income and gains that are restricted.                                       |
- i., ii., and iii.
  - i., ii., iii., and vi.
  - i., ii., iii., iv., and vi.
  - i., ii., iii., iv., v., and vi.



# Lesson 2: Common Problems Encountered When Preparing Financial Statement Notes

## INTRODUCTION

This lesson examines common problems that nonprofit organizations may encounter when preparing their financial statement notes. Common problems related to frequent disclosures may relate to disclosures about investments, promises to give, property and equipment, long-term debt, or expenses. Common problems related to general disclosures may relate to disclosures about related party transactions, contingencies, environmental remediation costs, or fair value. Common problems that occur when preparing other disclosures may include those related to accounting changes, income taxes, the equity method, or prior-period adjustments. This lesson takes a look at all of the common problems listed here, and others, as well.

### Learning Objectives:

Completion of this lesson will enable you to:

- Identify common problems that nonprofit organizations can encounter when preparing frequent disclosures for their financial statement notes and best practices for dealing with those problems.
- Recognize possible methods nonprofit organizations can use to deal with common problems that may arise when preparing general disclosures for the notes to the financial statements.
- Identify common problems nonprofit organizations may encounter when preparing other disclosures (such as those related to accounting changes and income taxes) for the notes to their financial statements.

## COMMON PROBLEMS THAT CAN OCCUR WHEN PREPARING FREQUENT DISCLOSURES

The following paragraphs describe possible solutions to common problems that arise in preparing note disclosures related to specific financial statement captions.

### Investments

The following topics and subtopics in the FASB Accounting Standards Codification provide guidance on investment carrying amounts, income, and gains and losses:

- FASB ASC 958-320 and 958-205 [formerly SFAS No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations* (as amended)] provide guidance for all nonprofit organizations. The accounting guidance applies to equity securities with readily determinable fair values and all debt securities, but some of its disclosure requirements apply to other types of investments as well.
- FASB ASC 815 [formerly SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* (as amended)] provides guidance for all derivative instruments. It requires that derivatives be measured at fair value and be recognized as either assets or liabilities in the statement of financial position.
- FASB ASC 320-10 and 325-20 [formerly FASB Staff Position (FSP) FAS 115-1 and FAS 124-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments"] address determining when an investment is considered impaired, whether the impairment is other than temporary, and measuring an impairment loss. It requires certain disclosures about cost method investments and unrealized losses that have not been recognized as other-than-temporary impairments.
- FASB ASC 958-810 (formerly SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*) applies to investments in equity securities for which either the equity method or consolidation is appropriate.

The following paragraphs discuss the required note disclosures relating to investments.

**Carrying Amounts.** FASB ASC 958-320; 958-205 (formerly SFAS No. 124) require disclosure of the carrying amounts of each major type of investment, such as equity securities, U.S. Treasury securities, debt securities, oil and gas properties, and real estate. The organization is also required to disclose the basis used to determine the carrying value for other investments not required by the Statement to be carried at fair value. Additional qualitative and quantitative information is required for investments in equity securities accounted for using the cost method as allowed by the Audit Guide. 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 958-205 (formerly SFAS No. 124) 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 (formerly 2008 Audit Guide, Paragraph 8.19) allows an organization to report investment gains and income that are restricted to specific uses by the donor as unrestricted support 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 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 958-320 (formerly FSP FAS 115-1 and FAS 124-1) 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.

For colleges and universities, FASB ASC 958-325 (formerly 2008 Audit Guide, Paragraph 8.35) also requires that the amount of investment income and realized and unrealized gains and losses from investments other than debt securities and equity securities with readily determinable fair values 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. 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 (formerly SFAS No. 107) 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 (formerly SFAS No. 124) 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.

**Fair Value Disclosure Considerations.** FASB ASC 820-10 (formerly SFAS No. 157, *Fair Value Measurements*) expands the required disclosures about fair value measurements. Additional disclosures are also required if a nonprofit organization elects the fair value option available under FASB ASC 825-10 (formerly SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*) to measure investments. Entities are encouraged to present the required disclosures in combination with fair value disclosures required by other pronouncements. The disclosure requirements of FASB ASC 820-10 and 825-10 (formerly SFAS Nos. 157 and 159) are discussed later in this lesson. Prior to the issuance of FASB ASC 825-10 (formerly SFAS No. 157), FASB ASC 825-10-50-10 (formerly SFAS No. 107, *Disclosures about Fair Value of Financial Instruments*), already required organizations to present information about the methods and assumptions used in estimating the fair values of financial instruments. The provisions of FASB ASC 825-10 (formerly SFAS No. 107) are optional if an organization meets certain criteria, one

of which is that it is a nonpublic entity. A discussion of the FASB ASC 825-10 (formerly SFAS No. 107) disclosure requirements and which organizations are exempted from those requirements can be found in Lesson 3.

## Endowment Funds

FASB ASC 958-205-45-28 through 45-32 (formerly FSP FAS 117-1) 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 958-205-51-1A. FASB ASC 958-205-45-28 through 45-32 are effective for fiscal years ending after December 15, 2008.

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, FASB ASC 958-205-50-2 (formerly SFAS No. 124) 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.

## 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 (formerly Paragraph 22 of SFAS No. 116) 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 (formerly SFAS No. 159) 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 (formerly SFAS No. 116) requires the following disclosures about conditional promises, including conditional promises in valid wills:

- 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.

**Fair Value Disclosure Considerations.** FASB ASC 820-10 (formerly SFAS No. 157, *Fair Value Measurements*) expands the required disclosures about fair value measurements if promises to give are subsequently measured at fair value. Additional disclosures are also required if a nonprofit organization elects the *fair value option* available under FASB ASC 825-10 (formerly SFAS No. 159) to measure unconditional promises to give subsequent to their initial recording. The disclosure requirements of FASB ASC 820-10 and 825-10 (formerly SFAS Nos. 157 and 159) are discussed later in this lesson.

## Property and Equipment

**General Disclosure Requirements.** FASB ASC 360-10-50-1 (formerly APB Opinion No. 12) 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 be used for developing 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 (formerly SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*) 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 (formerly SFAS No. 116) includes disclosure requirements that are specific to nonprofit organizations. The following paragraphs discuss those disclosure requirements.

FASB ASC 958-360-50-1 (formerly Paragraph 16 of SFAS No. 116) 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 or restricted contribution revenue if the donor restrictions are met in the same reporting period in which the contributions are recognized. See discussion of restricted assets later in this lesson.

FASB ASC 958-360-50-1 (formerly Paragraph 9.13 of the 2008 Audit Guide ) requires organizations to describe their policy for capitalizing property and equipment.

FASB ASC 958-360-50-2 (formerly 2008 Audit Guide, Paragraph 9.13) requires 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:

- a. Nondepreciable assets.
- b. Property and equipment that represents construction in process, is held for sale, or is held for investing purposes.
- c. Any other amounts that are not held for use in the organization's activities.
- d. Donor-restricted assets that are to be used to invest in property and equipment.
- e. Leasehold improvements.
- f. Assets from capital leases recorded under FASB ASC 840 (formerly SFAS No. 13).
- g. Capitalized interest.

FASB ASC 958-360-50-1 (formerly 2008 Audit Guide) requires disclosure of the basis of valuation of the property and equipment. In addition, FASB ASC 958-360-50-3 (formerly 2008 Audit Guide, Paragraph 9.15) requires 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.
- Impaired long-lived assets reported at fair value.

If the nonprofit organization has access to property and equipment without owning or leasing it, the financial statements should disclose the nature of the relationship with the owner of the property or equipment. Also, FASB ASC 958-360-50-4 (formerly 2008 Audit Guide, Paragraph 9.04) notes the nonprofit organization should disclose the amount of property and equipment used in operations but not recorded on the statement of financial position because title is held by grantors, and the terms of such grantor agreements.

## **Collections**

Information about capitalized collections is generally included in the statement of financial position. Under FASB ASC 958 (formerly SFAS No. 116) 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 (formerly 2008 Audit Guide, Paragraph 7.11) 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 equipment. FASB ASC 958-210-45-6 (formerly 2008 Audit Guide, Paragraph 3.03) 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 (formerly 2008 Audit Guide, Paragraph 3.07) 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 (formerly SFAS No. 117, Paragraph 16) permits, but does not require, organizations to disclose self-imposed limitations on the use of unrestricted net assets (for example, board designated) if total unrestricted net assets are displayed on the statement of financial position. See the discussion earlier in this lesson, however, concerning disclosure requirements for board-designated endowment funds.

FASB ASC 958-210-45-7 (formerly 2008 Audit Guide, Paragraph 4.05) 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.

### Trade Receivables and Other Financing Activities

FASB ASC 310-10-50 and 860-20-50 [formerly SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*] apply to any entity, including a nonprofit organization, that lends to or finances the activities of others. Many nonprofit organizations engage in lending or financing arrangements that involve extending credit relating to the organization's programs. Examples of receivables included in the scope of FASB ASC 310-10-50 and 860-20-50 (formerly SOP 01-06) 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.
- Assessments receivable (e.g., from members of a country club to finance the construction of a new clubhouse).

- Notes or mortgages receivable from entities borrowing from a nonprofit organization that makes facilities loans, loans to purchase musical equipment, etc.
- Loans from the national organization to the local affiliate organization.
- Certain receivables from related parties.

Promises to give are not included in the scope of FASB ASC 310-50-50 and 860-20-50 (formerly SOP 01-6) because they do not result from a lending or financing transaction. Similarly, grants receivable related to grants that are considered contributions are not included in the scope of the requirements. However, if a grant is considered an exchange transaction (i.e., not a contribution), any related receivable could be considered essentially a "trade receivable" and be included in the scope of the requirements.

The requirements could be considered not to apply to amounts due from a financially interrelated nonprofit organization 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.

For trade receivables, FASB ASC 310-50-50 and 860-20-50 (formerly SOP 01-6) require organizations to report receivable balances on the statement of financial position less an allowance for uncollectibles. Structurally, FASB ASC 310-50-50 and FASB ASC 860-20-50 (formerly SOP 01-6) first provide guidance for all entities with activities included in its scope then provide additional guidance for financial institutions and other types of entities whose operating activities consist largely of providing long-term financing. The required disclosures generally fall into the following categories:

- a. Accounting policies for trade receivables, such as the basis of accounting for them and the method of recognizing interest assessed on balances outstanding.
- b. Accounting policies for credit losses and doubtful accounts.
- c. Accounting policies for nonaccrual and past-due trade receivables, such as the policies for placing receivables on nonaccrual status, recording payments received on nonaccrual loans, charging off uncollectible amounts, and determining past-due or delinquency status.
- d. Gains and losses from sales of trade receivables.
- e. Foreclosed and repossessed assets.
- f. The carrying amount of trade receivables on nonaccrual status and receivables that are past-due 90 days or more and still accruing interest.
- g. The carrying amount and classification of trade receivables that serves as collateral for borrowings.

Many of the required disclosures discussed above will generally not be applicable to nonprofit organizations. This may be either 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 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.

However, the requirements to disclose the accounting policies for trade receivables and credit losses and doubtful accounts and the carrying amount of receivables pledged as collateral are likely to be applicable to most organizations with trade receivables. In addition, the disclosure requirements of other pronouncements may also be applicable. For example, 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 entities should account for recoveries of doubtful accounts. Instead, it allows entities 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.

**Accounting Policies for Trade Receivables and Credit Losses and Doubtful Accounts.** These 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 provision for 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—

- 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 issued.
- The entity'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 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.

## Deferred Revenue and Refundable Advances

Various types of deferred revenue may be received by a nonprofit organization (this is discussed further in *PPC's Guide to Preparing Nonprofit Financial Statements*). Revenue from exchange transactions may be deferred (e.g., subscription revenue 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 if the information will be useful to the reader.

## Promises to Give to Others

If the organization has made a promise to give to others as described in FASB ASC 720-25-25-1 (formerly SFAS No. 116, Paragraph 18), the organization must record a liability (or reduce an asset if a liability is being forgiven). According to FASB ASC 958-405-50-1 (formerly 2008 Audit Guide, Paragraph 10.09), 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.

**Fair Value Disclosure Considerations.** Additional disclosures are required if a nonprofit organization elects the *fair value option* available under FASB ASC 825-10 (formerly SFAS No. 159) to measure unconditional promises to give to others subsequent to their initial recording. Those disclosure requirements are discussed later in this lesson.

## 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 (formerly 2008 Audit Guide, Paragraph 4.05) requires disclosure of any special borrowing arrangements.

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?

**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 (formerly SFAS No. 47, *Disclosures of Long-Term Obligations*) requires disclosure of principal reductions during each of the next five years.
- FASB ASC 835-20-50-1 (formerly SFAS No. 34, *Capitalization of Interest Cost*) requires disclosure of interest costs.

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

**Disclosing Payment Terms for Combined Debt.** If notes payable have been combined because of immateriality, the preparer 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%."

Since the grouping relates to immaterial items, either alternative is acceptable. If the second alternative is chosen, 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 of more use than comparative amounts.

**Need to Apportion Debt Schedule between Current and Noncurrent.** If a classified statement of financial position is presented, captions can be used to 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. Therefore, such detail does not need to be provided unless the additional information would be useful to the reader; for example, when statements are prepared primarily for management's use.

### **Donated Materials, Facilities, and Services**

Many nonprofit organizations receive significant amounts of donated materials for the organization to sell or use in its programs or supporting services. Volunteers provide nonprofit organizations with 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 in determining which donations should be recorded in the financial statements and the proper valuation of those donations that are to be recognized.

**What Disclosures Are Required?** There are no special disclosure requirements related to donated materials. Disclosures that are required for donations of services include:

- 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. 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. 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.

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

**Donations of Long-lived Assets.** FASB ASC 958-605-55-24 (formerly 2008 Audit Guide, Paragraph 5.57) notes that an organization should record contribution revenue for the free or reduced-cost use of long-lived assets such as facilities. According to the FASB ASC 958-605-55-24 (formerly 2008 Audit Guide, Paragraph 5.58), if there is an unconditional promise to give the use of long-lived assets, the caption in the financial statements can be descriptive of the asset whose use is contributed instead of identifying it as a receivable. For example, the amount recorded on the statement of financial position could be labeled "building" rather than "contributions receivable."

## 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 the nonprofit organization does not comply with the restrictions?

**Additional Disclosure Requirements.** GAAP requires reporting contributions received and promises to give as an increase in net assets immediately, even if the donor has restricted their use and the restriction will be met in a future reporting period; that is, none are deferred. As a result, restricted contribution revenue is recorded immediately, either as an increase in temporarily restricted net assets or permanently restricted net assets, depending on the nature of the donor restriction, and no further note disclosure is required. However, FASB ASC 958-210-50-3 (formerly SFAS No. 117, Paragraph 14) requires disclosure of information about the nature and amount of the different types of permanent or temporary restrictions on net assets.

If a nonprofit organization chooses to show restricted contributions that are met in the reporting period in which the contribution is made as unrestricted contribution revenue, GAAP requires that policy to be followed consistently for all such contributions and to be disclosed. An organization is required to have a similar policy for donor-restricted investment income and gains. Restricted investment income and contributions of donor-restricted long-lived assets were discussed earlier in this course.

**Disclosing Noncompliance with Restrictions.** If restrictions on contributions are not complied with, disclosure as a contingency may be required if the criteria discussed later in this lesson are met. For example, possible claims for reimbursement of disallowed costs from granting agencies may be disclosed as contingencies. Or, the use of income from investing endowment funds for current operating purposes may be in violation of the endowment instrument, requiring disclosure in the notes to the financial statements. FASB ASC 958-450-50-2 (formerly 2008 Audit Guide, Paragraph 3.50) requires disclosure of noncompliance with donor-imposed restrictions if (a) there is a reasonable possibility that a material contingent liability has been incurred at the financial statement date or (b) there is at least a reasonable possibility that the noncompliance could lead to a material loss of revenue or cause the organization to be unable to continue as a going concern. Such noncompliance could result from organizations failing to maintain necessary amounts of cash (or equivalents) or an appropriate composition of assets to comply with donor restrictions.

## Organizations that Raise or Hold Contributions for Others

FASB ASC 958 (formerly SFAS No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*) requires the following disclosures:

- a. If an organization discloses the ratio of fund-raising expenses to funds raised in its financial statements, it should also disclose the method used to compute the ratio. (FASB ASC 958-205-50-3) (formerly SFAS No. 136, Paragraph 20)
- b. If an organization transfers assets to a recipient organization and specifies itself or its affiliate as the beneficiary, the organization should disclose the following information for each period for which it presents a statement of financial position: (FASB ASC 958-605-50-6) (formerly SFAS No. 136, Paragraph 19)
  - (1) The recipient organization receiving the transfer,
  - (2) Whether the organization granted variance power to the recipient organization, and if so, a description of the variance power,
  - (3) How the recipient organization will distribute the assets to the organization or its affiliates, and
  - (4) The aggregate amount 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.

- c. If the organization acts as an intermediary or agent and chooses to record the receipt of nonfinancial assets specified for a beneficiary, the organization should disclose that policy. (FASB ASC 958-605-50-4) (formerly SFAS No. 136, Paragraph 11)

Organizations should also consider whether the related party disclosure requirements included in FASB ASC 850-10 (formerly SFAS No. 57) and FASB ASC 958-810 (formerly SOP 94-3) 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 disclosures relate to net assets:

- FASB ASC 958-210-50-3 (formerly SFAS No. 117, Paragraph 14) requires a description and dollar amount of the different types of permanent and temporary restrictions on net assets, either in the notes or on the face of the statement of financial position.
- FASB ASC 958-210-50-2 (formerly SFAS No. 117, Paragraph 16) states disclosure of the following is usually made in the notes to the financial statements:
  - Limits on unrestricted net assets resulting from loan covenants.
  - Limits on unrestricted net assets in contracts with suppliers, creditors, and others.
- Although not required, FASB ASC 958-210-45-11 (formerly SFAS No. 117, Paragraph 16) suggests disclosure of information regarding self-imposed limits, such as voluntary resolutions of the board of directors.

Disclosures required for donor-restricted and board-designated endowment funds were discussed earlier in this lesson.

## Expenses

**Classifications.** Expenses of nonprofit organizations can be classified by a natural classification or a functional classification. The natural, or object, classification of expenses represents the type of expense, e.g., salaries and employee benefits, professional fees, occupancy, postage and shipping, supplies, telephone, travel, etc. Functional expenses are classified 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 expenses. They want to know the costs of providing the organization's program services and the relationship of program expenses to supporting expenses. Expenses are required to be reported by their functional classification either on the face of the statement of activities or in the notes to the financial statements. In addition, FASB ASC 958-720-45-5 (formerly 2008 Audit Guide, Paragraph 13.31) 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 (formerly 2008 Audit Guide, Paragraph 13.31) 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 (formerly SFAS No. 154, *Accounting Changes and Error Corrections*) 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) (formerly 2008 Audit Guide, Paragraph 13.34).
- 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) (formerly SFAS No. 136).

FASB ASC 958-720 (formerly SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*) 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 (formerly 2008 Audit Guide, Paragraph 6.20) 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 (formerly 2008 Audit Guide, Paragraph 6.20) 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.

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

**Fair Value Disclosure Considerations.** FASB ASC 820-10 (formerly SFAS No. 157, *Fair Value Measurements*) expands the required disclosures about fair value measurements. Additional disclosures are also required if a nonprofit organization elects the *fair value option* available under FASB ASC 825-10 (formerly SFAS No. 159). Both statements encourage entities to present the required disclosures in combination with other fair value disclosures. The disclosure requirements are discussed later in this lesson. Also, organizations with split-interest liabilities that contain embedded derivatives may elect the fair value option under FASB ASC 815-15-25 (formerly SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments*).

**SELF-STUDY QUIZ**

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

7. The Brinkman-Kinch Foundation, a nonprofit organization, owns a variety of investments. In the notes to its financial statements, the foundation discloses the carrying amounts for each of its major types of investments. Is the foundation required to disclose anything else related to carrying amounts?
  - a. The foundation must disclose the basis it uses to determine the carrying value for investments not required to be carried at fair value.
  - b. The foundation must disclose all the components of its investment return, such as investment income.
  - c. The foundation must disclose additional quantitative and qualitative information for all investments in equity securities.
  - d. The foundation must disclose all methods and assumptions used to estimate the fair value of all investments.
8. The Brinkman-Kinch foundation incurs investment management fees on its investments. How are its financial statements affected?
  - a. The total amount of investment income before such fees are assessed must be reported.
  - b. The amount of such fees should be disclosed in the statements or the notes.
  - c. Quantitative information aggregated by category of investment must be presented in tabular form.
  - d. A reconciliation that shows how the investment return is reported in the statement of activities is required.
9. The Brinkman-Kinch Foundation has concentrations of risk. What disclosure is the foundation required to make under FASB ASC 825-10?
  - a. The disclosure of any significant concentrations of credit risk that come from financial instruments.
  - b. The disclosure of quantitative information about market risks that come from financial instruments.
  - c. The disclosure of information about investments, such as the nature and carrying amount of investments, for the most recent statement of financial position.
  - d. The disclosure of fair value information.
10. Extend a Paw, a nonprofit animal rescue organization, owns various property and equipment. Which of the following disclosures is required by this organization because it is a nonprofit organization?
  - a. Disclosure of immaterial amounts presented in an "Other" caption.
  - b. Disclosure of depreciation expense.
  - c. Disclosure of the balances of major classes of depreciable assets by function or nature at the statement of financial position date.
  - d. Disclosure of the organization's policy related to the implying of time restrictions on long-lived assets given as gifts.

11. Extend a Paw also has access to use certain equipment without owning or leasing it. What disclosure should be made in the financial statements in regards to this arrangement?
  - a. Disclosure of any capitalized interest related to the equipment.
  - b. Disclosure of any liens to which this equipment is subject.
  - c. Disclosure of the organization's relationship with the equipment owner.
  - d. Disclosure of any leasehold improvements that were made to the equipment.
12. Which of the following nonprofit organizations would be required to make disclosures related to trade receivables and other financing activities?
  - a. The Red Organization only grants unsecured credit during the course of its activities.
  - b. The Blue Organization's balance of trade receivables is immaterial as of the statement of financial position date.
  - c. The Green Organization's interest income on trade receivables is immaterial to the changes in net assets.
  - d. The Yellow Organization has charged off uncollectible amounts related to trade receivables during the past year.
13. The Clothes Closet, a nonprofit organization, receives significant amounts of donated materials that it uses in its programs to help families in need. How would the disclosures in the organization's financial statement notes be affected?
  - a. Donations of such materials would not affect the financial statement notes.
  - b. The activities and programs in which the donations were used should be disclosed.
  - c. The fair value of the donations should be disclosed.
  - d. The donated assets should be described in the notes to the financial statements.
14. Clean Water United (CWU), a nonprofit organization, must determine whether to classify expenses in its financial statements as natural or functional. This decision can affect CWU's financial statement disclosures, including disclosures about fund-raising activities. Which of the following should be considered when making this decision?
  - a. To use functional classification, CWU will break down expenses under labels like salaries and employee benefits, supplies, and travel.
  - b. Contributors, governing boards, and other groups will be more interested in seeing CWU's expenses broken down using natural classification.
  - c. No matter which classification method is chosen, CWU must disclose the total cost of all fund-raising activities.
  - d. CWU is required to disclose the amount of joint costs for each joint activity.

## 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.)

7. The Brinkman-Kinch Foundation, a nonprofit organization, owns a variety of investments. In the notes to its financial statements, the foundation discloses the carrying amounts for each of its major types of investments. Is the foundation required to disclose anything else related to carrying amounts? **(Page 134)**
  - a. **The foundation must disclose the basis it uses to determine the carrying value for investments not required to be carried at fair value. [This answer is correct. FASB ASC 958-320 and 958-205 provides guidance to nonprofit organizations regarding disclosures related to carrying amounts. In addition to the disclosures described in this scenario, the foundation is also required to disclose the basis used to determine the carrying value for other investments not required by the authoritative guidance to be carried at fair value.]**
  - b. The foundation must disclose all the components of its investment return, such as investment income. [This answer is incorrect. This is a required disclosure under FASB ASC 958-320 and 958-205, but it is a disclosure related to realized and unrealized gains and losses on investments, not a disclosure related to carrying amounts.]
  - c. The foundation must disclose additional quantitative and qualitative information for all investments in equity securities. [This answer is incorrect. Under FASB ASC 958-320 and 958-205, the foundation is required to disclose additional qualitative and quantitative information for investments in equity securities accounted for using the cost method as allowed by the Audit Guide. This disclosure is not needed for all equity securities.]
  - d. The foundation must disclose all methods and assumptions used to estimate the fair value of all investments. [This answer is incorrect. Under FASB ASC 958-320 and 958-205, if the foundation carries investments other than financial instruments at fair value, the methods and assumptions used to estimate fair value should be disclosed. This disclosure would not be needed for all investments.]
8. The Brinkman-Kinch foundation incurs investment management fees on its investments. How are its financial statements affected? **(Page 134)**
  - a. The total amount of investment income before such fees are assessed must be reported. [This answer is incorrect. GAAP allows organizations to report investment income net of related expenses, such as investment management or custodial fees.]
  - b. **The amount of such fees should be disclosed in the statements or the notes. [This answer is correct. According to GAAP, the amount of expenses such as investment management or custodial fees must be disclosed either on the face of the statement of activities or in the notes to the financial statements.]**
  - c. Quantitative information aggregated by category of investment must be presented in tabular form. [This answer is incorrect. If a loss has not been recognized for impaired investments in equity securities accounted for using the cost method, FASB ASC 958-320 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 position for 12 months are longer. However, this information would not need to be disclosed related to investment management fees.]
  - d. A reconciliation that shows how the investment return is reported in the statement of activities is required. [This answer is incorrect. 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. However, this is not required because an organization has investment management fees.]

9. The Brinkman-Kinch Foundation has concentrations of risk. What disclosure is the foundation required to make under FASB ASC 825-10? **(Page 134)**
- a. **The disclosure of any significant concentrations of credit risk that come from financial instruments. [This answer is correct. FASB ASC 825-10 (formerly SFAS No. 107) requires the foundation to make this disclosure under these circumstances.]**
  - b. The disclosure of quantitative information about market risks that come from financial instruments. [This answer is incorrect. This disclosure is encouraged by FASB ASC 825-10, but it is not required, so the foundation does not have to make the disclosure.]
  - c. The disclosure of information about investments, such as the nature and carrying amount of investments, for the most recent statement of financial position. [This answer is incorrect. This disclosure is required by FASB ASC 958-320, not FASB ASC 825-10. However, if applicable, the foundation should make this disclosure to comply with authoritative guidance.]
  - d. The disclosure of fair value information. [This answer is incorrect. Fair value disclosure considerations are separate from disclosures required for concentrations of credit risk, so, while the foundation might need to make fair value disclosures, it would not be because of the situation described above.]
10. Extend a Paw, a nonprofit animal rescue organization, owns various property and equipment. Which of the following disclosures is required by this organization because it is a nonprofit organization? **(Page 137)**
- a. Disclosure of immaterial amounts presented in an "Other" caption. [This answer is incorrect. This is not a disclosure requirement found in authoritative literature for any type of organization or entity. This is a best practice that a nonprofit can use to develop its disclosure for major classes of property and equipment.]
  - b. Disclosure of depreciation expense. [This answer is incorrect. This is a general disclosure requirement about property and equipment that is required by FASB ASC 360-10-50-1. It is not specific to nonprofit organizations.]
  - c. Disclosure of the balances of major classes of depreciable assets by function or nature at the statement of financial position date. [This answer is incorrect. Under FASB ASC 360-10-50-1, this is a general disclosure requirement related to property and equipment. It is not specific to a nonprofit organization.]
  - d. **Disclosure of the organization's policy related to the implying of time restrictions on long-lived assets given as gifts. [This answer is correct. In addition to the general disclosure requirements related to property and equipment, FASB ASC 958 includes disclosure requirements that are specific to nonprofit organizations. 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.]**
11. Extend a Paw also has access to use certain equipment without owning or leasing it. What disclosure should be made in the financial statements in regards to this arrangement? **(Page 137)**
- a. Disclosure of any capitalized interest related to the equipment. [This answer is incorrect. Under FASB ASC 958-360-50-2, organizations must separately disclose components of property and equipment on the statement of financial position or in the notes to the financial statements. One of the components that must be disclosed is capitalized interest. However, this disclosure is not related to the scenario described above.]
  - b. Disclosure of any liens to which this equipment is subject. [This answer is incorrect. Under FASB 958-360-50-3, certain information about the liquidity of property and equipment must be disclosed, including any limitations on the organization's use of the property and equipment, such as if property and equipment are pledged as collateral or subject to a lien. However, that disclosure does not relate to property an organization has access to without owning or leasing it.]
  - c. **Disclosure of the organization's relationship with the equipment owner. [This answer is correct. If the nonprofit organization has access to property and equipment without owning or leasing it, the**

**financial statements should disclose the nature of the relationship with the owner of the property or equipment as required by the Audit Guide, Paragraph 9.16. Also, FASB ASC 958-360-50-4 notes that the nonprofit organization should disclose the amount of property and equipment used in operations but not recorded on the statement of financial position because the title is held by grantors, and the terms of such grantor agreements.]**

- d. Disclosure of any leasehold improvements that were made to the equipment. [This answer is incorrect. Certain components of property and equipment must be separately disclosed on the statement of financial position or in the notes to the financial statement for an organization to be in compliance with FASB ASC 958-360-50-2. One such component is leasehold improvements. However, this disclosure does not relate to the scenario described in this question.]
12. Which of the following nonprofit organizations would be required to make disclosures related to trade receivables and other financing activities? **(Page 139)**
- a. The Red Organization only grants unsecured credit during the course of its activities. [This answer is incorrect. Many disclosures related to trade receivables and other financing activities that are required by authoritative pronouncements generally will not be applicable to nonprofit organizations. One reason for this is if the nonprofit organization does not engage in the types of transactions underlying the disclosure requirement. If an organization only grants unsecured credit, it will not have any foreclosed or repossessed assets to disclose.]
- b. The Blue Organization's balance of trade receivables is immaterial as of the statement of financial position date. [This answer is incorrect. It is possible for the disclosures related to trade receivables and other financing activities not to apply to nonprofit organizations. One example of circumstances that this would occur is if the type of transaction related to the required disclosure is not material to the organization's financial statements.]
- c. The Green Organization's interest income on trade receivables is immaterial to the changes in net assets. [This answer is incorrect. If this is the case, the related accounting policies would not be material to the financial statements, and the organization would not be required to disclose them.]
- d. The Yellow Organization has charged off uncollectible amounts related to trade receivables during the past year. [This answer is correct. FASB ASC 310-50-50 and 860-20-50 require organizations to report receivable balances on the statement of financial position less an allowance for uncollectibles. The required disclosures generally fall into several categories, one of which is disclosing accounting policies for nonaccrual and past-due trade receivables, such as the policies for placing receivables on nonaccrual status, recording payments received on nonaccrual loans, charging off uncollectible amounts, and determining past-due or delinquency status.]**
13. The Clothes Closet, a nonprofit organization, receives significant amounts of donated materials that it uses in its programs to help families in need. How would the disclosures in the organization's financial statement notes be affected? **(Page 142)**
- a. Donations of such materials would not affect the financial statement notes. [This answer is correct. There are no special disclosure requirements related to donated materials; therefore, the Clothes Closet would not have to make special disclosures in the notes to its financial statements.]**
- b. The activities and programs in which the donations were used should be disclosed. [This answer is incorrect. This disclosure would be necessary if the Clothes Closet received donations of services. It is not needed for donations of materials.]
- c. The fair value of the donations should be disclosed. [This answer is incorrect. If the Clothes Closet received donated services that were not recognized as revenues in the financial statements, it should disclose the fair value of those services (if it is practical). However, this disclosure requirement does not apply to donated materials.]

- d. The donated assets should be described in the notes to the financial statements. [This answer is incorrect. If the Clothes Closet has an unconditional promise to give the use of long-lived assets, the caption in the financial statements can be descriptive of the asset whose use is contributed instead of identifying it as a receivable. However, this disclosure does not apply to donated materials.]
14. Clean Water United (CWU), a nonprofit organization, must determine whether to classify expenses in its financial statements as natural or functional. This decision can affect CWU's financial statement disclosures, including disclosures about fund-raising activities. Which of the following should be considered when making this decision? **(Page 145)**
- a. To use functional classification, CWU will break down expenses under labels like salaries and employee benefits, supplies, and travel. [This answer is incorrect. Expenses are broken down this way when the natural, or object, classification method is used. If the functional classification method is used, CWU would classify expenses according to the purpose for which they are incurred (i.e., expenses for program services and supporting services).]
- b. Contributors, governing boards, and other groups will be more interested in seeing CWU's expenses broken down using natural classification. [This answer is incorrect. Contributors, funding sources, governing boards, and regulatory groups are usually more interested in functional expenses than they are in natural expenses. They want to know the costs of providing the organization's program services and the relationship of the program expenses to supporting expenses. Expenses are required to be reported by their functional classification on the face of the financial statements.]
- c. No matter which classification method is chosen, CWU must disclose the total cost of all fund-raising activities. [This answer is correct. 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. FASB ASC 958-720-50-1 requires disclosure of the total cost of all fund-raising activities, whether expenses are classified using functional classification or natural classification.]**
- d. CWU is required to disclose the amount of joint costs for each joint activity. [This answer is incorrect. FASB ASC 958-720 requires certain disclosures related to fund-raising, such as the types of activities for which joint costs have been incurred and a statement that joint costs have been allocated. GAAP encourages, but does not require, the disclosure of the amount of joint costs for each joint activity.]

## 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. FASB ASC 850-10-50-1 (formerly SFAS No. 57, *Related Party Disclosures*) requires the following disclosures for material related party transactions:

- a. The nature of the relationship involved.
- b. A description of the transactions, including those to which no amounts or nominal amounts were ascribed, for each of the periods for which statements of activities are presented, and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements.
- c. The dollar amounts of transactions for each of the periods for which statements of activities are presented 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 as of the date of each statement of financial position presented and, if not otherwise apparent, the terms and manner of settlement.

FASB 850-10-50-6 (formerly SFAS No. 57) 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 (formerly FASB Interpretation No. 45) for guarantees discussed later in this lesson.

**Typical Related Party Transactions.** The most common related party disclosures for nonprofit organizations include material transactions with the following:

- a. Members of the organization's management and governing board (e.g., board of directors or trustees, president, executive director, etc.) and their immediate families.
- b. Significant contributors, if they can significantly influence the management or operating policies of the organization by the restrictions on their contributions or otherwise to an extent that the organization is prevented from pursuing its own interests. A nonprofit organization may be economically dependent on significant contributors; however, such parties are not considered related parties solely because of the organization's economic dependency on them. Thus, a significant contributor of unrestricted resources might not be considered a related party, whereas a significant contributor of restricted resources might be considered a related party if the restrictions in effect constituted significant influence on management or operating policies.
- c. A separate entity to which the organization transfers some of its resources, whose assets are held for the organization's benefit, if control exists.

- d. A separate entity whose funding is primarily derived from sources other than public contributions that is controlled by the organization and to which the organization assigns functions.
- e. Trusts for the benefit of employees, such as pension trusts that are managed by or under the trusteeship of management or the governing board, and affiliated or financially interrelated organizations.
- f. Brother-sister organizations and certain national and local affiliates.
- g. Entities for which investments are accounted for by the equity method by the organization.

Salaries, expense allowances, and other compensation arrangements are explicitly excluded from related party disclosure requirements.

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 lease arrangement?

**Nature of Relationship.** Disclosure of the relationship and amounts often may be conveniently provided through captions in the statement of financial position. "Nature of the relationship" can be interpreted to mean position rather than an individual's name. Accordingly, captions usually may simply refer to "officers" or "affiliates." However, GAAP 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, best practices indicate that the settlement terms of notes should be disclosed to conform with GAAP and that the disclosure normally may be provided most efficiently 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. 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 generally would be sufficient.

### **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 (formerly Appendix D of SFAS No. 87, *Employers' Accounting for Pensions*) 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 under the provisions of FASB ASC 715 (formerly SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*). Postretirement benefits include health care benefits (such as dental, hearing, and vision coverage) and life insurance benefits provided to retirees, their dependents, or survivors.

**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.

**Required Disclosures.** Disclosure requirements for pension plans, postretirement benefits, and postemployment benefits are relatively complex. FASB ASC 715-20 [formerly SFAS No. 132(R)] includes disclosure requirements for pensions and other postretirement 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.

In December 2008, the FASB revised the disclosure requirements for nonpublic entities included in FASB ASC 715-20-50-5 [formerly Paragraph 8 of SFAS No. 132(R)]. The revisions require (a) additional disclosures about the plan assets of defined benefit pension or other postretirement plans and (b) disclosure of the amount of net periodic benefit cost recognized. The requirement to disclose the amount of the net periodic benefit cost was effective on December 30, 2008. The additional disclosures about plan assets are required for fiscal years ending after December 15, 2009, with earlier application permitted.

For fiscal years ending after December 15, 2008, entities are required to measure plan assets and benefit obligations as of the date of their fiscal year-end statement of financial position, with certain exceptions. Entities had previously been permitted to use either the date of the financial statements or a date not more than three months prior to that date, if used consistently from year to year. If an entity changes its measurement date to comply with the new requirement, in the year of the revision it must disclose the effect on unrestricted net assets from applying the requirement.

**General Disclosure Requirements.** 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.

**Required Disclosures for Defined Contribution Plans.** FASB ASC 715-70-50-1 [formerly SFAS No. 132(R)] 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 could be useful if employers provide it in their general plan descriptions.

## 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. Grants recorded as promises to give to others were discussed previously in this lesson.

In addition to the required disclosures for commitments, FASB ASC 840 (formerly SFAS No. 13) 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.

FASB ASC 958-450-50-2 and 50-3 (formerly 2008 Audit Guide, Paragraphs 3.50 and 10.14) specifically note that contingencies related to noncompliance with donor restrictions should be disclosed, including the amounts and circumstances if the noncompliance is the result of the organization's failure to maintain adequate funds to comply

with donor restrictions. The Audit Guide, Paragraph 2.28, notes that if there has been an allegation or determination of illegality and it is reasonably possible that fines, penalties, or damages will be imposed, disclosure of a contingent liability in accordance with FASB ASC 450 (formerly SFAS No. 5) may be necessary.

Under FASB ASC 450 (formerly SFAS No. 5, *Accounting for Contingencies*), 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. FASB ASC 450 (formerly SFAS No. 5) 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—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, in a Technical Practice Aid (TIS 3200.17) the AICPA states that 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 860-30-50-1 (formerly SFAS No. 5, *Accounting for Contingencies*) requires disclosure of a nonprofit organization's assets that are pledged as collateral for loans.
- FASB ASC 850-10-05-4 (formerly SFAS No. 57, *Related Party Disclosures*) includes guarantees in its definition of related party transactions requiring disclosure.
- FASB ASC 310-10-50-5 and 860-30-50-1 (formerly 2008 Audit Guide, Paragraph 5.78) require disclosure of contributions receivable pledged as collateral or limited in their use.

The following paragraphs provide best practices for dealing with 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 can 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.

However, GAAP does require 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. 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 could be considered 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. 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, terms such as "secured" and "unsecured" can be used. 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 (formerly FIN 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others") 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 (formerly SFAS No. 5).
- 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

If a nonprofit organization's ability to continue as a going concern is in doubt, SAS No. 59 (AU 341) specifies that it may be necessary to disclose the principal conditions that raise a question about continued existence and related matters. Common questions in disclosing such information concern when it is really necessary and how to word the information.

SAS No. 59 (AU 341) notes that uncertainty about an organization's ability to continue as a going concern relates to its inability to continue to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of its activities, restructuring of debt, externally forced revisions of its activities, or similar actions. The accountants' evaluation of a nonprofit organization's ability to continue as a going concern is not merely a matter of evaluating the recoverability, classifications, and amounts of recorded assets and liabilities. SAS No. 59 requires auditors to modify their report if they have substantial doubt about an entity's ability to continue as a going concern, even if recoverability of assets or classification of liabilities is not in question. Some readers interpret the going concern disclosures as predicting doom. In fact, many view them as causing an organization to fail. Accordingly, the decision to disclose such information should not be taken lightly. Normally the disclosure is

not provided unless there are serious concerns about the viability of the organization. If disclosure is necessary, the following can be considered:

- a. The disclosure should include all relevant factors, such as:
  - (1) Pertinent conditions and events giving rise to the assessment of the organization's ability to continue as a going concern, even if the information is apparent from the financial statements.
  - (2) The possible effects of such conditions and events.
  - (3) Management's evaluation of the significance of the conditions and events and any mitigating factors.
  - (4) Management's plans, including disclosure of possible discontinuance of activities.
  - (5) Information about the recoverability or classification of recorded assets or the amounts or classifications of liabilities.
- b. The wording should be neutral and should not be unduly pessimistic or optimistic.
- c. If there are no mitigating factors or management has no specific plans to overcome the conditions, the note should not disclose their absence.

**Proposed New Guidance related to Going Concern.** The FASB currently has a going concern project on its agenda. The objective of the project is to include in the FASB authoritative literature guidance related to going concern issues, including (a) preparing financial statements as a going concern and the responsibility of an entity to evaluate its ability to continue as a going concern and (b) required disclosures when financial statements are not prepared on a going concern basis and when there is substantial doubt about the entity's ability to continue as a going concern. In October 2008, the FASB issued an exposure draft of a proposed standard, *Going Concern*. After the comment period on the proposed Standard ended, the FASB decided to broaden the scope of the project to (a) enhance disclosures of short-term and long-term risks, specifically risks for which there is a more-than-remote likelihood of occurrence; (b) define *substantial doubt* in terms of an entity's ability to continue as a going concern; and (c) define when it is appropriate for an entity to apply the liquidation basis of accounting. The FASB is also addressing the time frame for the disclosures of short-term and long-term risks and for the assessment of an entity's ability to continue as a going concern. The FASB plans to make clear that this time frame is neither a bright-line 12 months nor an indefinite look-forward period. The proposed effective date of this revised guidance is not yet known, but accountants should be alert in case the FASB applies a short effective date. The FASB intends to issue the final standard in 2010.

### Contingencies—Lawsuits

If there are material lawsuits against the nonprofit organization, FASB ASC 450-20-50-4 (formerly SFAS No. 5) requires disclosure of the following information unless the possibility of the loss is remote: (As noted previously, 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 possible loss or range of loss or a statement 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 (formerly SFAS No. 5)] because the accounting standards for accrual and disclosure are based on those terms.

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 (formerly SOP 96-1, *Environmental Remediation Liabilities*) provides guidance for disclosing environmental remediation liabilities and contingencies. The following paragraphs explain the SOP's 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 (formerly SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*) also apply to environmental remediation liabilities. In addition, FASB ASC 450-20 (formerly SFAS No. 5, *Accounting for Contingencies*), provides the primary guidance relevant to disclosures of environmental remediation loss contingencies.

**Disclosure of Accounting Policies.** FASB ASC 410-30-50-4 (formerly SOP 96-1) 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 (formerly SOP 94-6) for certain significant estimates are met. (See Lesson 3 for the criteria.)

**Unaccrued Contingencies.** For reasonably possible loss contingencies (including reasonably possible losses in excess of accrued amounts), the following disclosures should be made:

- a. A description of the contingency and an estimate of the possible loss (or the fact that such an estimate cannot be made).
- 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 (formerly SOP 94-6) are met. (See Lesson 3.)

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 (formerly SOP 96-1), 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.** 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. (See Lesson 3.)
- 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

With the increasing emphasis on fair value measurements in generally accepted accounting principles, the FASB issued FASB ASC 820 (formerly SFAS No. 157, *Fair Value Measurements*) in September 2006. That guidance provides a common definition of fair value, establishes a framework to measure fair value within GAAP, and increases the disclosures about fair value measurements. It generally applies under other accounting pronouncements that require or permit fair value measurements; it does not require any new fair value measurements. FASB ASC 820 (formerly SFAS No. 157) also applies to determining the fair value information that must be disclosed, such as the disclosure of fair value information for financial instruments required by FASB ASC 825 (formerly SFAS No. 107, *Disclosures about Fair Value of 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.

When originally issued, FASB ASC 820 (formerly SFAS No. 157) was to be effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years, with early adoption encouraged. In February 2008, the FASB deferred the effective date to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years, for nonfinancial assets and nonfinancial liabilities other than items that are recognized or disclosed at fair value in the financial statements on a recurring (at least annual) basis. The deferral does not apply to entities that have issued interim or annual financial statements in which the measurement and disclosure provisions of FASB ASC 820 (formerly SFAS No. 157) have been applied. Specific disclosures are required until the guidance is fully applied.

*PPC's Guide to Preparing Nonprofit Financial Statements* discusses applying the guidance about fair value measurements. This discussion describes the disclosures about fair value measurements that are required by FASB ASC 820-10 (formerly SFAS No. 157).

The guidance in FASB ASC 820-10 (formerly SFAS No. 157) expands the fair value information that must be disclosed in the notes to the financial statements. Those disclosures 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. As an example, the FASB ASC 820-10 (formerly SFAS No. 157) disclosures are required in addition to the disclosures about fair value measurements required by FASB ASC 825-10 (formerly SFAS No. 107, *Disclosures about Fair Value of Financial Instruments*). GAAP encourages combining the fair value disclosures required by FASB ASC 820-10 (formerly SFAS No. 157) with fair value disclosures required by other accounting pronouncements. Organizations are also encouraged to disclose information about measurements similar to fair value, such as inventories measured at market value under FASB ASC 330 (formerly ARB 43, Ch. 4, *Inventory Pricing*).

**Disclosures before Accounting Standards Update 2010-06.** For assets and liabilities measured at fair value on a recurring basis, organizations should disclose information that allows financial statement users to assess (a) the inputs used to develop such measurements and (b) the effect on changes in net assets of recurring measurements that use significant unobservable (Level 3) inputs. The following information should be disclosed for recurring measurements for each interim and annual period (unless otherwise specified) separately for each major category of assets and liabilities, with quantitative disclosures presented in tabular format:

- a. The fair value measurements and the level within the fair value hierarchy in which the fair value measurements fall, segregating fair value measurements using Level 1 inputs, Level 2 inputs, and Level 3 inputs.

- b. For fair value measurements using Level 3 inputs, a reconciliation of the beginning and ending balances, separately presenting changes attributable to the following (disclosures for derivative assets and liabilities may be presented net):
  - (1) Total gains or losses for the period (realized and unrealized), segregating those gains or losses included in changes in net assets and a description of where such gains or losses are reported in the statement of activities,
  - (2) Purchases, sales, issuances, and settlements (net), and
  - (3) Transfers in or out of Level 3 (for example, transfers due to changes in the observability of significant inputs).
- c. Total gains or losses for the period in (b)(1) included in changes in net assets due to the change in unrealized gains or losses that relate to assets and liabilities held at the reporting date and a description of where such unrealized gains or losses are reported in the statement of activities.
- d. The valuation technique used in measuring fair value and a discussion of any changes in valuation techniques during the period.

For assets and liabilities measured at fair value on a nonrecurring basis subsequent to initial recognition, information should be disclosed to allow financial statement users to assess the inputs used to develop such measurements. The following information should be disclosed for nonrecurring measurements for each interim and annual period (unless otherwise specified) separately for each major category of assets and liabilities, with quantitative disclosures presented in tabular format:

- a. Fair value measurements recorded during the period and the reasons for such measurements.
- b. The level within the fair value hierarchy in which the fair value measurements fall, segregating fair value measurements using Level 1 inputs, Level 2 inputs, and Level 3 inputs.
- c. For fair value measurements using Level 3 inputs, a description of those inputs and the information used to develop the inputs.
- d. The valuation technique used in measuring fair value and a discussion of any changes in the valuation technique used to measure similar assets or liabilities in prior periods.

**Accounting Standards Update 2010-06.** Accounting Standards Update (ASU) 2010-06, *Fair Value Measurements and Disclosures: Improving Disclosures about Fair Value Measurements*, requires some new disclosures and clarifies some existing disclosure requirements about fair value measurement as set forth in FASB ASC 820-10. ASU 2010-06, which was codified primarily in FASB ASC 820-10-50, requires separate disclosures of significant transfers in and out of Levels 1 and 2 and the reasons for the transfers, and separate disclosure of the activity in Level 3 fair value measurements (for example, purchases, sales, issuances, and settlements rather than a net number). Additionally, disclosures are required to include details about the valuation techniques and inputs used to measure fair value for Level 2 and 3 measurements.

ASU 2010-06 also clarifies that the fair value measurement disclosures should be for each *class* of asset and liability. For equity and debt securities, ASU 2010-06 notes that the class of asset and liability should be determined on the basis of the nature and risks of the investments in a manner consistent with the guidance in FASB ASC 320-10-50-1B, as discussed in the following paragraph. Additionally, if applicable, accountants should look at the guidance on major security type as described in FASB ASC 942-320-50-2, even if the equity securities or debt securities are not within the scope of paragraph FASB ASC 320-10-50-1B. For all other assets and liabilities, determining the appropriate classes will require judgment.

FASB ASC 320-10-50-1B notes that major security types should be based on the nature and risks of the security. In determining each class of asset (i.e., whether to provide additional detail for a particular security), an organization should consider:

- (Shared) activity or business sector.
- Vintage.
- Geographic concentration.
- Credit quality.
- Economic characteristic.

FASB ASC 942-320-50-2 provides the following guidance on major security types for financial institutions:

- Equity securities.
- Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies.
- Debt securities issued by states of the United States and political subdivisions of the states.
- Debt securities issued by foreign governments.
- Corporate debt securities.
- Mortgage-backed securities.
- Other debt securities.

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).

**Disclosures after Accounting Standards Update 2010-06.** For assets and liabilities measured at fair value on a recurring basis, organizations should disclose information that allows financial statement users to assess (a) the valuation techniques and inputs used to develop such measurements and (b) the effect on changes in net assets of recurring measurements that use significant unobservable (Level 3) inputs. The following information should be disclosed for recurring measurements for each interim and annual period (unless otherwise specified) separately for each major class of assets and liabilities, with quantitative disclosures presented in tabular format:

- a. The fair value measurements and the level within the fair value hierarchy in which the fair value measurements fall, segregating fair value measurements using Level 1 inputs, Level 2 inputs, and Level 3 inputs.
- b. The amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements, the reasons for the transfers, and the policies for determining the timing of when transfers between levels are recognized. Significant transfers into each level shall be disclosed separately from transfers out of each level.
- c. For fair value measurements using Level 3 inputs, a reconciliation of the beginning and ending balances, separately presenting changes attributable to the following (disclosures for derivative assets and liabilities may be presented either gross or net):
  - (1) Total gains or losses for the period (realized and unrealized), separately presenting gains or losses included in changes in net assets and a description of where such gains or losses are reported in the statement of activities,

- (2) Purchases, sales, issuances, and settlements (disclosed separately), and
  - (3) Transfers in or out of Level 3 (for example, transfers due to changes in the observability of significant inputs) and the policies for determining the timing of when transfers between levels are recognized. Significant transfers into Level 3 shall be disclosed separately from significant transfers out of Level 3.
- d. Total gains or losses for the period in (b)(1) included in changes in net assets due to the change in unrealized gains or losses that relate to assets and liabilities held at the reporting date and a description of where such unrealized gains or losses are reported in the statement of activities.
  - e. The valuation technique(s) used in measuring fair value for Level 2 and Level 3 measurements and a discussion of any changes in valuation techniques during the period.

For assets and liabilities measured at fair value on a nonrecurring basis subsequent to initial recognition, information should be disclosed to allow financial statement users to assess the valuation techniques and inputs used to develop such measurements. The following information should be disclosed for nonrecurring measurements for each interim and annual period (unless otherwise specified) separately for each major class of assets and liabilities, with quantitative disclosures presented in tabular format:

- a. Fair value measurements recorded during the period and the reasons for such measurements.
- b. The level within the fair value hierarchy in which the fair value measurements fall, segregating fair value measurements using Level 1 inputs, Level 2 inputs, and Level 3 inputs.
- c. For fair value measurements using Level 2 or Level 3 inputs, the valuation technique used in measuring fair value and a discussion of any changes in the valuation technique used to measure similar assets or liabilities in prior periods.

### Fair Value Option

FASB ASC 825-10 (formerly SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*) 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 820-10 (formerly SFAS No. 157).

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 (formerly SFAS No. 159) in combination with other fair value disclosures required by other pronouncements. FASB ASC 825-10-55-13 (formerly Appendix B of SFAS No. 159) provides illustrative fair value disclosures that include selected required disclosures.

The FASB ASC 825-10 (formerly SFAS No. 159) disclosures 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 (formerly SFAS No. 165, *Subsequent Events*) includes accounting and disclosure standards on subsequent events that formerly resided in auditing standards. The new guidance does not apply to subsequent

events specifically addressed in other applicable GAAP, including FASB ASC 740-10-55 (formerly FIN 48, "Accounting for Uncertainty in Income Taxes") or FASB ASC 450-20-50 and 20-55 (formerly SFAS No. 5, *Accounting for Contingencies*). The new guidance is effective for interim or annual financial periods ending after June 15, 2009, and should be applied prospectively.

GAAP 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 and that affect the estimates inherent in preparing the financial statements. The proper accounting treatment for those events is *adjustment* of the financial statements. In other words, new information available after the date of the statement of financial position affects the estimates that were used in preparing the financial statements, and that information is considered in adjusting the financial statements at that date. For example, a litigation accrual would be adjusted to 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 issued or 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 this category that requires the financial statements to be adjusted. 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 ongoing and 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 issued or 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 in the next paragraph.

**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 but arose after that date but before the financial statements are issued or 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. The proper accounting treatment for those events is disclosure in the financial statements of 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 (formerly Paragraph 12 of SFAS No. 165) 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.

According to FASB ASC 855-10-20 (formerly SFAS No. 165, Paragraphs 5 and 6), 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.

### **Related Entities**

Under FASB ASC 958-810 (formerly SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*), certain disclosures are required regarding investments in 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 (formerly SFAS No. 57, *Related Party Disclosures*).
- 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 (formerly SFAS No. 57). 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 (formerly SOP 94-3).
- 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.

**SELF-STUDY QUIZ**

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

15. Go Green, a nonprofit organization, must determine if it has any related parties and if it is required to disclose any related party transactions. Disclosure of which of the following would be required?
  - a. Expense allowances, salaries, and other compensation arrangements.
  - b. A description of all material related party transactions.
  - c. A statement that the related party transaction was made at arm's length.
  - d. Amounts due to or from related parties as of the date of the statement of financial position.
16. Define the term *postemployment benefits*.
  - a. Periodic payments that are made to a person who has retired from employment or to that person's beneficiary pursuant to the terms of a pension plan.
  - b. Health care and life insurance benefits provided to retirees, their dependents, and/or their survivors.
  - c. Benefits that are paid to former or inactive employees, their beneficiaries, and their covered dependents after the employees' employment but before their retirement.
17. Which of the following would the Rainy Day Foundation, a nonprofit organization, be required to disclose about its pension plan?
  - a. Investment strategies of the pension plan.
  - b. The amount of gross periodic benefit cost recognized.
  - c. The value of plan assets and benefit obligations three months prior to the date of the financial statements.
  - d. The benefit payments expected from the pension plan for the next five fiscal years.
18. The Rainy Day Foundation is scheduled to make grant payments to others over future periods. The payments would be accounted for as exchange transactions. What is the correct term for this type of arrangement?
  - a. Commitment.
  - b. Contingency.
19. The Learning Center, a nonprofit organization, has a debtor loan agreement that includes a restrictive covenant. The center violates the covenant; however, it obtains an unconditional waiver from its lender in which the lender waives the right to demand payment for two years. Is disclosure of this event required?
  - a. Yes.
  - b. No.
20. Horse Sense, a nonprofit organization that does horse therapy with disabled children, has a collateral arrangement with their bank secured by daily receipts. The organization maintains an account at the bank and the participants in the program send their payments directly to the account at the bank. Does this arrangement need to be disclosed in the financial statements?
  - a. Yes.
  - b. No.

21. In which of the following scenarios, has a disclosure issue related to a nonprofit organization been dealt with correctly?
- a. Gracie, auditor of the Echo Organization, has substantial doubt about the organization's ability to continue as a going concern. In her disclosure, Gracie uses pessimistic language to emphasize how dire the organization's situation is.
  - b. The Foxtrot Organization is facing a material lawsuit. Possibility of loss of the lawsuit is greater than remote. The organization optimistically includes a statement in its disclosure that the contingency is not expected to be material because it expects to win the case.
  - c. The Sierra Organization is facing environmental remediation costs. It discloses whether the liabilities for these costs were measured on a discounted basis. It also discloses the circumstances that would trigger the liability and the organization's policy for recognizing recoveries.
  - d. The Tango Organization has assets and liabilities that are measured at fair value on a recurring basis. As part of its fair value disclosures, the organization provides a reconciliation of the beginning and ending balances for fair value measurements related to Level 2 inputs.
22. The Dynamo Group, a nonprofit organization, elects the fair value option to account for some of its financial assets and liabilities. Which of the following options can the organization use to present the affected assets and liabilities in its financial statements?
- a. It can present them combined with non-fair-value amounts in the same line item. No further information is needed.
  - b. It can present the fair value amounts in a separate line item from the non-fair-value amounts.
  - c. It can present information about the affected assets using the historical cost model.
23. Which of the following nonprofit organizations has experienced a Type I subsequent event? Assume that all the events occurred between the date of the statement of financial position and the date the financial statements were issued.
- a. Recycle More is uncertain about a previously recorded promise to give.
  - b. Pet Rescue incurs a material debt.
  - c. Blanket Donation loses grant funding.
  - d. Carbon Footprint loses its tax-exempt status due to a condition occurring after the financial statement date.
24. The Alston Foundation, a nonprofit organization, has an investment of 45% in the Newton Fund, a nonprofit foundation. This represents an economic interest in the foundation, but does not give Alston control of the Newton Fund. In addition, the two entities do not consolidate their financial statements. Which of the following is true regarding the requirements of the financial statements of Alston Foundation?
- a. Related party disclosures must be made as required under FASB ASC 850.
  - b. A summary of Newton Fund's financial information must be disclosed.
  - c. The disclosure requirements of FASB ASC 850-10-50 should be followed.
  - d. External restrictions on distributions between the related parties should be disclosed in the financial statements.

**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. Go Green, a nonprofit organization, must determine if it has any related parties and if it is required to disclose any related party transactions. Disclosure of which of the following would be required? **(Page 153)**
- a. Expense allowances, salaries, and other compensation arrangements. [This answer is incorrect. Salaries, expense allowances, and other compensation are explicitly excluded from related party disclosure requirements; therefore, Go Green would not have to make this disclosure.]
  - b. A description of all material related party transactions. [This answer is incorrect. According to FASB ASC 850-10-50-1, if Go Green has related party transactions, it is required to disclose a description of all the transactions, including those to which no amounts or nominal amounts were ascribed, for each of the periods for which statements of activities are presented, and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements. Only disclosing descriptions of material related party transactions would not put Go Green in compliance with the authoritative pronouncement.]
  - c. A statement that the related party transaction was made at arm's length. [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. **Amounts due to or from related parties as of the date of the statement of financial position. [This answer is correct. Under FASB ASC 850-10-50-1, Go Green should disclose amounts due from or to related parties as of the date of each statement of financial position presented and, if not otherwise apparent, the terms and manner of settlement.]**
16. Define the term *postemployment benefits*. **(Page 155)**
- a. Periodic payments that are made to a person who has retired from employment or to that person's beneficiary pursuant to the terms of a pension plan. [This answer is incorrect. According to FASB ASC 715-30-20, this is the definition of *pension benefits*.]
  - b. Health care and life insurance benefits provided to retirees, their dependents, and/or their survivors. [This answer is incorrect. This is the definition of *postretirement benefits*. Postretirement benefits are accounted for under the provisions of FASB ASC 715.]
  - c. **Benefits that are paid to former or inactive employees, their beneficiaries, and their covered dependents after the employees' employment but before their retirement. [This answer is correct. This is the correct definition for the term *postemployment benefits*. An example of this type of benefit is the continuation of health care benefits or life insurance coverage.]**
17. Which of the following would the Rainy Day Foundation, a nonprofit organization, be required to disclose about its pension plan? **(Page 155)**
- a. **Investment strategies of the pension plan. [This answer is correct. Under FASB ASC 715-20, nonprofit organizations with pension plans, postretirement benefits, or postemployment benefits are required to disclose information on investment strategies.]**
  - b. The amount of gross periodic benefit cost recognized. [This answer is incorrect. The FASB ASC 715-20-50-5 revised the disclosure requirements for nonpublic entities. One of the revisions require the disclosure of the amount of net periodic benefit cost recognized, not the gross amount. This requirement was effective on December 20, 2008.]
  - c. The value of plan assets and benefit obligations three months prior to the date of the financial statements. [This answer is incorrect. For fiscal years ending after December 15, 2008, entities are required to measure

plan assets and benefit obligations as of the date of their fiscal year-end statement of financial position, with certain exceptions. Entities had previously been permitted to use either the date of the financial statements or a date not more than three months prior to that date, if used consistently from year to year. If an entity changes its measurement date to comply with the new requirement, in the year of the revision it must disclose the effect on unrestricted net assets from applying the requirement.]

- d. The benefit payments expected from the pension plan for the next five fiscal years. [This answer is incorrect. Nonprofit organizations are required to disclose certain information according to FASB ASC 715-20. One of those disclosures is the expected benefit payments in the next 10 fiscal years related to pension plans and other postretirement benefit plans.]
18. The Rainy Day Foundation is scheduled to make grant payments to others over future periods. The payments would be accounted for as exchange transactions. What is the correct term for this type of arrangement? **(Page 156)**
- a. **Commitment.** [This answer is correct. Commitments are contractual obligations for a future expenditure. In the above scenario, the Rainy Day Foundation has a commitment to make those grant payments.]
- b. Contingency. [This answer is incorrect. Contingencies are existing conditions that may create a legal obligation in the future but that arise from past transactions or events. An example of a contingency would be if the Rainy Day Foundation had possible reimbursement to donors for noncompliance with restrictions on contributions.]
19. The Learning Center, a nonprofit organization, has a debtor loan agreement that includes a restrictive covenant. The center violates the covenant; however, it obtains an unconditional waiver from its lender in which the lender waives the right to demand payment for two years. Is disclosure of this event required? **(Page 157)**
- a. Yes. [This answer is incorrect. If the center had not obtained the unconditional waiver, disclosure of the condition and classification as a current liability would be required. However, that is not the case in this scenario.]
- b. **No.** [This answer is correct. Due to obtaining the unconditional waiver, the center does not have a contingent liability and is not required to make a disclosure. However, in a Technical Practice Aid (TIS 3200.17), the AICPA states that disclosure of the existing violation and the waiver period should be considered. That information may be important to financial statement users.]
20. Horse Sense, a nonprofit organization that does horse therapy with disabled children, has a collateral arrangement with their bank secured by daily receipts. The organization maintains an account at the bank and the participants in the program send their payments directly to the account at the bank. Does this arrangement need to be disclosed in the financial statements? **(Page 158)**
- a. **Yes.** [This answer is correct. 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.]
- b. No. [This answer is incorrect. According to FASB ASC 860, the substance of such an arrangement is that cash is pledged and meets the requirement for disclosure in the nonprofit organization's financial statements.]
21. In which of the following scenarios, has a disclosure issue related to a nonprofit organization been dealt with correctly? **(Page 161)**
- a. Gracie, auditor of the Echo Organization, has substantial doubt about the organization's ability to continue as a going concern. In her disclosure, Gracie uses pessimistic language to emphasize how dire the

- organization's situation is. [This answer is incorrect. SAS No. 59 requires auditors to modify their report if they have substantial doubt about an entity's ability to continue as a going concern, even if recoverability of assets or classification of liabilities is not in question. Therefore, in this scenario, Gracie should make the disclosure. However, when making said disclosure, Gracie should use neutral wording and not be unduly pessimistic or optimistic.]
- b. The Foxtrot Organization is facing a material lawsuit. Possibility of loss of the lawsuit is greater than remote. The organization optimistically includes a statement in its disclosure that the contingency is not expected to be material because it expects to win the case. [This answer is incorrect. FASB ASC 450-20-50-4 requires the organization to disclose the nature of the contingency and to estimate the possible loss or range of loss or include a statement 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.]
- c. **The Sierra Organization is facing environmental remediation costs. It discloses whether the liabilities for these costs were measured on a discounted basis. It also discloses the circumstances that would trigger the liability and the organization's policy for recognizing recoveries. [This answer is correct. Under FASB ASC 410-30-50-4, the organization is required to make the first disclosure listed in this scenario and encouraged, but not required, to make the other disclosures. The Sierra Organization has handled its environmental remediation liabilities correctly.]**
- d. The Tango Organization has assets and liabilities that are measured at fair value on a recurring basis. As part of its fair value disclosures, the organization provides a reconciliation of the beginning and ending balances for fair value measurements related to Level 2 inputs. [This answer is incorrect. This type of reconciliation should be disclosed for measurements related to Level 3 inputs, not Level 2 inputs.]
22. The Dynamo Group, a nonprofit organization, elects the fair value option to account for some of its financial assets and liabilities. Which of the following options can the organization use to present the affected assets and liabilities in its financial statements? **(Page 166)**
- a. It can present them combined with non-fair-value amounts in the same line item. No further information is needed. [This answer is incorrect. According to FASB ASC 820-10, 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. One way the organization can do that is to present the aggregate of fair value and non-fair-value amounts in the same line item in the statement of financial position and parenthetically disclose the amount measured at fair value included in the aggregate amount.]
- b. **It can present the fair value amounts in a separate line item from the non-fair-value amounts. [This answer is correct. Whenever the fair value option is elected, fair value measurements should be made following the guidance in FASB ASC 820-10. One method the organization can use to present this information in its financial statements is to use two separate line items to display the fair value and non-fair-value carrying amounts.]**
- c. It can present information about the affected assets using the historical cost model. [This answer is incorrect. FASB ASC 825-10 disclosures are generally designed to provide information about assets and liabilities that, absent the fair value option election, would have been reported under the historical cost model or would not otherwise be required to be revalued at each measurement date.]
23. Which of the following nonprofit organizations has experienced a recognized (type I) subsequent event? Assume that all the events occurred between the date of the statement of financial position and the date the financial statements were issued. **(Page 167)**
- a. **Recycle More is uncertain about a previously recorded promise to give. [This answer is correct. Recognized (type 1) subsequent events consist of events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet. 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 recognized (type I) category that require the financial statements to be adjusted.]**

- b. Pet Rescue incurs a material debt. [This answer is incorrect. This type of subsequent event is classified as nonrecognized (type II). Nonrecognized (type II) subsequent events are events that provide evidence about conditions that did not exist at the date of the statement of financial position but arose after that date but before the financial statements are issued or available to be issued. They should not be recognized in the financial statements but should be disclosed if disclosure is considered necessary to keep the financial statements from being misleading.]
  - c. Blanket Donation loses grant funding. [This answer is incorrect. This nonprofit organization has experienced a nonrecognized (type II) subsequent event. The loss of grant funding did not exist at the date of the statement of financial position but arose after that date but before the financial statements are issued or available to be issued.]
  - d. Carbon Footprint loses its tax-exempt status due to a condition occurring after the financial statement date. [This answer is incorrect. The subsequent event experienced by this nonprofit organization would be classified as nonrecognized (type II). The loss of tax-exempt status arose after the date of the statement of financial position but before the financial statements are issued or available to be issued.]
24. The Alston Foundation, a nonprofit organization, has an investment of 45% in the Newton Fund, a nonprofit foundation. This represents an economic interest in the foundation, but does not give Alston control of the Newton Fund. In addition, the two entities do not consolidate their financial statements. Which of the following is true regarding the requirements of the financial statements of Alston Foundation? **(Page 168)**
- a. Related party disclosures must be made as required under FASB ASC 850. [This answer is incorrect. These disclosures are required under FASB ASC 958-810 when a nonprofit organization controls another nonprofit entity, with control evidenced through a contract document or affiliation agreement and the nonprofit organization has an economic interest in that entity. Alston Foundation does have an economic interest in Newton Fund, but not control, so this does not apply.]
  - b. A summary of Newton Fund's financial information must be disclosed. [This answer is incorrect. If a nonprofit organization controlled another nonprofit entity using a control document or affiliation agreement and has an economic interest in that entity, it would be required to disclose a summary of the related nonprofit entity's financial information, including total assets, liabilities, net assets, revenue and expenses. Since the Alston Foundation does not have control of the Newton Fund, this is not applicable.]
  - c. **The disclosure requirements of FASB ASC 850-10-50 should be followed. [This answer is correct. If either control or an economic interest exists, but not both, as in the case of the Alston Foundation, 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 (formerly SFAS No. 57).]**
  - d. External restrictions on distributions between the related parties should be disclosed in the financial statements. [This answer is incorrect. 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 should be disclosed if consolidated financial statements are presented. In this case, the Alston Foundation and the Newton Fund have not consolidated their financial statements.]

## 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:

- 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 (before and after any extraordinary items) 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 10.07, notes that FASB ASC 740-10 (formerly SFAS No. 109, *Accounting for Income Taxes*) provides guidance for recognizing current and deferred taxes payable or refundable.

FASB ASC 958-720-50-1 (formerly 2008 Audit Guide, Paragraph 13.59) 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.

**Accounting for 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.

Accounting Standards Update 2009-06, *Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities*, amended the definition of a tax position to note that it encompasses the organization's status as a tax-exempt nonprofit entity. (ASU 2009-06 is codified in FASB ASC 740-10, and the definition of a tax position is included in the FASB ASC Master Glossary at FASB ASC 740-10-20.) For nonprofit organizations, tax positions also include:

- Whether the organization's activities are related to its exempt purpose.
- How the organization allocates revenue and expenses between its exempt purpose and unrelated business activities.

ASU 2009-6 also exempts nonpublic entities from the requirement in FASB ASC 740-10-50 (formerly FIN 48) to provide a tabular reconciliation of the total amount of unrecognized tax benefits at the beginning and end of the years presented. For entities that have already adopted the accounting for uncertainty in income taxes guidance, ASU 2009-06 is effective for periods ending after September 15, 2009. For entities that had not yet adopted the original guidance, ASU 2009-06 is effective when the accounting for uncertainty in income taxes guidance is adopted, which is generally for financial statements of years beginning after December 15, 2008.

FASB ASC 740-10 (formerly FIN 48) requires a description of tax years that remain subject to examination by major tax jurisdictions to be disclosed. The authors believe the purpose of the disclosure is to alert the financial statements users that an item in the financial statements could change as a result of a tax audit. Accordingly, the authors believe the disclosure is not relevant for most organizations since their financial statements do not reflect income taxes. However, if the organization is subject to unrelated business income taxes, then the disclosure would apply. Also, if the organization's status as a tax-exempt nonprofit entity is in question, then the authors believe the disclosure would apply.

FASB ASC 740-10 (formerly FIN 48) 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 accounting 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 in the following paragraphs. 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 (formerly APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*), 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 or exercise of outstanding stock options and warrants.
  - d. Market value of investment if a quoted market price is available (not required for investments in subsidiaries).

FASB ASC 958-810 (formerly SOP 94-3) continues to allow nonprofit organizations the option of market value reporting in certain circumstances in which FASB ASC 323 (formerly APB Opinion No. 18) 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 (formerly SFAS No. 159) were discussed 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 (formerly SFAS No. 159) requires the disclosures in 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 (formerly SFAS No. 144) requires certain disclosures about discontinued operations in the financial statements, including the gain or loss on disposal (if not presented on the face of the statement of activities). The following information should be disclosed in the notes to the financial statements in the period that a long-lived asset (disposal group) either has been sold or is classified as held for sale:

- a. A description of the facts and circumstances leading to the expected disposal, the expected manner and timing of that disposal, and, if not separately presented on the face of the statement of financial position, the carrying amounts of the major classes of assets and liabilities included in the disposal group.
- b. The loss recognized for any initial or subsequent write-down to fair value less cost to sell (or gain recognized for subsequent increases in fair value to the extent of such losses) and, if not presented separately on the face of the statement of activities, the caption in that statement that includes the gain or loss.
- c. If applicable, amounts of revenue and income or loss reported in discontinued operations.
- d. The segment in which the long-lived asset (disposal group) is reported, if applicable.

In addition, the following disclosures should be made for each period in which a component of an entity has been disposed of or classified as held for sale:

- a. Operating results for the component, including any gain or loss on disposal, less applicable income taxes, if any, reported as a separate component of the change in net assets before extraordinary items and the cumulative effect of accounting changes, if applicable.

- b. The nature and amount of any adjustments to amounts previously reported in discontinued operations that are directly related to the disposal of a component of the entity in a prior period. (Such adjustments should be classified separately in the current period in discontinued operations.)
- c. Assets and liabilities of the disposal group presented separately in the asset and liability sections of the statement of financial position, with the major classes of such assets and liabilities separately disclosed either on the face of the statement of financial position or in the notes.

In addition, if a decision was made during the period not to sell a long-lived asset previously classified as held for sale, a description of the facts and circumstances leading to the decision and the effect of the decision on the change in net assets for all periods presented should be disclosed in the notes to financial statements that include the period of that decision.

In addition, additional disclosures are required in situations where the discontinued operation generates continuing cash flows and in situations where the reporting entity has continued involvement with the component after disposal.

### **Costs to Retire Long-lived Assets/Asset Retirement Obligations**

FASB ASC 410-20 (formerly SFAS No. 143, *Accounting for Asset Retirement Obligations*) 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 (formerly SFAS No. 143) 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 (formerly SFAS No. 143, paragraph 22) requires 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 (formerly APB Opinion No. 9, *Reporting the Results of Operations*, Paragraph 26) 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 (formerly SFAS No. 154, *Accounting Changes and Error Corrections*) 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.

25. The Harmonic Conservatory is a nonprofit organization. Will the organization's financial statements be affected by income taxes?
- a. No, because nonprofit organizations are exempt from all possible income taxes.
  - b. Yes, because, if certain circumstances exist, income tax disclosures could be needed.
  - c. No, because the organization is not a private foundation.
26. The Harmonic Conservatory disposes of a long-lived asset because the related operations have been discontinued. Which of the following disclosures should be included in the notes to the organization's financial statements?
- a. The loss that the organization recognizes for any write-down (initial or subsequent) to fair value less cost to sell.
  - b. A schedule that includes summarized information about assets, liabilities, and the results of operations for material investments in unconsolidated subsidiaries.
  - c. A description of the long-lived asset and any asset retirement obligations.
  - d. The cumulative effect of the change, in total and by class, on net assets as of the beginning of the earliest period presented in the financial statements.

**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.)

25. The Harmonic Conservatory is a nonprofit organization. Will the organization's financial statements be affected by income taxes? **(Page 175)**
- a. No, because nonprofit organizations are exempt from all possible income taxes. [This answer is incorrect. Under the Internal Revenue Code, there are circumstances in which a nonprofit organization will be subject to income taxes. If the Harmonic Conservatory fits into those circumstances, its financial statements would be affected, including the notes to the financial statements.]
  - b. Yes, because, if certain circumstances exist, income tax disclosures could be needed. [This answer is correct. If the organization has unrelated business income, it might be subject to income taxes. FASB ASC 958-720-50-1 requires organizations to disclose the amount of income taxes in the notes to the financial statements. Organizations are also required to disclose the nature of the activities resulting in the taxes. In addition, FASB ASC 740-10 prescribes certain disclosure requirements that may be applicable for nonprofit organizations.]**
  - c. No, because the organization is not a private foundation. [This answer is incorrect. Private foundations are subject to excise taxes on net investment income. This particular type of tax would not apply to the Harmonic Conservatory because it is not a private foundation. However, this is not the only set of circumstances that must be considered to determine if the Harmonic Conservatory is subject to income taxes.]
26. The Harmonic Conservatory disposes of a long-lived asset because the related operations have been discontinued. Which of the following disclosures should be included in the notes to the organization's financial statements? **(Page 177)**
- a. The loss that the organization recognizes for any write-down (initial or subsequent) to fair value less cost to sell. [This answer is correct. FASB ASC 205-20-50 requires certain disclosures about discontinued operations in the financial statements, including gain or loss on disposal (if not presented on the face of the statement of activities). Certain information should be disclosed in the notes to the financial statements in the period that a long-lived asset either has been sold or is classified as held for sale. The disclosure described in this answer choice should be made. Another example of a disclosure needed in this situation is the amounts of any revenue and income or loss reported in discontinued operations.]**
  - b. A schedule that includes summarized information about assets, liabilities, and the results of operations for material investments in unconsolidated subsidiaries. [This answer is incorrect. FASB ASC 323-10-50-3 requires this disclosure of nonprofit organizations that own nonmarketable equity securities accounted for by the equity method.]
  - c. A description of the long-lived asset and any asset retirement obligations. [This answer is incorrect. FASB ASC 410-20-50-1 requires this disclosure if a nonprofit organization has asset retirement obligations. This is different from the sale or disposal of a long-lived asset.]
  - d. The cumulative effect of the change, in total and by class, on net assets as of the beginning of the earliest period presented in the financial statements. [This answer is incorrect. FASB ASC 250-10-50-7 requires this disclosure when a nonprofit organization restates its financial statements to correct an error.]

**EXAMINATION FOR CPE CREDIT****Lesson 2 (NFSTG102)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

7. What authoritative pronouncement provides accounting guidance for all nonprofit organizations regarding equity securities for which fair value can readily be determined, debt securities, and other investments?
  - a. FASB ASC 320-10 and 325-20.
  - b. FASB ASC 815.
  - c. FASB ASC 958-320 and 958-205.
  - d. FASB ASC 958-810.
8. Under FASB ASC 958-325, which of the following organizations must disclose the amount of investment income and realized/unrealized gains and losses that come from investments other than debt securities and equity securities that have fair values that are readily determinable?
  - a. Silver Lake University.
  - b. Lower Valley Preparatory School.
  - c. The Clothes Closet, a Section 501(c)(3) organization.
  - d. Second Avenue Baptist Church.
9. The Golden Retriever Foundation, a nonprofit organization, has a donor-restricted endowment fund. The amount of funds in the endowment meets the amount required by the donors. Which of the following must be disclosed by the foundation?
  - a. The sum of net deficiencies in the donor-restricted endowment fund.
  - b. A reconciliation of the foundation's entire investment return.
  - c. The foundation's policies for endowment spending.
  - d. A direct transcript of laws underlying the net asset classification of donor-restricted endowment funds.
10. The Golden Retriever Foundation receives conditional promises to give. Which of the following disclosures is the foundation required to make about this promise to give?
  - a. If a discount is associated with the promise, the amount of the unamortized discount.
  - b. The total of amounts that were promised to the foundation.
  - c. The total amount of the contribution receivable and its effective interest rate.
  - d. Promises that are pledged as collateral or limited as to use in some other way.

11. Kids' Space is a nonprofit organization. Which of its receivables would be considered a lending or financing arrangement and, therefore, included in the scope of FASB ASC 310-10-50 and 860-20-50?
- Receivables from clients for tutoring services.
  - Promises to give.
  - Receivables from grants that would be considered contributions.
  - All receivables from related parties.
12. Which of the following nonprofit organizations would **not** be required to make a disclosure under related authoritative pronouncements?
- The Tanglewood Fund makes a promise to give to another organization.
  - The Corgi Coalition has trade receivables, some of which are pledged as collateral.
  - Clean Streets publishes a magazine and accounts for subscription fees as deferred revenue.
  - The Art Conservatory has a collection that it capitalizes prospectively.
13. If a nonprofit organization has net assets, which of the following disclosures are required by authoritative guidance? (List all that apply.)
- |  |  |
|--|--|
| i. A description of the different types of permanent and temporary restrictions on the net assets, as well as the relevant dollar amounts. | iv. The method used by the recipient organization to distribute the asset to the organization or its affiliates. |
| ii. Limits on unrestricted net assets that are a result of loan covenants.   | v. Limits on unrestricted net assets that come from contracts with suppliers, creditors, and others.             |
| iii. A description of variance power.  | vi. Information related to self-imposed limits.  |
- ii. and v.
  - i., ii., and v.
  - iii., iv., and vi.
  - i., ii., v., and vi.
14. Growing Together, a nonprofit organization, has split-interest agreements. How will these agreements affect the organization's financial statements?
- They must be aggregated and the total disclosed in the notes to the financial statements.
  - Any contributions or changes in value must be reported on the statement of financial position.
  - A list of all the terms for each agreement must be disclosed.
  - The basis used to recognize assets related to the agreements must be disclosed.

15. What term applies if a nonprofit organization has financial statement disclosures that relate to several financial statement captions or no financial statement captions?
- General disclosures.
  - Frequent disclosures.
  - Other disclosures.
  - Do not select this answer choice.
16. The Weatherford-Stone Group (WSG) is a nonprofit organization. A transaction with which of the following people/entities would WSG need to disclose in its financial statements as a related party transaction?
- Delilah Green is a significant contributor to WSG. Her contributions are unrestricted. WSG is economically dependent on her contributions.
  - Carver Limited (CL) is a separate entity controlled by WSG. WSG controls CL and assigns it functions. CL is funded by public contributions.
  - Jackson Carrington is the husband of Katrina Carrington, who serves as the chairman of WSG's board of directors.
  - The Layman Foundation (LF) is a separate entity controlled by WSG. WSG transfers some of its resources to LF, and LF uses those resources to perform its normal business operations.
17. Which of the following would be excluded from the definition of a pension plan?
- Defined contribution and defined benefit plans.
  - Death and disability payments that occur under a separate agreement.
  - Plans existing under a well-defined but unwritten organization policy.
  - Plans that are unfunded.
18. Which of the following nonprofit organizations has a *contingency*?
- Organization One has been threatened with future litigation.
  - Organization Two has a long-term lease which requires fixed payments over five years.
  - Organization Three has contracts for services that will not be performed until a future period.
  - Organization Four has contracts to buy large quantities of materials in a future period.
19. Typically, whether a contingency should be disclosed depends on the effect it will have on a nonprofit organization's current financial position or its future changes in net assets. Which of the following nonprofit organizations is required to disclose its contingency no matter what?
- Next year, the Apple Organization's union contracts will expire, which could lead to employee strikes.
  - Due to a failure to maintain adequate funds, the Orange Organization will have to reimburse restricted contributions to the donors.
  - The Grape Organization has an oral guarantee arrangement with a financial institution.
  - The IRS has an examination in progress of the Banana Organization's tax-exempt status.

20. Farmers Feeding People, a nonprofit organization, is the debtor in a loan agreement that contains restrictive debt covenants. During the period covered by the financial statements, the organization did not violate any of the covenants. How should the organization address this contingency in its financial statements?
- Because the foundation is in compliance, it does not have to disclose the contingency.
  - The foundation should disclose the contingency, but compliance does not have to be addressed.
  - The foundation should disclose the contingency and include positive assurance of compliance.
  - The foundation must obtain a waiver against the possibility of future violations and disclose this fact.
21. Match the following disclosures with the authoritative guidance that requires said disclosure.

**Disclosures****Authoritative Guidance**

- |   |                           |
|---|---------------------------|
| 1. The assets of a nonprofit organization that have been pledged as collateral for loans.   | i. The Audit Guide.       |
| 2. A guarantee that is a related party transaction.   | ii. GAAP                  |
| 3. Contributions receivable that are pledged as collateral or that have been limited in their use.  | iii. FASB ASC 850-10-05-4 |
| 4. The carrying amount and the classification of any assets pledged as collateral that were not reported separately in the statement of financial position. | iv. FASB ASC 860-30-50-1  |

- 1., ii.; 2., i.; 3., iv.; 4., iii.
  - 1., ii.; 2., iv.; 3., iv.; 4., i.
  - 1., iii.; 2., i.; 3., ii.; 4., iii.
  - 1., iv.; 2., iii.; 3., i.; 4., ii.
22. The Sparkville Clinic, a nonprofit organization, is named in addition to the care providers in a malpractice suit brought by a patient. The clinic's lawyers say this is a nuisance suit and that the damages claimed are out of proportion with damages suffered. The lawyers are willing to state on the record that the chances of an adverse outcome for the clinic are remote. How will this lawsuit affect the clinic's financial statements?
- The clinic must disclose the nature of the contingency related to the lawsuit and provide an estimate of the possible loss or range of loss (or include a statement that such an estimate cannot be made)
  - The clinic must include a statement that asserts that the contingency related to the lawsuit is not expected to be material.
  - The clinic is not required to make any disclosures about the nuisance suit under GAAP.
  - Do not select this answer choice.

23. The Harvest Foundation, a nonprofit organization, is facing environmental remediation liabilities. The liabilities have been accrued. Which of the following disclosures must the foundation make in its financial statements about this liability?
- The nature and the amount of the accrual of environmental remediation liabilities.
  - A description of the contingency and an estimate of possible loss that will affect the foundation.
  - The time frame the foundation estimates for making environmental remediation disbursements.
  - The total environmental remediation liability that was accrued by the foundation for an individual site.
24. You Can Read, a nonprofit organization, loses physical assets in a fire after the statement of financial position date but before the date that its financial statements are issued. What type of subsequent event is this, and how would it affect the financial statements?
- This is a recognized (type I) event, and the financial statements must be adjusted for it.
  - This is a recognized (type I) event, and it must be disclosed in the financial statements.
  - This is a nonrecognized (type II) event, and the financial statements must be adjusted for it.
  - This is a nonrecognized (type II) event, and it must be disclosed in the financial statements.
25. There are three types of accounting changes. Each type has its own disclosure requirements. Match the following accounting changes with the appropriate disclosure requirements.

**Accounting Changes**

**Disclosure Requirements**

- |                                     |   |
|-------------------------------------|---|
| 1. Changes in accounting estimates  | i. Disclose the nature of the change, the reason the change was made, and why the change is preferable. Disclose the method used to apply the change. If indirect effects of the change are recognized, disclose them. Disclose the effect of the change on the change in net assets and on the operating measure for post-change interim periods.  |
| 2. Changes in reporting entity      | ii. In the period of change, disclose the nature of the change and the reason the change was made. For all periods presented, disclose the effect of the change, in total and by class, on the change in net assets (both before and after any extraordinary items). If there will be no material effect in the period of change but a material effect is reasonably certain for later periods, disclose the nature of the change and the reason the change was made when financial statement for the period of change are presented. |
| 3. Changes in accounting principles | iii. If future years are affected, disclose the change's effect on the change in net assets. If there will be no material effect in the period of change but a material effect is reasonably certain for future periods, disclose a description of the change when financial statements of the period of change are presented. Routine changes do not require disclosure unless they are material.  |

- a. 1., i.; 2., iii.; 3., ii.
  - b. 1., ii.; 2., iii.; 3., i.
  - c. 1., ii.; 2., i.; 3., iii.
  - d. 1., iii.; 2., ii.; 3., i.
26. City Streets, a nonprofit organization, includes a financial statement disclosure that consists of the effects of an adjustment, both in total and by class, on the change in net assets for all periods presented in its financial statements. What circumstances prompted City Streets to make this disclosure?
- a. The organization needed to correct an error in previously issued financial statements.
  - b. The organization wanted to retire a long-lived asset.
  - c. The organization wanted to discontinue operations of a long-lived asset.
  - d. The organization was subject to income taxes on unrelated business income.

# Lesson 3: Disclosing Information about Financial Instruments and Risks and Uncertainties in Financial Statement Notes

## INTRODUCTION

This lesson discusses the disclosure of certain types of information that can affect a nonprofit organization's financial statement notes. First, the lesson takes a look at disclosing information about financial instruments. Topics covered include identifying financial instruments, credit risk and market risk disclosures, disclosing concentrations of credit risk for cash deposits, disclosing the fair value of financial instruments, and derivative financial instruments and hedging activities. Second, the lesson discusses disclosure of information about risks and uncertainties. Topics covered include significant estimates, current vulnerability due to concentrations, and practical considerations for disclosing significant risks and uncertainties, among others.

### Learning Objectives:

Completion of this lesson will enable you to:

- Compare and contrast different types of financial instruments, and prepare to disclose information about financial instruments in a nonprofit organization's financial statement notes.
- Assess issues that nonprofit organizations might have with disclosing information about risks and uncertainties in the notes to their financial statements.

## DISCLOSING OF INFORMATION ABOUT FINANCIAL INSTRUMENTS

### Overview of Accounting Literature

FASB ASC 825-10-50-10 (formerly SFAS No. 107, *Disclosures about Fair Value of Financial Instruments*) primarily requires disclosures about the fair value of financial instruments for which it is practicable to estimate that value. FASB ASC 958-320 (formerly SFAS No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*) addresses accounting for and disclosures about equity securities with readily determinable fair values and all debt securities. The disclosure requirements about the fair value of financial instruments are *optional* for nonpublic entities that—

- a. have total assets of less than \$100 million on the statement of financial position date, and
- b. have no instrument that, in whole or in part, is accounted for as a derivative instrument other than commitments related to the origination of mortgage loans to be held for sale during the reporting period.

Identifying financial instruments and determining the related disclosure requirements are often difficult. The following aspects of financial instruments are discussed:

- 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*. Consistent with common usage, cash 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 later in this lesson.
- 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 (formerly Paragraph 3 of SFAS No. 107), 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 later in this lesson.

**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. It is not authoritative, but its 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 beginning in the following paragraph 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 contractual rights and obligations under expired portions of the contracts. The following are common examples:

- 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.
- Promises to give receivable.
- Short-term and long-term notes payable.
- Accrued receivables and payables 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 (formerly SFAS No. 107).]
- 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 generally should 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.

The definition above 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 (formerly FIN 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others") 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 (formerly FIN 45) were discussed in Lesson 2.

**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 a general approach for determining the credit and market risk disclosures required by FASB ASC 825-10-50 (formerly SFAS No. 107):

- 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), describe the shared conditions, disclose the maximum loss that could result, describe the entity's policy of requiring collateral to minimize the risk, describe the collateral, and discuss the entity's access to the collateral.

**Financial Instruments Excluded from the Disclosure Requirements for Concentrations of Credit Risk.** FASB ASC 825-10-50-8 and 22 (formerly SFAS No. 107) 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 (formerly SFAS No. 47, *Disclosure of Long-Term Obligations*). (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.
- Financial instruments of a pension plan, including plan assets, when subject to the accounting and reporting requirements of FASB ASC 715 (formerly SFAS No. 87, *Employers' Accounting for Pensions*).
- Warranty obligations and rights.
- Noncontrolling interests in consolidated subsidiaries.

**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 (formerly SFAS No. 133) 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, credit risk is not considered to affect 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 (formerly SFAS No. 107) 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 (formerly SFAS No. 107) 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 (formerly SFAS No. 133).

For example, if a significant portion of a nonprofit organization's promises to give are receivable from the only factory in the town, that concentration of credit risk could be disclosed, whether or not the factory is experiencing financial difficulties.

### **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 could be viewed as cash. If the definition of cash discussed earlier in this lesson is used, such accounts could be viewed as cash and, therefore, are subject to credit risk.

As discussed previously, 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?** Best practices indicate that 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. (On January 1, 2010, the standard coverage limit will return to \$100,000 for all deposit categories except IRAs and certain retirement accounts, which will continue to be insured up to \$250,000 per owner.) (Effective October 3, 2008, the Economic Stabilization Act of 2008 temporarily raised the basic limit on federal deposit insurance coverage from \$100,000 to \$250,000 per depositor. Subsequent legislation provided that the basic deposit insurance limit will return to \$100,000 after December 31, 2013. In addition, unlimited deposit insurance coverage is available through December 31, 2009, for non-interest bearing deposit transaction accounts at institutions participating in the FDIC's Temporary Liquidity Guarantee Program. More information related to the changes in deposit insurance coverage can be found on the FDIC's website at [www.fdic.gov](http://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. It is permitted to borrow up to \$1 billion from the U.S. Treasury through the Securities and Exchange Commission if its funds are insufficient. Although the certainty of coverage and ease of collection are not as assured when compared to the FDIC, the authors consider SIPC insurance 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). Another view is that credit risk for cash deposits should 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, in a nonauthoritative Technical Practice Aid (TIS 2110.06), the AICPA stated that *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 technical practice aid 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. For example, 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 previously 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	<u>244,600</u>	<u>244,600</u>
	<u>\$ 973,100</u>	610,900
Petty cash		<u>900</u>
		<u>\$ 611,800</u>

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.)	<u>244,600</u>
	<u>\$ 637,500</u>

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

FASB ASC 825-10-50-10 (formerly SFAS No. 107, *Disclosures about Fair Value of Financial Instruments*) requires 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 the disclosure requirements of other generally accepted accounting principles that already require disclosure of, or subsequent measurement at, fair value. 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.

A nonpublic entity is defined for this requirement as an entity that (a) does not trade its debt or equity securities in a public market (i.e., stock exchange or an over-the-counter market); (b) is not at conduit bond or obligor for conduit debt securities traded in a public market; (c) does not file with a regulatory agency when selling its debt or equity securities in a public market; (d) 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.

As noted above, many nonprofit organizations are exempt from the disclosure requirements of FASB ASC 825-10 (formerly SFAS No. 107). However, some nonprofit organizations may choose to voluntarily disclose fair value information. FASB ASC 820 (formerly SFAS No. 157, *Fair Value Measurements*) amends FASB ASC 825-10 (formerly SFAS No. 107) to eliminate the guidance on how to determine fair value; however, it does not change the disclosure requirements of FASB ASC 825-10 (formerly SFAS No. 107). The fair value disclosure requirements are discussed in Lesson 2.

**Financial Instruments Excluded from the Disclosure Requirements.** FASB ASC 825-10-50-8 (formerly SFAS No. 107) specifically excludes the following financial instruments from the disclosure requirements:

- 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 (formerly SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, a replacement of FASB Statement No. 125*).
- Certain insurance contracts.
- Lease contracts.
- Warranty obligations and rights.
- Unconditional purchase obligations as defined in FASB ASC 10-50-2 (formerly Paragraph 6 of FASB Statement No. 47, *Disclosure of Long-Term Obligations*).
- Investments accounted for under the equity method in accordance with the requirements of FASB ASC 323 (formerly APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*).
- Noncontrolling interests in consolidated subsidiaries.
- Equity investments in consolidated subsidiaries.

In addition, the requirements presume that the carrying value of trade receivables and trade payables approximates fair value. Therefore, fair value disclosures are required only when that is not the case.

**Determining the Fair Value of Financial Instruments.** FASB ASC 820 (formerly SFAS No. 157, *Fair Value Measurements*) provides a common definition of fair value, establishes a framework to measure fair value within GAAP, and requires disclosures about fair value measurements. It generally applies under other accounting pronouncements that require or permit fair value measurements, including the disclosure of fair value information for financial instruments. Fair value measurements are discussed in Lesson 2.

**Disclosure Requirements.** When it is cost effective to estimate the fair value of a financial instrument, fair value should be disclosed either in the body of the financial statements or in the notes. In addition, the methods and significant assumptions used to estimate fair value should be disclosed. The following considerations apply when preparing the disclosures:

- 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 (formerly FIN 39) or FASB ASC 210-20-45-11 through 45-17 (formerly FIN 41).
- As discussed previously, FASB ASC 820 (formerly SFAS No. 157) expands the disclosures about measuring fair value that exist within GAAP. FASB ASC 820 (formerly SFAS No. 157) encourages, but does not require, the combination of fair value disclosures of that Statement with those required by other pronouncements such as FASB ASC 825 (formerly SFAS No. 107).

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 prohibit financial statement readers from readily assessing the effects of fluctuations in financial instrument values without a table. Accordingly, in those situations, a separate table could 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 financial statement 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.

### **Derivative Financial Instruments and Hedging Activities**

FASB ASC 815-10-50 (formerly SFAS No. 133) (as amended) requires the following disclosures to be made separately for (a) derivative instruments (and nonderivative instruments) designated as fair value hedging instruments, (b) derivative instruments (and nonderivative instruments) designated as hedging instruments for hedges of the foreign currency exposure of a net investment in a foreign operation, and (c) all other derivatives:

- a. The organization's objectives for holding or issuing each type of hedging instrument, including the context needed to understand the objectives and the organization's strategies for achieving the objectives.
- b. The organization's risk management policy for each type of hedge, including a description of the items or transactions for which risks are hedged.
- c. The purpose of the derivative activity for derivative instruments not designated as hedging instruments.

FASB ASC 815-10 (formerly SFAS No. 133) requires disclosure of the following for derivative instruments designated and qualifying as fair value hedging instruments [as well as nonderivative instruments that may give rise to foreign currency transaction gains or losses under FASB ASC 830 (formerly SFAS No. 52)] and for the related hedged items:

- a. The net gain or loss recognized as a change in net assets during the reporting period representing the amount of the hedges' ineffectiveness and the component of the derivative instruments' gain or loss, if any, excluded from the assessment of hedge effectiveness.
- b. A description of where the net gain or loss is reported in the statement of activities.
- c. The amount of net gain or loss recognized as a change in net assets when a hedged firm commitment no longer qualifies as a fair value hedge.

FASB ASC 815-15-50-1 (formerly SFAS No. 133) (as amended) also requires specific disclosures related to certain hybrid financial instruments measured at fair value. The preceding disclosures must be made for each reporting period for which a complete set of financial statements is presented.

**SELF-STUDY QUIZ**

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

27. There are three different categories of financial instruments. Which of the following would be categorized as *cash*?
  - a. A U.S. Treasury bill.
  - b. Demand deposits.
  - c. Common stock.
  - d. Options to purchase stock.
  
28. Caring Hearts, a nonprofit organization, has a promises to give receivable. This is considered what type of contract?
  - a. Unconditional receivable-payable contract.
  - b. Conditional receivable-payable contract.
  - c. Financial option contract.
  - d. Financial forward contract.
  
29. A nonprofit organization enters into a financial option contract with a for-profit entity. The contract is a mortgage loan with a prepayment right. The nonprofit organization is the holder of the contract, and when it exercises its option to exchange financial instruments with the other entity, the option is favorable for the nonprofit organization. At that time, the option is unfavorable to the for-profit entity, the option writer. Would this contract be considered a financial instrument?
  - a. Yes.
  - b. No.
  
30. The Incredible Group, a nonprofit organization, has a contract with Edna's Instruments. However, if Edna's Instruments does not deliver the promised goods by the date specified in the contract, it will cost the Incredible Group a significant amount of cash paying out guarantees to its customers. This is an example of what type of risk?
  - a. Credit risk.
  - b. Market risk.
  - c. The risk of theft or physical loss.
  
31. The Incredible Group has a concentration of credit risk. A significant portion of its assets are deposited in one financial institution. When disclosing this credit risk in the financial statements, what amount should the organization use?
  - a. The amount of deposits in transit.
  - b. The bank statement balance.
  - c. The amount of outstanding checks.

32. If some of the Incredible Group's cash deposits are insured, which of the following would be true?
- a. Credit risk for the organization's cash deposits can be reduced by the amount of the insurance.
  - b. If the Incredible Group's accounts contain \$300,000, only \$250,000 will be insured by the FDIC.
  - c. Any repurchase agreements held by the Incredible Group will be both uninsured and unsecured.
  - d. The FDIC provides insurance to the Incredible Group's deposits with broker-dealers.
33. The Holiday Toy Association is a nonprofit organization. It is also considered a nonpublic entity, and its total assets are \$3 million on its statement of financial position date. None of its financial instruments would be accounted for as a derivative. Is it required to make fair value disclosures?
- a. Yes.
  - b. No.
34. The Holiday Toy Association makes fair value disclosures about its financial instruments in its financial statements. Which of the following statements best describes an aspect of that process?
- a. The organization must disclose fair value in the notes to the financial statements.
  - b. The organization should not mention financial instruments for which it is not cost effective to disclose the fair value.
  - c. The organization should not aggregate the fair values of nonderivative financial instruments.
  - d. Using multiple notes for the disclosure saves the organization from including a summary table.

**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.)

27. There are three different categories of financial instruments. Which of the following would be categorized as *cash*? (Page 190)
- a. A U.S. Treasury bill. [This answer is incorrect. This is considered a cash equivalent, which is different from cash. Cash equivalents are defined under FASB ASC 230-11-20 as short-term, highly liquid investments that are both readily convertible to known amounts of cash, and so near to maturity that they present insignificant risk of changes in value because of changes in interest rates. Although cash equivalents are not cash, they are normally financial instruments. Treasury bills would also be considered an unconditional receivable-payable contract.]
  - b. Demand deposits. [This answer is correct. It is relatively straightforward to identify financial instruments that fall into the cash category. Cash for this purpose is the same as the items that are reflected on an organization's statement of cash flows, and it includes, among other things, 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.]**
  - c. Common stock. [This answer is incorrect. Common stock is categorized as evidence of an ownership interest in an entity, which is a separate category of financial instrument. Preferred stock is another example of this category of financial instrument.]
  - d. Options to purchase stock. [This answer is incorrect. Warrants and options to subscribe to or purchase stock from an issuing entity are categorized as evidence of an ownership interest in an entity. This is a separate category of financial instrument.]
28. Caring Hearts, a nonprofit organization, has a promises to give receivable. This is considered what type of contract? (Page 191)
- a. Unconditional receivable-payable contract. [This answer is correct. The FASB's discussion memorandum, *Distinguishing between Liability and Equity Instruments and Accounting for Instruments of Both*, defines six categories of financial instruments. Five deal with contracts, and one deals with equity instruments. Under this memorandum, a promises to give receivable is a common example of an unconditional receivable-payable contract. An unconditional receivable-payable contract 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 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 before a specified date.]**
  - b. Conditional receivable-payable contract. [This answer is incorrect. According to the FASB memorandum, the condition in this type of contract must be a specified event beyond the control of either party. That is not the case with a promises to give receivable.]
  - c. Financial option contract. [This answer is incorrect. A financial option contract imposes a contractual obligation on an entity to exchange other financial instruments with the option holder on potentially unfavorable terms if an event within the control of the holder occurs. According to the FASB memorandum, promises to give receivables do not fall under this category.]
  - d. Financial forward contract. [This answer is incorrect. A financial forward contract imposes an unconditional obligation on both entities to exchange other financial instruments with the other entity on potentially unfavorable terms, and conveys to each entity an unconditional right to exchange other financial instruments on potentially favorable terms. Based on the guidance in the FASB memorandum, promises to give receivables are not an example of this category of contracts.]

29. A nonprofit organization enters into a financial option contract with a for-profit entity. The contract is a mortgage loan with a prepayment right. The nonprofit organization is the holder of the contract, and when it exercises its option to exchange financial instruments with the other entity, the option is favorable for the nonprofit organization. At that time, the option is unfavorable to the for-profit entity, the option writer. Would this contract be considered a financial instrument? **(Page 192)**
- Yes. [This answer is correct. According to the FASB memorandum, a financial option contract is a financial instrument only if the option is potentially unfavorable to the option writer. Therefore, in this scenario, the financial option contract is a financial instrument because it is unfavorable to the for-profit entity at the time the obligation is imposed.]**
  - No. [This answer is incorrect. Because, per the FASB memorandum, the financial option contract has the option to be unfavorable to the option writer, it would be considered a financial instrument in this scenario. Another example of a situation in which a financial option contract would not be considered a financial instrument is if the option involves the exchange of assets other than financial instruments.]
30. The Incredible Group, a nonprofit organization, has a contract with Edna's Instruments. However, if Edna's Instruments does not deliver the promised goods by the date specified in the contract, it will cost the Incredible Group a significant amount of cash paying out guarantees to its customers. This is an example of what type of risk? **(Page 194)**
- Credit risk. [This answer is correct. Credit risk is defined as the possibility that a loss may occur from the failure of another party to perform according to the terms of a contract. Credit and market 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.]**
  - Market risk. [This answer is incorrect. Market risk is defined as the possibility that future changes in market prices may make a financial instrument less valuable or more onerous. Because the risk in the scenario above has to do with the parties in the contract and not the market for the goods that will be delivered, it would not be an example of market risk.]
  - The risk of theft or physical loss. [This answer is incorrect. No theft or physical loss took place in the scenario above; therefore, this scenario is an example of one of the other two types of risk that can result in accounting loss.]
31. The Incredible Group has a concentration of credit risk. A significant portion of its assets are deposited in one financial institution. When disclosing this credit risk in the financial statements, what amount should the organization use? **(Page 195)**
- The amount of deposits in transit. [This answer is incorrect. The financial institution generally is not responsible for deposits in transit. 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 received by the bank after its daily cutoff would have the same credit risk as those for undeposited receipts. Therefore, these types of deposits should not be disclosed in the above scenario.]
  - The bank statement balance. [This answer is correct. Best practices indicate that 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 this disclosure requirement is to disclose concentrations of credit risk that result from maintaining cash deposits in financial entities.]**
  - The amount of outstanding checks. [This answer is incorrect. The bank will not reduce its deposit liability until checks clear. In the event of a bank failure, the bank would be responsible for its deposit liability, not the deposit liability reduced by outstanding checks. The Incredible Group would be required to satisfy outstanding checks with other funds. Therefore, the amount of outstanding checks should not be disclosed in the above scenario.]

32. If some of the Incredible Group's cash deposits are insured, which of the following would be true? **(Page 196)**
- a. Credit risk for the organization's cash deposits can be reduced by the amount of the insurance. [This answer is incorrect. GAAP does not address this issue; therefore, it is a matter of professional judgment. 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. Another view is that credit risk for cash deposits should 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.]
  - b. If the Incredible Group's accounts contain \$300,000, only \$250,000 will be insured by the FDIC. [This answer is correct. The Federal Deposit Insurance Corporation (FDIC) is a federal agency that insures the deposits of many banks. It 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.]**
  - c. Any repurchase agreements held by the Incredible Group will be both uninsured and unsecured. [This answer is incorrect. This is true of commercial paper, but repurchase agreements, while uninsured, are secured by pools of marketable securities of federal agencies.]
  - d. The FDIC provides insurance to the Incredible Group's deposits with broker-dealers. [This answer is incorrect. 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.]
33. The Holiday Toy Association is a nonprofit organization. It is also considered a nonpublic entity, and its total assets are \$3 million on its statement of financial position date. None of its financial instruments would be accounted for as a derivative. Is it required to make fair value disclosures? **(Page 198)**
- a. Yes. [This answer is incorrect. Many nonprofit organizations are exempt from the disclosure requirements of FASB ASC 825-10. However, some nonprofit organizations may choose to voluntarily disclose fair value information.]
  - b. No. [This answer is correct. FASB ASC 825-10-50-10 requires disclosure of fair value of all financial instruments for which it is practicable to estimate that value. 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.]**
34. The Holiday Toy Association makes fair value disclosures about its financial instruments in its financial statements. Which of the following statements best describes an aspect of that process? **(Page 199)**
- a. The organization must disclose fair value in the notes to the financial statements. [This answer is incorrect. According to the authoritative guidance, the fair value of a financial instrument should be disclosed either in the body of the financial statements or in the notes.]
  - b. The organization should not mention financial instruments for which it is not cost effective to disclose the fair value. [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.]
  - c. The organization should not aggregate the fair values of nonderivative financial instruments. [This answer is correct. 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 or FASB ASC 210-20.]**

- d. Using multiple notes for the disclosure saves the organization from including a summary table. [This answer is incorrect. 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.]

## DISCLOSING INFORMATION ABOUT RISKS AND UNCERTAINTIES

In general terms, uncertainty stems from the inability to predict the future, and risks exist because uncertainty exists. FASB ASC 275 (formerly SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*) 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 (formerly SOP 94-6) requires disclosure in the following four areas:

- Nature of activities.
- Use of estimates in the preparation of financial statements.
- Certain significant estimates.
- Current vulnerability due to 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. Certain risks and uncertainties are explicitly excluded 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 that the organization performs and its sources of revenues. Also required is disclosure of the entity's principal markets, including the locations of those markets. Finally, 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. It can be communicated by using terms such as "predominantly," "about equally," or "major." 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, a nonprofit organization's financial statements may already provide information on the significance of different programs using expenses as a basis. GAAP requires nonprofit organizations to report functional expense information about major classes of programs either in the financial statements or the notes to the financial statements.

FASB ASC 958-205-50-1 (formerly 2008 Audit Guide, Paragraph 13.31) requires a description of the organization's activities, including each major class of programs, to be disclosed. As discussed earlier in this lesson, FASB ASC 825-10 (formerly SFAS No. 107) (as amended) 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 lesson.

### Certain Significant Estimates

GAAP requires additional disclosures for certain *significant* estimates. According to FASB ASC 275-10-50-8 (formerly SOP 94-6), disclosure regarding an estimate is required "when known information available before the financial statements are issued or 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.

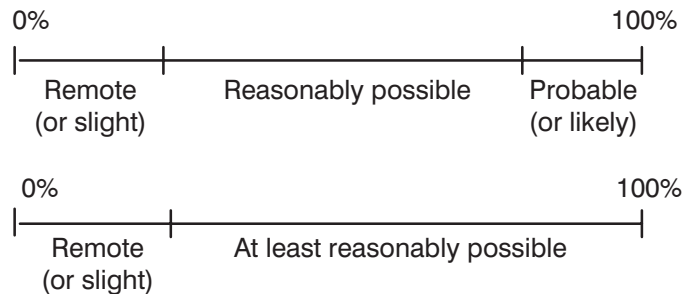
**Existing Condition.** The *italicized* wording in the first criterion is intended to clarify that the condition that may cause the estimate to change in the near term must be "an existing condition." This is consistent with the GAAP requirements for accounting for loss contingencies, and it helps to 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 (formerly SOP 94-6) as it does in FASB ASC 450 (formerly SFAS No. 5, *Accounting for Contingencies*). FASB ASC 450-20-20 (formerly SFAS No. 5) 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 (formerly SOP 94-6) 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.** This term is defined in FASB ASC 275-10-20 (formerly Paragraph 7 of SOP 94-6) as “a period of time not to exceed one year from the date of the financial statements.” This is the same time period established by SAS No. 59 (AU 341) for evaluating an entity’s ability to continue as a going concern.

**Material.** The second criterion about significant estimates is that the effect of the change would be material to the financial statements. FASB ASC 275-10-50-14 (formerly SOP 94-6) 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 (formerly SFAS No. 107, *Disclosures about Fair Value of Financial Instruments*).

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 about significant estimates are to be considered using “known information available before the financial statements are issued 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 (formerly SFAS No. 5), which refers to “information available before the financial statements are issued or are available to be issued.”

**Examples of Estimates.** The AICPA Audit Risk Alert, *Not-for-Profit Organizations Industry Developments—1996*, listed several examples of estimates that are frequently applicable to nonprofit organizations, such as:

- Valuation of loans or promises to give.
- Cost capitalized for computer software.
- Specialized equipment subject to rapid technological obsolescence.
- Environmental remediation liabilities.
- Estimates related to the disposition of a business or asset (i.e., estimated proceeds and expected losses).
- Long-term obligations for pensions or postemployment benefits.
- Liabilities for unrelated business income taxes.
- Recorded or contingent liabilities resulting from audits of grants.

**Example Disclosure.** If an estimate meets the criteria for disclosure as a significant estimate, 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 market, 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 (formerly SFAS No. 5, *Accounting for Contingencies*). A point of confusion for many practitioners is how the requirements for disclosing certain significant estimates according to FASB ASC 275 (formerly SOP 94-6) relate to the requirements for disclosing loss contingencies under FASB ASC 450 (formerly SFAS No. 5). The following paragraphs compare and contrast the requirements.

Both FASB ASC 275 (formerly SOP 94-6) and FASB ASC 450 (formerly SFAS No. 5) 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 3-1 summarizes when the disclosure requirements of FASB ASC 275 (formerly SOP 94-6) and FASB ASC 450 (formerly SFAS No. 5) should be considered.

**Exhibit 3-1**

**When to Consider the Disclosure Requirements of FASB ASC 275 (formerly SOP 94-6) and FASB ASC 450 (formerly SFAS No. 5)**

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

\* \* \*

**Current Vulnerability Due to Concentrations**

FASB ASC 275-10-50 (formerly SOP 94-6) 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 requirements to disclose vulnerabilities due to concentrations, disclosure of market or contributor concentrations may provide the necessary disclosure for credit risk concentrations also.

**What Is a Concentration?** FASB ASC 275-10-50-16 (formerly SOP 94-6) does not specifically define “concentration.” It states in Paragraph 20 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. For example, the concentration must be an "existing condition" and must be "at least reasonably possible." Also, the criteria are to be considered "information known to management before the financial statements are issued or 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 (formerly SOP 94-6) 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 3-2 summarizes the disclosure requirements of for significant risks and uncertainties.

**Exhibit 3-2**

**Disclosing Significant Risks and Uncertainties**

	<b>Nature of Activities</b>	<b>Use of Estimates</b>	<b>Certain Significant Estimates</b>	<b>Concentrations</b>
<b>When to Disclose?</b>	<ul style="list-style-type: none"> <li>• Always.</li> </ul>	<ul style="list-style-type: none"> <li>• Always.</li> </ul>	<ul style="list-style-type: none"> <li>• 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.</li> </ul> <p>AND</p> <ul style="list-style-type: none"> <li>• The change in estimate would have a material effect on the financial statements.</li> </ul>	<ul style="list-style-type: none"> <li>• A concentration exists at the financial statement date.</li> </ul> <p>AND</p> <ul style="list-style-type: none"> <li>• The concentration increases the organization’s vulnerability to the risk of a near-term severe impact.</li> </ul> <p>AND</p> <ul style="list-style-type: none"> <li>• It is reasonably possible that the events able to cause the severe impact could occur in the near term.</li> </ul>
<b>Threshold for Disclosing?</b>	<ul style="list-style-type: none"> <li>• N/A</li> </ul>	<ul style="list-style-type: none"> <li>• N/A</li> </ul>	<ul style="list-style-type: none"> <li>• Potential <i>material</i> effect on financial statements.</li> </ul>	<ul style="list-style-type: none"> <li>• Potential <i>severe</i> impact to the organization.</li> </ul>

	<b>Nature of Activities</b>	<b>Use of Estimates</b>	<b>Certain Significant Estimates</b>	<b>Concentrations</b>
<b>What to Disclose?</b>	<ul style="list-style-type: none"> <li>• Description of products or services (including each major class of programs).</li> <li>• Sources of revenues for the organization’s services.</li> <li>• Relative importance of each business.</li> <li>• Basis used to determine relative importance of each business.</li> <li>• Principal markets and locations of the markets.</li> </ul>	<ul style="list-style-type: none"> <li>• Explanation that management estimates are used in preparing financial statements.</li> </ul>	<ul style="list-style-type: none"> <li>• Nature of uncertainty.</li> <li>• An indication that it is at least reasonably possible that a change in the estimate will occur in the near term.</li> </ul>	<ul style="list-style-type: none"> <li>• Description of the concentration.</li> <li>• Information about the general nature of the risk associated with the concentration.</li> <li>• Additional disclosures for concentrations of labor or foreign operations.</li> </ul>

\* \* \*

**Practical Considerations for Disclosing Significant Risks and Uncertainties**

The requirements for disclosing significant risks and uncertainties were discussed earlier in this lesson. 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.

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 best practices indicate that 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.

The term *severe impact* can be interpreted 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.** One method for deciding whether 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.

**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.

35. The Rockman Foundation, a nonprofit organization, includes a disclosure in the notes to its financial statements that informs financial statement users about its principal services and its revenue sources. What type of disclosure is this?
- The nature of its activities.
  - Its use of estimates.
  - Its use of certain significant estimates.
  - Its current vulnerability.
36. The Rockman Foundation is determining which estimates require disclosure as *significant estimates*. For an estimate to be significant, it must be reasonably possible that an effect an estimate has on the financial statements will change in the near term. How is *reasonably possible* defined when applying this definition?
- The future event that will cause the change is likely to occur.
  - The future event has a chance of occurring that is greater than remote but less than likely.
  - There is only a slight chance that the future event will occur.
37. When making the determination described in the previous question, the Rockman Foundation would also need to consider which of the following?
- The possibility of change that may occur within two years of the financial statement date.
  - Estimates resulting in no amount can be excluded from the disclosure.
  - Estimates used to determine disclosures of gain and loss contingencies and recorded amounts.
  - Disclosure of all estimates used in the financial statements is required.
38. The Rockman Foundation must also determine if it has current vulnerabilities due to concentrations that it must disclose in its financial statements. Disclosure is only necessary if three criteria are met. Which of the following is one of those criteria?
- The concentration must meet the definition laid out in FASB ASC 275-10-50-16.
  - The organization is vulnerable to the risk of a severe impact in the near term because of the concentration.
  - It is probable that the events that would cause a severe impact will occur in the near term.
39. The Beta Group, a nonprofit organization, plans to make a disclosure about the nature of its activities using a single description. It plans to put this description in the first note to the financial statements. Information about all of the following should be included in this note, **except**:
- The group's major products and services.
  - The group's business lines.
  - The group's use of estimates.
  - The group's principal markets.

40. The Beta Group includes the following disclosure in the notes to its financial statements:

In 20X0, the Organization began operating a second hand store using donated items for inventory. Because this activity is new for the Organization, management estimated the cost of the donated inventory using the results of the subsequent sales. If changes in the estimate occur, they will be reported in the statement of activities in the year they occur. As the Organization gains more experience, it may find that in 20X1 its estimate in 20X0 was under or overestimated by an amount that is material to the financial statements for 20X1.

This is an example of what type of disclosure?

- a. Nature of activities.
- b. General use of estimates.
- c. Certain significant estimates.
- d. Current vulnerability due to concentrations.

**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.)

35. The Rockman Foundation, a nonprofit organization, includes a disclosure in the notes to its financial statements that informs financial statement users about its principal services and its revenue sources. What type of disclosure is this? **(Page 207)**
- The nature of its activities. [This answer is correct. Under FASB ASC 275-10-50-1, all financial statements should include a description of the major products or services the reporting entity sells or provides. For a nonprofit organization, such as the Rockman Foundation, that would include the principal services it performs and its sources of revenues.]**
  - Its use of estimates. [This answer is incorrect. This type of disclosure, as required by FASB ASC 275-10-50-1, would have to provide users an explanation that preparation of financial statements requires the use of management's estimates. The disclosure described in this scenario does not include that information.]
  - Its use of certain significant estimates. [This answer is incorrect. Assuming the criteria are met, GAAP requires additional disclosures for certain *significant* estimates. The disclosure the Rockman Foundation made, as described above, does not include that information.]
  - Its current vulnerability. [This answer is incorrect. Under FASB ASC 275-10-50, entities must consider disclosing certain types of concentrations, such as concentrations in revenue from particular products, services, or fund-raising events. However, this is not the disclosure described in the scenario above.]
36. The Rockman Foundation is determining which estimates require disclosure as *significant estimates*. For an estimate to be significant, it must be reasonably possible that an effect an estimate has on the financial statements will change in the near term. How is *reasonably possible* defined when applying this definition? **(Page 208)**
- The future event that will cause the change is likely to occur. [This answer is incorrect. Under FASB ASC 450-20-20, this is the definition of *probable*. A probable event is more likely to happen than a reasonably possible event.]
  - The future event has a chance of occurring that is greater than remote but less than likely. [This answer is correct. According to FASB ASC 450-20-20, this is the definition of *reasonably possible*. Consequently, *reasonably possible* means anything more than remote but less than likely.]**
  - There is only a slight chance that the future event will occur. [This answer is incorrect. This is the definition of *remote* under FASB ASC 450-20-20. A reasonably possible event is more likely to happen than a remote event.]
37. When making the determination described in the previous question, the Rockman Foundation would also need to consider which of the following? **(Page 209)**
- The possibility of change that may occur within two years of the financial statement date. [This answer is incorrect. Change that will occur in the near term should be considered. *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."]
  - Estimates resulting in no amount can be excluded from the disclosure. [This answer is incorrect. Under FASB ASC 275-10-50-14, it is possible for a disclosure to be required even if no estimate is recognized in the financial statements (that is, the estimate is zero).]
  - Estimates used to determine disclosures of gain and loss contingencies and recorded amounts. [This answer is correct. 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. FASB ASC 275-10-50-8 requires disclosure of an estimate when known information available before the financial statements are issued or are available to be issued indicates that 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 conforming event,s and the effect of the change would be material to the financial statements.]**

- d. Disclosure of all estimates used in the financial statements is required. [This answer is incorrect. 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.]
38. The Rockman Foundation must also determine if it has current vulnerabilities due to concentrations that it must disclose in its financial statements. Disclosure is only necessary if three criteria are met. Which of the following is one of those criteria? **(Page 213)**
- a. The concentration must meet the definition laid out in FASB ASC 275-10-50-16. [This answer is incorrect. 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."]
- b. The organization is vulnerable to the risk of a severe impact in the near term because of the concentration. [This answer is correct. FASB ASC 275-10-50 requires disclosure of concentrations that meet certain criteria. All applicable criteria must be met for disclosure to be required. One of the pieces of criteria is that the concentration must make the organization vulnerable to the risk of a near-term severe impact.]**
- c. It is probable that the events that would cause a severe impact will occur in the near term. [This answer is incorrect. Based on FASB ASC 275-10-50, the criteria is that it is at least reasonably possible (not probable) that the events that could cause the severe impact will occur in the near term.]
39. The Beta Group, a nonprofit organization, plans to make a disclosure about the nature of its activities using a single description. It plans to put this description in the first note to the financial statements. Information about all of the following should be included in this note, **except: (215)**
- a. The group's major products and services. [This answer is incorrect. The practical advice about significant risks and uncertainties disclosures was developed to give organization's best practices to follow when making these disclosures. Those best practices indicate that disclosure of this information is part of the nature of activities. The group should describe broad product and service groups. If the statement of activities presents expenses by major program, the group should either repeat the major programs or use a broader description.]
- b. The group's business lines. [This answer is incorrect. Business lines are not the same as major products and services, but, according to the best practices developed in this course to help organizations make appropriate disclosures, business lines are part of the nature of activities disclosure. Many nonprofit organizations have only one line. However, if the group has more than one, it should disclose the relative importance of each line to the entity's financial results and describe how that determination was made.]
- c. The group's use of estimates. [This answer is correct. Best practices were developed in this course to help organizations make the best possible disclosures related to risks and uncertainties. According to that advice, the nature of activities disclosure and the general use of estimates disclosure are two separate disclosures. The goal of disclosing the use of estimates is to alert readers that certain amounts reported in the financial statements are estimated. That is different from the goal behind authoritative guidance's requirements for making nature of activities disclosures.]**

- d. The group's principal markets. [This answer is incorrect. This is part of the nature of activities disclosure, according to the best practices developed using the practical guidance in this course. This guidance should help organizations make appropriate disclosures, including the nature of activities disclosure. When disclosing principal markets, general descriptions of industry and geographical concentrations normally give the reader enough information about principal markets.]

40. The Beta Group includes the following disclosure in the notes to its financial statements:

In 20X0, the Organization began operating a second hand store using donated items for inventory. Because this activity is new for the Organization, management estimated the cost of the donated inventory using the results of the subsequent sales. If changes in the estimate occur, they will be reported in the statement of activities in the year they occur. As the Organization gains more experience, it may find that in 20X1 its estimate in 20X0 was under or overestimated by an amount that is material to the financial statements for 20X1.

This is an example of what type of disclosure? **(Page 217)**

- a. Nature of activities. [This answer is incorrect. An example disclosure for the nature of activities would be: Lane Private School provides educational instruction to children in grades K–12 primarily from the southern area of Chicago.]
- b. General use of estimates. [This answer is incorrect. An example disclosure for general use of estimates would be: Generally accepted accounting principles require management to estimate some amounts reported in the financial statements; actual amounts could differ.]
- c. Certain significant estimates. [This answer is correct. 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. This is an example of a disclosure about certain significant estimates if it was presented in the financial statements as a policy note.]**
- d. Current vulnerability due to concentrations. [This answer is incorrect. Disclosing current vulnerability due to concentrations informs the reader about concentrations that exist at the statement of financial position date. That is not the case in the example disclosure above.]

**EXAMINATION FOR CPE CREDIT****Lesson 3 (NFSTG103)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

27. According to FASB Concepts Statement No. 6, which of the following is excluded from the definition of a financial instrument?
- a. Currency on hand.
  - b. Short-term investments that have maturities of three months or less.
  - c. The future portion of a noncancelable operating lease.
  - d. A contract that gives the first entity the obligation to deliver cash to the second entity and that gives the second entity the right to receive cash from the first entity.
28. The Mellman Group, a nonprofit organization, enters into a contract with MegaCo. The contract obligates the Mellman Group to deliver a specified amount of cash to MegaCo if a specified event that is beyond the control of either entity occurs. The contract gives MegaCo the right to receive the cash from the Mellman Group if said event occurs. Under the FASB's discussion memorandum, *Distinguishing between Liability and Equity Instruments and Accounting for Instruments of Both*, what type of contract is this?
- a. Unconditional receivable-payable contract.
  - b. Conditional receivable-payable contract.
  - c. Financial option contract.
  - d. Financial guarantee or other conditional exchange.
29. Nonprofit X enters into a financial forward contract with Nonprofit Z. Under the contract, Nonprofit X has the right to supply inventory to Nonprofit Z in exchange for cash using terms that are potentially unfavorable to Nonprofit Z. Does this contract qualify as a financial instrument?
- a. Yes.
  - b. No.
  - c. Do not select this answer choice.
  - d. Do not select this answer choice.
30. The Anti-Litter Coalition, a nonprofit organization, has obligations to pay pension benefits to former employees. Would this obligation be subject to the disclosure requirements found in FASB ASC 825-10-50-22?
- a. Yes, because it is a financial instrument.
  - b. Yes, because it is a deferred compensation arrangement.
  - c. No, because it is not a financial instrument.
  - d. No, because it is specifically excluded by FASB ASC 825-10-50-22.

31. Which of the following nonprofit organizations has made a required disclosure under FASB ASC 825-10-50-21?
- The Epsilon Organization discloses quantitative information about the market risks related to its financial instruments.
  - The Omega Organization discloses information about the economic characteristics that affect its concentration of credit risk.
  - The Sigma Organization discloses information about warranty obligations and rights.
  - The Zeta Organization discloses information about unconditional purchase obligations that are subject to FASB ASC 440-10-50-2 requirements.
32. A nonprofit organization deposits a significant portion of its funds in three financial entities based in the same geographic region. Disclosures about this situation would concern a concentration of what type of risk?
- Credit risk.
  - Market risk.
  - The risk of theft or physical loss.
  - Do not select this answer choice.
33. The Starlight Center, a nonprofit organization, plans to disclose a concentration of credit risk in its financial statements. How must that information be disclosed?
- All concentrations of credit risk must be disclosed in a single note to the financial statements.
  - A separate note is required for each credit risk concentration element (cash, accounts receivable, etc.).
  - The organization can make the disclosure in the way that is most efficient and effective.
  - No disclosure is required in this situation.
34. If a nonprofit organization has a derivative instrument that is designated as a fair value hedging instrument, FASB ASC 815-10-50 requires it make a separate disclosure of which of the following?
- The objectives of the organization for holding or issuing this type of hedging instrument.
  - The net gain or loss that the organization recognized as a change in net assets during the reporting period.
  - A description of where any net gain or loss is reported in the organization's statement of activities.
  - The amount of gain or loss the organization recognized as a change in net assets when a hedged firm commitment no longer qualifies as a fair value hedge.
35. FASB ASC 275-10-50-1 requires that all entities, including nonprofit organizations, make which of the following disclosures about risks and uncertainties?
- Disclosures of estimates and current vulnerability in certain concentrations.
  - Disclosures of the nature of the entity's activities and how it used estimates to prepare its financial statements.
  - Disclosures related to management, internal control structure deficiencies, and sudden catastrophes.
  - Disclosure of all possible risks and uncertainties.

36. Safety First, a nonprofit organization, includes the following disclosure in its financial statements:

Management used assumptions and estimates to prepare the financial statements. These assumptions and estimates affect the amounts of assets and liabilities that were reported, the contingent assets and liabilities that were disclosed, and the revenues and expenses that were reported. Actual results could differ from the estimates.

What type of disclosure is this?

- a. Nature of activities.
  - b. Use of estimates.
  - c. Certain significant estimates.
  - d. Current vulnerability due to certain concentrations.
37. What type of estimate is more likely to meet the disclosure criteria for a significant estimate?
- a. Recurring estimate.
  - b. Nonrecurring estimate.
  - c. Do not select this answer choice.
  - d. Do not select this answer choice.
38. Which of the following nonprofit organizations has a disclosure for which FASB ASC 450 (formerly SFAS No. 5, *Accounting for Contingencies*) applies, but FASB ASC 275 (formerly SOP 94-6) does not?
- a. The Spring Organization has a loss contingency at the financial statement date, and it is reasonably possible that the estimate for this contingency will change by a material amount within the next year.
  - b. The Summer Organization has a loss contingency at the financial statement date, and it is remotely possible that the estimate for this contingency will change by a material amount within the next year.
  - c. The Autumn Organization has a gain contingency.
  - d. The Winter Organization has an estimate that affects the financial statements without involving a contingency.
39. Which of the following nonprofit organizations has correctly dealt with a concentration disclosure in its financial statements?
- a. Foreign Aid has a significant concentration of foreign operations. However, because it does not believe it is reasonably possible for anything to occur that would cause a severe impact and disrupt foreign operations, it does not disclose this concentration.
  - b. National Trust has a group of contributors with similar economic characteristics. Because its concentration is not with a single entity, it does not disclose the concentration in its financial statements.
  - c. The Beaker Group has a concentration in the volume of business it transacts with Bunsen Town, its biggest customer. It discloses this concentration in the financial statements along with a statement that it does not expect revenue from this customer will be lost.
  - d. Due to a concentration, Lucky Dog anticipates there will be a material effect that may influence a user's decisions. In its disclosure, it states that this concentration could have a severe impact on operations.

40. A nonprofit organization must decide whether to disclose sources of revenue in its financial statements and how much information to include if it does make the disclosure. Which of the following pieces of advice might prove helpful in making this decision?
- a. The organization should only disclose a source of revenue if it is 50% or more of total revenue.
  - b. Important sources of revenue should be mentioned both on the face of the statements and in the notes.
  - c. If the source is to be disclosed, its name and relevant information (address, phone number, etc.) should be included.
  - d. If loss of the source would adversely affect key operating statistics by a material amount, the source should be disclosed.

## GLOSSARY

**Accounting changes:** Changes in accounting estimates, changes in the reporting entity, and changes in accounting principles. The different types of accounting changes have their own disclosure requirements.

**Accounting loss:** A change to net assets that would result from losing the contractual right or settling the contractual obligation of a financial instrument.

**Accounting policies:** The specific accounting principles and methods of applying those principles that have been adopted for preparing the financial statements.

**Cash:** 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

**Commitments:** Contractual obligations for a future expenditure.

**Conditional promises to give:** Promises to give that 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.

**Contingencies:** Existing conditions that may create a legal obligation in the future but that arise from past transactions.

**Contracts that require the exchange of cash or other financial instruments:** A contract that (1) imposes on one entity a contractual obligation to either deliver cash or another financial instrument to a second entity or exchange other financial instruments on potentially unfavorable terms with the second entity and (2) conveys to that second entity a contractual right to either receive cash or another financial instrument from the first entity or exchange other financial instruments on potentially favorable terms with the first entity or events.

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

**Evidence of an ownership interest in an entity:** Common stock, preferred stock, certificates of interest or participation, and warrants and options to subscribe to or purchase stock from an issuing entity.

**Fair value option:** FASB ASC 825-10 (formerly SFAS No. 159) provides the option of electing to account for financial assets and liabilities at fair value. Whenever this option is elected, fair value measurements should be made following the guidance in FASB ASC 820-10 (formerly SFAS No. 157).

**Financial instruments:** The three categories of financial instruments are (1) cash, (2) evidence of an ownership interest in an entity, and (3) a contract that requires the exchange of cash or other financial instruments.

**Functional classification:** A method for classifying the expenses of nonprofit organizations. Functional expenses are classified according to the purpose for which they are incurred (i.e., expenses for program services and supporting services).

**General disclosures:** Financial statement 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).

**Market risk:** The possibility that future changes in market prices may make a financial instrument less valuable or more onerous.

**Natural classification:** A method for classifying the expenses of nonprofit organizations. The natural, or object, classification of expenses represents the type of expense, e.g., salaries and employee benefits, professional fees, occupancy, postage and shipping, supplies, telephone, travel, etc.

**Necessary disclosures:** Disclosures required for a fair presentation in conformity with GAAP. Determining what these disclosures are requires consideration of (1) specific disclosures required by authoritative pronouncements

and (2) disclosures not specifically required by authoritative pronouncements but that are necessary to keep financial statements from being misleading.

**Nonrecognized (type II) subsequent events:** Events that provide evidence about conditions that did not exist at the date of the statement of financial position but arose after that date but before the financial statements are issued or available to be issued.

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

**Pension benefits:** Periodic (usually monthly) payments made pursuant to the terms of a pension plan to a person who has retired from employment or to that person's beneficiary.

**Postemployment benefits:** Benefits paid after employment but before retirement to former or inactive employees, their beneficiaries, and their covered dependents.

**Postretirement benefits:** Benefits including health care benefits (such as dental, hearing, and vision coverage) and life insurance benefits provided to retirees, their dependents, or survivors.

**Recognized (type I) subsequent events:** Events that provide additional evidence about conditions that existed at the date of the statement of financial position and that affect the estimates inherent in preparing the financial statements.

**Severe impact:** A significant financially disruptive effect on the normal functioning of the entity. Severe impact is a higher threshold than material.

**Unconditional 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.

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## COMPANION TO PPC'S GUIDE TO PREPARING NONPROFIT FINANCIAL STATEMENTS

### COURSE 3

## STATEMENTS OF FUNCTIONAL EXPENSES AND CASH FLOWS (NFSTG103)

### OVERVIEW

**COURSE DESCRIPTION:** Although FASB ASC 958 requires only voluntary health and welfare organizations to present a statement of functional expenses, it is recommended that other non-profit organizations consider including a schedule of functional expenses as a supplementary schedule to the financial statements. In addition, FASB ASC 958 requires that external financial statements of nonprofit organizations include a statement of cash flows. This course discusses the authoritative literature as well as the form and presentation considerations of the statement of functional expenses. In addition, this course discusses the authoritative literature, as well as the presentation of specific types of transactions in the statement of cash flows. Disclosure of noncash transactions is also covered.

**PUBLICATION/REVISION DATE:** April 2010

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

**PREREQUISITE/ADVANCE PREPARATION:** Basic knowledge of accounting

**CPE CREDIT:** 6 QAS Hours, 6 Registry Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at [www.nasba.org](http://www.nasba.org) for a listing of states that accept QAS hours.

**FIELD OF STUDY:** Accounting

**EXPIRATION DATE:** Postmark by **April 30, 2011**

**KNOWLEDGE LEVEL:** Basic

#### Learning Objectives:

#### Lesson 1—The Statement of Functional Expenses

Completion of this lesson will enable you to:

- Identify the requirements of FASB ASC 958 and its effect on the statement of functional expenses.
- Determine the form and presentation requirements for the statement of functional expenses.

#### Lesson 2—The Statement of Cash Flows

Completion of this lesson will enable you to:

- Recognize the requirements and definitions of FASB ASC 230 and how it pertains to the statement of cash flows and the three types of cash flows.
- Identify the format requirements and the style considerations of the statement of cash flows.
- Distinguish what transactions and events are included in cash flows from operating activities and specify the advantages and disadvantages to the direct and indirect methods of presenting cash flows from operating activities.
- Determine the treatment under FASB ASC 230 of agency or custodial funds, extraordinary items, cumulative accounting adjustments and discontinued operations on the statement of cash flows.

- Identify the proper treatment of other adjustments to arrive at net cash flows from operating activities.
- Determine how investing activities are required to be presented on the statement of cash flows including capital expenditures, investments, and loans.
- Recognize the requirements for financing activities presented on the statement of cash flows, including restricted contributions and investment income, as well as debt.
- Identify disclosures for noncash investing and financing activities, including assets acquired by assuming a liability, by gift, or by purchasing a subsidiary.

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# Lesson 1: The Statement of Functional Expenses

## INTRODUCTION

This lesson describes the requirement of authoritative literature pertaining to the statement of functional expenses, as well as the form and presentation considerations for the statement or schedule of functional expenses.

### Learning Objectives:

Completion of this lesson will enable you to:

- Identify the requirements of FASB ASC 958 and its effect on the statement of functional expenses.
- Determine the form and presentation requirements for the statement of functional expenses.

## AUTHORITATIVE LITERATURE

### Authoritative Basis for Statement of Functional Expenses

FASB ASC 958-720-45-2 (formerly SFAS No. 117, *Financial Statements of Not-for-Profit Organizations*) requires all organizations to present information about expenses (but not losses) by their functional classification, such as major classes of program services and supporting activities, in either the statement of activities or the notes to the financial statements. FASB ASC 958-205-05-5 (formerly SFAS No. 117) also requires voluntary health and welfare organizations to present a statement of functional expenses, which shows information about natural and functional classifications, as an additional basic financial statement. The Statement 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. 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 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, which would be reflected on a schedule or statement of functional expenses, would have already been done. For best practices, 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.

### 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, e.g., by each program and by the management and general, fund-raising, and membership development supporting functions. In short, it is a detailed analysis of the expense portion of the statement of activities in matrix format. Natural expense classifications include such items as salaries, rent, electricity, interest expense, depreciation, professional fees, and insurance. The level of detail (the number of natural expense categories 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 (formerly SFAS No. 117) 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 example in the preceding paragraph, 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 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.

**SELF-STUDY QUIZ**

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

1. A requirement of FASB ASC 958-720-45-2 (formerly SFAS No. 117, *Financial Statements of Not-for-Profit Organizations*) is that all organizations must present expense information by their functional classification:
  - a. In either the statement of activities or the notes to the financial statements.
  - b. As an additional basic financial statement for all nonprofit organizations.
  - c. In a functional expense schedule included as a supplementary schedule.
  
2. Which statement is accurate concerning the level of detail required on the statement of functional expenses?
  - a. FASB ASC 958 dictates the level of detail that meets compliance.
  - b. The reader should see all of the details of the expenses.
  - c. The level of detail can vary depending on the nature and complexity of activities.
  - d. As long as salaries are always broken out by detail, the rest is a matter of choice.

## 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. A requirement of FASB ASC 958-720-45-2 (formerly SFAS No. 117, *Financial Statements of Not-for-Profit Organizations*) is that all organizations must present expense information by their functional classification: **(Page 235)**
  - a. **In either the statement of activities or the notes to the financial statements. [This answer is correct. All organizations are required to present this information. Although only voluntary health and welfare organizations are required under FASB ASC 958-205-05-5 to present a statement of functional expenses as an additional basic financial statement, other types of nonprofit organizations are encouraged to present this information in this same manner.]**
  - b. As an additional basic financial statement for all nonprofit organizations. [This answer is not correct. Only voluntary health and welfare organizations have this requirement. It shows information about natural and functional classifications.]
  - c. In a functional expense schedule included as a supplementary schedule. [This answer is not correct. While a functional expense schedule included as a supplementary schedule is 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 the function expense schedule.]
2. Which statement is accurate concerning the level of detail required on the statement of functional expenses? **(Page 235)**
  - a. FASB ASC 958 dictates the level of detail that meets compliance. [This answer is not correct. There is not a regulation stating the exact number of natural expense categories to present.]
  - b. The reader should see all of the details of the expenses. [This answer is not correct. Although the statement, presented in matrix format, is a detailed analysis of the expense portion of the statement of activities, and all expenses must be included on the statement, all details of the expenses are not necessary.]
  - c. **The level of detail can vary depending on the nature and complexity of activities. [This answer is correct. The goal to be reached is for the reader to be able to understand the nature of the incurred expenses of the organization's activities or programs.]**
  - d. As long as salaries are always broken out by detail, the rest is a matter of choice. [This answer is not correct. Salaries are one example of a natural expense classification that is often used to show the detail of expenses of significant programs and supporting services, however, it is not mandatory to break out salaries.]

## PRESENTATION AND FORM 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 (formerly SFAS No. 117) also refers to the statement by that same title. If the organization is not required to present that statement as a basic financial statement and elects to provide that information in a supplemental 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 lesson.

**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 disbursed.”

**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 up as follows:

ABC Organization  
Schedules of Functional Expenses  
Years Ended December 31, 20X7 and 20X6

### Format

FASB ASC 958 (formerly SFAS No. 117) does not prescribe any specific format for a statement of functional expenses, other than noting in its basis for conclusions that it should be in a matrix format. However, this guidance does not include an example. 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 (Object) Classification.* The natural, or object, classification of expenses represents the type of expense, 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 type of expense. Natural classifications are typically not the same as functional classifications such as management and general or fund-raising. Captions for the natural classification of expenses are generally listed down the left side of the statement or schedule of functional expenses.
- *Functional Classification.* This is the classification of expenses according to the purpose for which they 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 it is believed that 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 categories 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 expenses to the proper functions, and the statement or schedule shows how those expenses are allocated.

**Captions.** Captions, or natural expense categories, 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 will be 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 would be if that 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 (formerly 2008 Audit Guide, Paragraph 13.31) states that if total program expenses are not evident on the face of the statement of activities (e.g., 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. It is believed that if a statement of functional expenses (which is required to include *all* expenses regardless of placement within the statement of activities) 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, a suggestion might be that those statements 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:

	<u>Unrestricted</u>
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	<u>(93,225)</u> 32,765

Gala	55,378	
Less: Cost of direct benefits to donors	<u>(41,632)</u>	13,746
Investment return (net of \$5,500 investment expenses)		<u>98,678</u>
REVENUE, GAINS, AND OTHER SUPPORT		841,468
<b>EXPENSES</b>		
Program services		
Exhibits		281,749
Education		207,975
Supporting services		
Management and general		43,683
Membership development		20,095
Fund-raising		<u>22,087</u>
	EXPENSES	<u>575,589</u>
	INCREASE IN NET ASSETS	<u>\$ 265,879</u>

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 1-1 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 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. In a previous paragraph, it was suggested using a subtotal to reconcile certain statements of activities to their related statements or schedules of functional expenses. (Exhibit 1-1 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 (such as 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.

**Comparative Financial Statements.** FASB ASC 205-10-45 (formerly ARB 43, Chapter 2A, *Form of Statements—Comparative Financial Statements*) 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 categories that are listed down the right hand side of the statement. FASB ASC 958-205-45-8 (formerly 2008 Audit Guide, Paragraph 3.20) 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 (formerly SFAS No. 117) to be in conformity with GAAP. That means that for voluntary health and welfare organizations required to present a statement of functional expenses, 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.

**Exhibit 1-1**

**Example Statement of Functional Expenses**

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
			*	*	*					

Should an organization choose to present only comparative totals for the prior period, appropriate titles are required to be used and a note to the financial statements be included, 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, assuming that all of the financial statements include only comparative totals.

The financial statements include certain prior-year summarized comparative information in total but not by net asset class. Such information does not include sufficient detail to constitute a presentation in conformity with 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 can include that information in a supplemental schedule of functional expenses. The supplemental information is not required for a fair presentation in accordance with GAAP. Therefore, the schedule can 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 categories can be listed down the right hand side of the statement.

### Allocating Expenses

Salaries and other expenses pertaining to more than one function are required to be allocated to the separate 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, the basis for allocating expenses should be consistent from period to period. An objective basis based on related financial or nonfinancial data is preferable to a subjective basis. For example, occupancy expenses (such as 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. It is also recommended disclosing in the notes to the financial statements the general allocation methods such as allocations based on time estimates.

Management should review its expense allocations periodically and revise them as necessary to help ensure they accurately reflect the nature and level of the nonprofit organization's current activities. A change in allocation method is generally considered a change in accounting principle under FASB ASC 250 (formerly SFAS No. 154) unless the facts and circumstances related to the basis for the allocation have changed.



**SELF-STUDY QUIZ**

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

3. Abigail is preparing GAAP financial statements for CubbyOrg which is a voluntary health and welfare organization. Which title should Abigail choose for the statement of functional expenses?
  - a. Schedule of Functional Expenses.
  - b. Statement of Functional Expenses.
  - c. Statement of Functional Expenses Disbursed.
  - d. Statement of Functional Expenses—Cash Basis.
  
4. In which scenario would it make sense for the captions and totals to differ between the statement of activities and the statement or schedule of functional expenses?
  - a. When the preparer has chosen to include column headings and totals for “Total program services” and “Total supporting services” on the statement of activities.
  - b. When the preparer has chosen to intersperse expenses throughout the related revenues on the statement of activities.
  - c. When the notes to the financial statements disclose total program expenses and total supporting services.
  - d. When the statement of functional expenses is serving as its disclosure of total program expenses.
  
5. PeterPaulOrg is a nonprofit organization with a new controller, Mary. Mary is preparing the organization's financial statements and knows she is required to:
  - a. Allocate expenses pertaining to more than one function to the separate functions.
  - b. Present percentage information by function on the statement of functional expenses.
  - c. Disclose the general allocation methods used to allocate expenses.
  - d. 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.)**

3. Abigail is preparing GAAP financial statements for CubbyOrg which is a voluntary health and welfare organization. Which title should Abigail choose for the statement of functional expenses? **(Page 239)**
  - a. Schedule of Functional Expenses. [This answer is not correct. This title would be used for an organization that is not required to present the statement of functional expenses, but voluntarily chooses to include the information in a supplemental schedule.]
  - b. Statement of Functional Expenses. [This answer is correct. Because CubbyOrg is a voluntary health and welfare organization, it is required to present the statement of functional expenses with the basic financial statements. This is the correct title dictated by FASB ASC 958.]**
  - c. Statement of Functional Expenses Disbursed. [This answer is not correct. This title would be used by an organization that is preparing their financials on a comprehensive basis of accounting other than GAAP. This title will distinguish it from a GAAP presentation.]
  - d. Statement of Functional Expenses—Cash Basis. [This answer is not correct. This title would be used by an organization that is preparing their financials on the cash basis of accounting.]
4. In which scenario would it make sense for the captions and totals to differ between the statement of activities and the statement or schedule of functional expenses? **(Page 240)**
  - a. When the preparer has chosen to include column headings and totals for “Total program services” and “Total supporting services” on the statement of activities. [This answer is not correct. Using these captions and totals on the statement of activities would usually dictate that these same captions and totals should be included on the statement or schedule of functional expenses.]
  - b. When the preparer has chosen to intersperse expenses throughout the related revenues on the statement of activities. [This answer is not correct. Generally, when captions and totals are not used on the statement of activities, they are not used on the statement or schedule of functional expenses. Rather the preparer should consider only including a total column for “Total expenses”.]
  - c. When the notes to the financial statements disclose total program expenses and total supporting services. [This answer is not correct. This is not a reason for the captions and totals to be different on the two statements. When the expenses are interspersed with the related revenue on the statement of activities, the notes to the financial statements must disclose total program expenses and total supporting services.]
  - d. When the statement of functional expenses is serving as its disclosure of total program expenses. [This answer is correct. In this case, the statement of functional expenses will have total columns for “Total program services” and “Total supporting services,” even though those same captions and totals are not reflected on the statement of activities.]**
5. PeterPaulOrg is a nonprofit organization with a new controller, Mary. Mary is preparing the organization's financial statements and knows she is required to: **(Page 243)**
  - a. Allocate expenses pertaining to more than one function to the separate functions. [This answer is correct. Allocation of salaries and other expenses pertaining to more than one function are required by FASB ASC 958. To present a statement or supplementary schedule of function expenses, direct cost must be identified and indirect costs must be allocated to the program and supporting functions.]**
  - b. Present percentage information by function on the statement of functional expenses. [This answer is not correct. Presenting percentages on the statement of functional expenses is a choice. It is not addressed in the authoritative literature for nonprofit organizations.]
  - c. Disclose the general allocation methods used to allocate expenses. [This answer is not correct. 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. Maintain detailed records concerning expense allocation. [This answer is not correct. Detailed records are not necessary. The requirement is that the basis for allocation be consistent from period to period. A change in allocation method is generally considered a change in accounting principle under FASB ASC 250 (formerly SFAS No. 154).]

**EXAMINATION FOR CPE CREDIT****Lesson 1 (NFSTG103)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Natalie is preparing the financial statements for the nonprofit organization BearsRorg. She chooses to include a schedule of functional expenses prepared in matrix format as a supplementary schedule to the financial statements, which is a requirement for her organization. Based on this information, what do we know for sure about BearsRorg?
  - a. BearsRorg is a voluntary health and welfare organization.
  - b. BearsRorg has a large donor requiring this expense information.
  - c. BearsRorg is in noncompliance by reporting this information in this format.
  - d. Do not select this answer choice.
  
2. FASB ASC 958 requires all expenses to be included in a statement of functional expenses. Which of the following would be included on that statement?
  - a. A loss when a tornado took the roof off the office building.
  - b. Cost of a fund-raising activity that is held occasionally and considered peripheral.
  - c. Change in the value of a split-interest agreement.
  - d. Expenses related to an ongoing and central activity.
  
3. Match the expense classifications that will be used on the statement or schedule of functional expenses with the correct descriptions or examples.
 

1. Natural Classification	i. Direct and indirect costs related to organization's program or activity
2. Functional Classification	ii. Generally listed down the left side of the statement of functional expenses
	iii. Classified according to the purpose for which the expense is incurred
	iv. Supporting service costs
	v. Classified according to the type of expense
	vi. Salaries, supplies, telephone
	vii. Fund-raising, general, membership development

  - a. 1 ii v vi; 2 i iii iv vii
  - b. 1 ii iii iv vii; 2 i v vi
  - c. 1 ii v vii; 2 i iii iv vi
  - d. 1 i iii iv; 2 ii v vi vii

4. Alma Letter is preparing financial statements for ElemenopyOrg which is a voluntary health and welfare organization. Ms. Letter is researching how to handle the comparative financial information on the required statement of functional expenses. Which answer below is the correct way for Ms. Letter to present this information on the statement of functional expenses for ElemenopyOrg?
- a. Ms. Letter can include the information in whatever form the organization decides.
  - b. Ms. Letter should prepare a complete statement of functional expenses in matrix format for the prior year.
  - c. Ms. Letter should include comparative totals for the prior year at the bottom and along the right side of the statement.
  - d. Ms. Letter must prepare a complete presentation for both years presented on one page.
5. 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 salaries based on location of each employee's office in the building.
  - b. Allocation of property insurance based on revenue dollars of each program.
  - c. Allocation of rent expense based on square footage of space occupied by each program.
  - d. Allocation of utilities based on number of employees working on each program or support service.

# Lesson 2: THE STATEMENT OF CASH FLOWS

## INTRODUCTION

This lesson describes the authoritative literature pertaining to the statement of cash flows as well as the details concerning preparation and presentation of the statement of cash flows.

### Learning Objectives:

Completion of this lesson will enable you to:

- Recognize the requirements and definitions of FASB ASC 230 and how it pertains to the statement of cash flows and the three types of cash flows.
- Identify the format requirements and the style considerations of the statement of cash flows.
- Distinguish what transactions and events are included in cash flows from operating activities and specify the advantages and disadvantages to the direct and indirect methods of presenting cash flows from operating activities.
- Determine the treatment under FASB ASC 230 of agency or custodial funds, extraordinary items, cumulative accounting adjustments and discontinued operations on the statement of cash flows.
- Identify the proper treatment of other adjustments to arrive at net cash flows from operating activities.
- Determine how investing activities are required to be presented on the statement of cash flows including capital expenditures, investments, and loans.
- Recognize the requirements for financing activities presented on the statement of cash flows, including restricted contributions and investment income, as well as debt.
- Identify disclosures for noncash investing and financing activities, including assets acquired by assuming a liability, by gift, or by purchasing a subsidiary.

## AUTHORITATIVE LITERATURE AND OVERVIEW

### Authoritative Basis for Statement of Cash Flows

FASB ASC 958-230 (formerly SFAS No. 117, *Financial Statements of Not-for-Profit Organizations*) requires that external financial statements of nonprofit organizations include a statement of cash flows. 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.

### When to Present the Statement

FASB ASC 230-10-15-3 (formerly SFAS No. 95) requires a statement that shows a nonprofit organization's cash receipts and payments during a period, classified by principal sources and uses, to be presented as a basic external financial statement 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.

The conditions apply to all entities, whether for-profit or nonprofit, that are required to present a statement of cash flows.

Authoritative literature does not prohibit presenting a statement of cash flows when the conditions listed on the previous page 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.

Common trust funds, variable annuity accounts, or similar funds maintained by a trustee, administrator, or guardian, are not required to present a statement of cash flows if the following conditions are met:

- a. Substantially all investments during the period were highly liquid.
- b. Substantially all investments are carried at market value.
- c. The entity had little or no debt, based on average debt outstanding during the period, in relation to average total assets.
- d. The entity presents a statement of changes in net assets.

All other entities meeting the requirements 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:

<u>Cash</u>	<u>Cash Equivalents</u>
<p><i>Definition</i> [FASB ASC 230-10-20 (formerly SFAS No. 95, Paragraph 7, footnote 1)]</p> <p>. . . 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. . . .</p> <p><i>Examples</i>—Certificates of deposit, money market accounts, and repurchase agreements that have the characteristics described above. (If penalties associated with certificates of deposit or money market accounts are material or if stated terms effectively restrict withdrawal of funds, the funds should be classified as cash equivalents or investments, depending on their maturities.)</p>	<p><i>Definition</i> [FASB ASC 230-10-20 (formerly SFAS No. 95, Paragraph 8)]</p> <p>. . . 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.</p> <p><i>Examples</i>—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. Only those investment that mature three months or less from the date they were purchased qualify as cash equivalents. For example, a three-month Treasury bill and a three-year Treasury note purchased three months from maturity both qualify as cash equivalents. A Treasury note purchased three years ago does not become a cash equivalent when its remaining maturity is three months, however.)</p>

FASB ASC 230-10-45-4 (formerly Paragraph 7 of SFAS No. 95) 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 permanently restricted for investment in endowment, 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." (The contribution would be an adjustment in the reconciliation of the change in net assets to net cash used or provided by operating activities.) 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 of the permanently restricted cash. A nonprofit organization is required to disclose its policy for determining which items are treated as cash equivalents and which are not. Therefore, best practices indicate that 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.

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. Alternatively, it is believed that a cash overdraft could be included in the definition of cash because the time required for the overdraft to be eliminated is insignificant. (While it is believed that cash overdrafts generally have such short lives that they are not analogous to accounts payable and could be treated as cash and cash equivalents in the statement of cash flows, they recognize that this treatment conflicts with an AICPA Technical Practice Aid at TIS 1300.15. However, AICPA Technical Practice Aids are not authoritative. They are issued by AICPA staff without action by a recognized standard-setting body and thus are not a source of established GAAP. Either method of presenting cash overdrafts is acceptable. Accountants should exercise professional judgment when preparing the statement of cash flows and present cash overdrafts in a manner appropriate to the entity's unique facts and circumstances. 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 (formerly Paragraph 7 of SFAS No. 95) 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 would say a reconciliation should be provided.

Not all investments that 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. As indicated above, 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.

Throughout this lesson, the term *cash* is used to include cash equivalents. Distinguishing between cash equivalents and short-term investments is discussed later in the lesson.

### **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 three 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 as discussed previously.

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 (formerly SFAS No. 95, Paragraph 14) allows cash flows from derivative instruments accounted for as fair value hedges to be classified 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 2-1 shows how a typical nonprofit organization's transactions would be classified into operating, investing, and financing activities according to the GAAP criteria.

### **Gross and Net Cash Flows Presentation**

Gross cash flows from investing and financing activities are generally required to be reported rather than 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*

1. Proceeds from sales of assets and cash payments for capital expenditures rather than the net change in property and equipment.
2. Proceeds from sales and maturities of securities and purchases of securities rather than the net change in those investments.
3. Loans made and collections on loans rather than the net change in notes and loans receivable.

#### *Financing Activities*

1. Proceeds from long-term borrowings and repayments of long-term obligations (including capital lease obligations) rather than the net change in long-term debt.
2. 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.

**Exhibit 2-1**

**Types of Cash Flows**

<b>STATEMENT OF CASH FLOWS</b>			<b>NONCASH INVESTING AND FINANCING TRANSACTIONS</b>
<b>OPERATING</b>	<b>INVESTING</b>	<b>FINANCING</b>	
<p><b>CASH RECEIPTS FROM:</b></p> <ul style="list-style-type: none"> <li>• Contributions (other than those restricted for long-term purposes)</li> <li>• Service recipients</li> <li>• Grants</li> <li>• Unrestricted or temporarily restricted interest and dividends available for current use</li> <li>• Other cash receipts not arising from investing or financing activities</li> </ul> <p><b>CASH PAYMENTS FOR:</b></p> <ul style="list-style-type: none"> <li>• Wages</li> <li>• Supplies</li> <li>• General and administrative expenses</li> <li>• Interest (excluding amounts capitalized as long-lived assets)</li> <li>• Grants</li> <li>• Settlement of an asset retirement obligation</li> <li>• Other cash payments not related to investing or financing activities</li> </ul>	<p><b>CASH RECEIPTS FROM:</b></p> <ul style="list-style-type: none"> <li>• Sale of property and equipment</li> <li>• Sale or maturity of investments</li> <li>• Collections on loans</li> <li>• Sale or insurance recoveries of collection items</li> <li>• Installment sales</li> <li>• Sale of subsidiary</li> </ul> <p><b>CASH PAYMENTS FOR:</b></p> <ul style="list-style-type: none"> <li>• Property and equipment (including capitalized interest)</li> <li>• Investments</li> <li>• Loans</li> <li>• Collections</li> <li>• Purchase of subsidiary</li> </ul>	<p><b>CASH RECEIPTS FROM:</b></p> <ul style="list-style-type: none"> <li>• Contributions restricted for long-term purposes</li> <li>• Short-term borrowings</li> <li>• Long-term borrowings</li> <li>• Interest and dividends restricted for long-term purposes</li> <li>• Issuance of membership shares</li> <li>• Derivatives that include a financing element</li> </ul> <p><b>CASH PAYMENTS FOR:</b></p> <ul style="list-style-type: none"> <li>• Repayment of amounts borrowed (e.g., short-term debt, long-term debt, and capital lease obligations)</li> <li>• Annuity obligations</li> <li>• Repurchase or redemption of membership shares</li> <li>• Distributions to counterparties of derivatives that include a financing element</li> <li>• Debt issue costs</li> </ul>	<ul style="list-style-type: none"> <li>• Acquiring nonoperating assets (e.g., property and equipment) by assuming liabilities</li> <li>• Acquiring assets by capital lease</li> <li>• Obtaining a building, securities, or collection items by receiving a gift</li> <li>• Capitalization of donated services</li> <li>• Settling liabilities by transferring non-cash assets or issuing membership shares</li> </ul>

\* \* \*

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. Transactions for which the organization is holding or disbursing cash on behalf of others (such as cash receipts and payments from agency or custodial funds and the collection and payment of sales taxes).

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 fund-raising 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. Either method is believed to be acceptable.

**SELF-STUDY QUIZ**

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

6. Which item is **not** considered cash or a cash equivalent?
  - a. Three month certificate of deposit with a material penalty.
  - b. Three month Treasury bill purchased three months from maturity.
  - c. Three year Treasury note purchased two months from maturity.
  - d. Treasury note purchased three years ago with remaining maturity of two months.
  
7. Katy Kay donates \$5,000 to KittyOrg on June 30, 20X0 with the stipulation that the donation must be maintained in perpetuity. KittyOrg has a fiscal year end of June 30. Where will the \$5,000 be included?
  - 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".
  - d. As an adjustment in the reconciliation of the change in net assets to net cash used or provided by financing activities.
  
8. In which example shown below does SFAS No. 95 permit reporting net cash flows?
  - a. Cash received from selling a certificate of deposit.
  - b. Cash paid out as a loan.
  - c. Cash paid for an office building.

**SELF-STUDY ANSWERS**

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

6. Which item is **not** considered cash or a cash equivalent? **(Page 250)**
- a. Three month certificate of deposit with a material penalty. [This answer is not correct. Due to the penalties, this certificate of deposit would not be considered cash, but it would be considered a cash equivalent.]
  - b. Three month Treasury bill purchased three months from maturity. [This answer is not correct. Because the Treasury bill matures within three months or less of when it was purchased, it is considered a cash equivalent.]
  - c. Three year Treasury note purchased two months from maturity. [This answer is not correct. Even though the Treasury note has a three year maturity, it was purchased within the three month requirement to meet the definition of a cash equivalent.]
  - d. Treasury note purchased three years ago with remaining maturity of two months. [This answer is correct. To qualify as a cash equivalent, an investment must mature three months or less from the date it was purchased. Even though this investment is going to mature within the three months, it was not purchased within the three months.]**
7. Katy Kay donates \$5,000 to KittyOrg on June 30, 20X0 with the stipulation that the donation must be maintained in perpetuity. KittyOrg has a fiscal year end of June 30. Where will the \$5,000 be included? **(Page 250)**
- a. Reflected in net cash flows from operating activities. [This answer is not correct. The cash received is permanently restricted for investment in endowment, so it can't be considered cash flow from operating activities.]
  - b. Reflected as a source of cash flows from financing activities. [This answer is correct. It would be titled "Collections of contributions restricted for investment in endowment". A corresponding amount would be shown as a use of cash flows from investing activities such as "Purchase of assets restricted for investment in endowment". This transaction nets no change in cash and cash equivalents for the period.]**
  - c. Included in "Cash and cash equivalents at end of period". [This answer is not correct. Because the cash has donor-imposed restrictions, it can not be aggregated with cash that is available for current use.]
  - d. As an adjustment in the reconciliation of the change in net assets to net cash used or provided by financing activities. [This answer is not correct. The adjustment would not be to net cash used or provided by *financing* activities, but to net cash used or provided by *operating* activities.]
8. In which example shown below is reporting net cash flows permitted? **(Page 254)**
- a. Cash received from selling a certificate of deposit. [This answer is correct. Although netting in this situation is not required since it can create an unnecessary record keeping burden, it is permitted.]**
  - b. Cash paid out as a loan. [This answer is not correct. Gross cash flows from loans made and collections on loans are required to be reported, rather than the net change in loans receivable.]
  - c. Cash paid for an office building. [This answer is not correct. Cash payments for capital expenditures are required to be reported as gross cash flows rather than net amounts because the gross disbursement is more relevant than the net amount.]

## STYLE AND FORM 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 it is anticipated that most preparers will follow the ending cash format (as shown in a following paragraph), they may revise the format of the statement to begin with "Cash at beginning of year."

Since fund accounting is not prohibited, some nonprofit organizations may decide to continue presenting disaggregated fund information in the statement of financial position and statement of activities. In that situation, it is believed that the nonprofit organization may elect to display disaggregated fund information in the statement of cash flows, similar to the other financial statements, or it may elect to aggregate all of the fund information and present a single-column statement of cash flows. Note, however, that for many nonprofit organizations, the financial statements most informative to their users are believed to be those that do not use fund accounting.

### Title

Although GAAP does not specify a title for statements of cash flows, the title, "statement of cash flows," is recommended.

**Specialized Titles.** Some situations require a specialized title. For example, a statement of cash flows presented on a comprehensive basis of accounting other than GAAP must have a different title to distinguish it from a GAAP presentation. Example statement titles for those presentations are presented in Exhibit Exhibit 2-1. (However, nonprofit organizations that present financial statements on a basis of accounting other than GAAP are not required to present a statement of cash flows.)

**Heading.** In addition to the statement title, the heading of the statement of cash flows should include the legal name of the organization and the period or periods for which the statement is presented. For example, a comparative presentation might be headed as follows:

ABC ORGANIZATION  
STATEMENTS OF CASH FLOWS  
Years Ended December 31, 20X7 and 20X6

### 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. One preference is to follow the format used in the illustrations included in FASB ASC 230-10-55 (formerly SFAS No. 95) 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 commercial enterprises and are used in the illustrative statements of cash flows in FASB ASC 230-10-55 (formerly Appendix to SFAS No. 95). 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, this lesson uses both “Change in net assets” and “Increase (decrease) in net assets” because the related statement of activities may use either. Finally, the caption “Net increase (decrease) in cash” is used to identify the 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.

	<u>20X7</u>	<u>20X6</u>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
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	<u>(5,000)</u>	<u>(3,500)</u>
<b>NET CASH PROVIDED (USED)         BY OPERATING ACTIVITIES</b>	<b>(28,600)</b>	<b>32,050</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
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	<u>1,800</u>	<u>4,000</u>
<b>NET CASH PROVIDED (USED)         BY INVESTING ACTIVITIES</b>	<b>10,800</b>	<b>(4,700)</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Reduction of long-term debt	(9,500)	(19,000)
Long-term borrowings	7,500	—
Collections of contributions restricted for investment in endowment	<u>5,000</u>	<u>3,500</u>
<b>NET CASH PROVIDED (USED)         BY FINANCING ACTIVITIES</b>	<b>3,000</b>	<b>(15,500)</b>
<b>NET INCREASE (DECREASE) IN CASH</b>	<b>(14,800)</b>	<b>11,850</b>
<b>CASH AT BEGINNING OF YEAR</b>	<b>39,150</b>	<b>27,300</b>
<b>CASH AT END OF YEAR</b>	<b><u>\$ 24,350</u></b>	<b><u>\$ 39,150</u></b>

When comparative statements are presented, grouping immaterial items under an "Other" caption is recommended, 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 the recommendations for handling those types of reclassifications. Note, however, that reclassifications between temporarily restricted net assets and unrestricted net assets 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. Also the reclassification need not be shown in the schedule summarizing noncash investing and financing transactions because the 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.

9. Amy Ames is preparing comparative financial statements including the statement of cash flows for BluesBrothersOrg at the end of the reporting period. She has made the decision not to use fund accounting on those statements. Which of the following is the best reason for that decision?
  - a. Fund accounting does not provide the most information to the users of the financial statements.
  - b. The use of fund accounting is prohibited for nonprofit organizations.
  - c. Amy made a poor decision because SFAS No. 95 requires fund accounting for nonprofit organizations.
  - d. When presenting comparative financial statements, fund accounting is not allowed.
  
10. Sally Ann discovers a material error in the prior year's financial statements while preparing current year financial statements. A demand note was classified as long-term last year. Sally discovers it is callable at the option of the creditor which means it should have been classified as a current liability. What is the correct course of action for Sally Ann to take?
  - a. Restate prior-period statement of cash flows and disclose in notes to financial statements.
  - b. It should be classified as cash flows from short-term borrowings in the current period.
  - c. Disclose the reclassification in the notes to the financial statements, and do not restate prior period financial statements.

**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. Amy Ames is preparing comparative financial statements including the statement of cash flows for BluesBrothersOrg at the end of the reporting period. She has made the decision not to use fund accounting on those statements. Which of the following is the best reason for that decision? **(Page 257)**
- a. **Fund accounting does not provide the most information to the users of the financial statements. [This answer is correct. Many accountants believe that the most informative financial statements for many nonprofit organizations are those that do not use fund accounting.]**
  - b. The use of fund accounting is prohibited for nonprofit organizations. [This answer is not correct. The opposite is true. Fund accounting is not prohibited. If a nonprofit organization presents disaggregated fund information in the statement of financial position and statement of activities, the organization may elect to display disaggregated fund information in the statement of cash flows.]
  - c. Amy made a poor decision because fund accounting for nonprofit organizations is required. [This answer is not correct. FASB ASC 958 does not speak to whether nonprofits can use fund accounting.]
  - d. When presenting comparative financial statements, fund accounting is not allowed. [This answer is not correct. There is no rule linking comparative financial statements with allowing or prohibiting the use of fund accounting.]
10. Sally Ann discovers a material error in the prior year's financial statements while preparing current year financial statements. A demand note was classified as long-term last year. Sally discovers it is callable at the option of the creditor which means it should have been classified as a current liability. What is the correct course of action for Sally Ann to take? **(Page 259)**
- a. **Restate prior-period statement of cash flows and disclose in notes to financial statements. [This answer is correct. Reclassifications made to correct errors in prior years require prior-period financial statements presented for comparative purposes to be restated. The statement of cash flows, as originally stated, would have shown cash flows from long-term borrowings. Restating prior year will show cash flows from short-term borrowings. A disclosure is needed to the notes since the reclassification is material.]**
  - b. It should be classified as cash flows from short-term borrowings in the current period. [This answer is incorrect. The original statement of cash flows would have presented it as cash flows from long-term borrowing and the restated financial statements for that period would show it as cash flows from short-term borrowings, but not in the current period.]
  - c. Disclose the reclassification in the notes to the financial statements, and do not restate prior period financial statements. [This answer is not correct. This is the proper treatment if this reclassification was due to a changed condition. A different course of action is required for a classification error.]

## OPERATING ACTIVITIES AND ASSOCIATED CASH FLOWS

### What Is Included?

FASB ASC 230-10-20 (formerly SFAS No. 95) 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 2-1 lists some typical examples of cash flows from operating activities.)

Cash payments to settle an asset retirement obligation have traits of more than one class of cash flows. However, FASB ASC 230-10-45-17 (formerly EITF Issue No. 02-6) states that these payments should be classified as an operating activity in the statement of cash flows.

The AICPA Technical Practice Aid at TIS 5600.17 further states that the cash allowances from the lessor are treated for accounting purposes as adjustments of rent.

### 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 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 entities, 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 permanent 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, the following categories of cash receipts and cash payments should be presented:

- Cash collected from customers, 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.
- Cash paid to grant recipients.
- Interest paid (net of amounts capitalized).
- Unrelated business income taxes or excise taxes paid, if any.
- Other operating cash payments, 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)
		(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. An illustration of a reconciliation of the change in net assets to operating cash flows is presented later in this lesson.

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.
- 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 flows 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 if the indirect presentation were used.

Preparers generally find that it takes more time to prepare a statement using the direct method than using the indirect method. 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. 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 and net unrealized and realized gains on investments and (b) changes during the period in operating assets and liabilities, such as receivables and inventories. The reconciliation should show all major classes of operating items, including, at a minimum, changes in receivables and payables related to operating activities and changes in inventories. Although FASB ASC 230-10-45-29 (formerly SFAS No. 95) 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 arise from investing or financing activities (e.g., short-term loans or notes receivable or payable not related to operating activities) should be shown as investing or financing activities, as appropriate. In addition, accounts payable may have aspects of financing or investing activities (e.g., equipment purchased on account). In those cases, it would not be appropriate to include the net change in payables arising from the financing or investing activity as an adjustment in arriving 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*, not unrestricted net assets or operating assets. The change in net assets includes the change in permanently restricted, temporarily restricted, and unrestricted net assets. 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
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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	<u>(85,800)</u>
NET CASH PROVIDED BY OPERATING ACTIVITIES	<u>\$ 12,350</u>

Regardless of whether the direct or indirect method is used, interest and income taxes, including unrelated business income taxes and excise taxes, paid, if any, are required to be disclosed. 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 (formerly SFAS No. 95) 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. Therefore, it is believed 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 (formerly SFAS No. 34) 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. It is believed 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 believed to be 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.

The indirect method is believed to be the predominant method used in practice because it is generally easier and takes less time to prepare a statement of cash flows using the indirect method.

**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 AICPA issued a technical practice aid providing guidance in that area. According to TIS 1300.20, 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.



**SELF-STUDY QUIZ**

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

11. While preparing the year end financial statements for BullyDogOrg, Beatrice Bean, the controller, considered each of the following transactions. Which one will Beatrice need to include in the Cash Flows from Operating Activities section of the statement of cash flows?
  - a. \$5,000 contribution received to be used to purchase a new building.
  - b. \$5,000 payment to purchase office equipment.
  - c. \$5,000 payment made to settle an asset retirement obligation.
  - d. \$5,000 dividend received from a donor-restricted donation.
  
12. Cindy Lou has made her decision to use the indirect method in preparing the statement of cash flows for WhoOrg. Which of the following is an advantage to using this method over the direct method?
  - a. Less time and easier to prepare.
  - b. The information for the indirect method is easily obtained.
  - c. More useful for making decisions.
  - d. Don't have to show noncash items.
  
13. FASB ASC 230 requires disclosure of interest paid regardless of whether the direct or indirect method is used. Based on the following facts, calculate the amount of interest paid to be disclosed.

Interest Payments	\$ 75,000
Capitalized Interest for inventory	\$ 10,000
Capitalized Interest for equipment	\$ 30,000

- a. \$45,000 should be disclosed as interest paid.
- b. \$75,000 should be disclosed as interest paid.
- c. \$35,000 should be disclosed as interest paid.
- d. \$45,000 should be disclosed as interest paid and \$40,000 should be disclosed as interest payments capitalized.

**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.)**

11. While preparing the year end financial statements for BullyDogOrg, Beatrice Bean, the controller, considered each of the following transactions. Which one will Beatrice need to include in the Cash Flows from Operating Activities section of the statement of cash flows? **(Page 263)**
- \$5,000 contribution received to be used to purchase a new building. [This answer is not correct. Contributions restricted for long-term purposes such as for the purchase of a building in cash flows from financing activities is included in the definition of cash flows from financing activities for nonprofit entities, as stated in FASB ASC 958-230-55-3.]
  - \$5,000 payment to purchase office equipment. [This answer is not correct. This payment is derived from an investing activity as the equipment will produce revenue over a long period of time and would be excluded from cash flows from operating activities.]
  - \$5,000 payment made to settle an asset retirement obligation [This answer is correct. FASB ASC 230-10-45-17 (formerly EITF Issue No. 02-6) acknowledges that these payments should be classified as operating activities even though the payments have traits of more than one class of cash flows.]**
  - \$5,000 dividend received from a donor-restricted donation. [This answer is not correct. According to FASB ASC 958-230-55-3, contributions, dividends, and interest received from donors who have restricted the contribution for a long-term purpose is not a part of operating cash receipts, but are considered financing activities.]
12. Cindy Lou has made her decision to use the indirect method in preparing the statement of cash flows for WhoOrg. Which of the following is an advantage to using this method over the direct method? **(Page 267)**
- Less time and easier to prepare. [This answer is correct. Predominantly, the indirect method is used in the preparation of the statement of cash flows because preparers generally find that it takes more time to prepare a statement using the direct method than using the indirect method. 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 directed and indirectly.]**
  - The information for the indirect method is easily obtained. [This answer is incorrect. Information required for the direct method is readily available or can be obtained without significant cost. This is an advantage of the direct method, not the indirect method.]
  - More useful for making decisions. [This answer is not correct. This is an advantage of the direct method. Management may find the relationship of specific cash receipts and payments to cash flows from operating activities more useful for purposes of making decisions. The indirect presentation is often considered too cluttered and cumbersome for easy analysis.]
  - Don't have to show noncash items. [This answer is not correct. Noncash items are shown as adjustments to the change in net assets using the indirect method.]
13. FASB ASC 230 requires disclosure of interest paid regardless of whether the direct or indirect method is used. Based on the following facts, calculate the amount of interest paid to be disclosed. **(Page 266)**

Interest Payments	\$ 75,000
Capitalized Interest for inventory	\$ 10,000
Capitalized Interest for equipment	\$ 30,000

- a. **\$45,000 should be disclosed as interest paid. [This answer is correct. FASB ASC 230-10-50-2 requires disclosure of interest paid net of amounts capitalized for plant or equipment. Interest capitalized for inventory does not need to be included. Therefore \$75,000 less \$30,000 = \$45,000.]**
- b. \$75,000 should be disclosed as interest paid. [This answer is not correct. FASB ASC 230-10-50-2 requires capitalized interest to be considered in the amount of the disclosure, but the amount disclosed should reflect the operating cash flows.]
- c. \$35,000 should be disclosed as interest paid. [This answer is not correct. Total interest payments should not be reduced by capitalized interest on inventory because that interest would be included in operating cash flow.]
- d. \$45,000 should be disclosed as interest paid and \$40,000 should be disclosed as interest payments capitalized. [This answer is not correct. Disclosing the amount of interest payments capitalized is not required by FASB ASC 230-10-50-2.]

## Agency or Custodial Funds

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, the cash effects of agency transactions *are* considered to be operating activities. Agency transactions may be reported gross or 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. 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 3.25, notes that organizations that have a primary mission component of receiving resources as agents should consider placing the statement of cash flows as the first statement in their financial statements to emphasize the information about agency transactions.

## Extraordinary Items, Cumulative Accounting Adjustments, and Discontinued Operations

GAAP does not require extraordinary items, cumulative accounting adjustments, or discontinued operations to be separately disclosed in statements of cash flows. Thus, the criteria for classifying transactions and events as operating, investing, or financing also would apply to extraordinary items, cumulative accounting adjustments, and discontinued operations. Specific recommendations are presented in the following paragraphs.

**Noncash Extraordinary Items.** Extraordinary items generally consist of gains or losses or write-offs of assets and, thus, are noncash items. Because GAAP does not require extraordinary items to be separately identified in the statement of cash flows, the recommendation is that they be treated in the same manner as other noncash items. Under the direct method of reporting cash flows from operating activities, the approach is simple; since cash flows from operating activities consist only of cash receipts and payments, noncash extraordinary items would be excluded. Under the indirect method, however, the change in net assets should be adjusted to arrive at the cash effects of operating activities by adding the noncash elements of extraordinary losses and subtracting the noncash elements of extraordinary gains to and from the change in net assets. To illustrate, assume that a nonprofit organization is located in an area of the United States where a hurricane would meet the criteria for being an extraordinary item. Also assume that the nonprofit organization's statement of activities included the following amounts:

INCREASE IN UNRESTRICTED NET ASSETS		
BEFORE EXTRAORDINARY ITEM	\$	35,000
EXTRAORDINARY ITEM—undepreciated cost of building destroyed by hurricane		(83,000)
DECREASE IN UNRESTRICTED NET ASSETS		(48,000)

To simplify the illustration, assume the following additional facts:

- a. No depreciation was recorded in the current year because the building was destroyed at the beginning of the year.
- b. The building was not insured, and, accordingly, the noncash element of the transaction is its undepreciated cost.
- c. The nonprofit organization owes no unrelated business income taxes related to the use of the building.

- d. Increase in unrestricted net assets before extraordinary item in the amount of \$35,000 has been received in cash. Similarly, increases of \$10,000 and \$4,000 in temporarily restricted and permanently restricted net assets, respectively, were also received in cash for the same period.

Cash flows from operating activities would be presented as follows:

<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>	
Change in net assets	\$ (34,000)
Adjustment to reconcile change in net assets to net cash provided by operating activities:	
Undepreciated cost of building destroyed by hurricane	83,000
<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>	<b>49,000</b>

If an extraordinary item affects both operating assets (e.g., inventories) and other nonoperating assets (e.g., buildings), it is believed that the noncash effects related to the operating assets are required to be shown separately from the change in those assets resulting from operating cash receipts and payments. Thus, the noncash effects of the extraordinary item generally would be shown as a single amount. [FASB ASC 230-10-55-1 (formerly SFAS No. 95, Paragraph 115, footnote 17) indicates that the effects of all noncash entries to accounts receivable and payable, inventories, and other operating assets and liabilities should be presented separately from the change in those operating balance sheet (statement of financial position) accounts that is attributable to cash receipts and payments.] To illustrate, assume the same facts as the preceding illustration except that the hurricane loss consisted of a \$12,000 loss of inventory and a \$40,000 write-off of the undepreciated cost of a warehouse that was destroyed. It is believed that cash flows from operating activities should be presented in a manner similar to that illustrated in the previous paragraph, using a caption such as “Inventory and undepreciated cost of building destroyed by hurricane.” In other words, the decrease in inventory in the amount of \$12,000 would be included in the noncash adjustment for the hurricane loss and generally would not be included with the change in inventory resulting from purchases and sales. If the noncash effects attributable to operating assets are material, GAAP is not believed to permit combining the noncash effects with the change attributable to operating cash receipts and payments, and a *presentation such as the following would not be acceptable:*

<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>	
Change in net assets	\$ (3,000)
Adjustment to reconcile change in net assets to net cash provided by operating activities:	
Undepreciated cost of warehouse destroyed by hurricane	40,000
Decrease in inventory	12,000
<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>	<b>49,000</b>

If a nonprofit organization experiences both an extraordinary loss and an ordinary loss, the noncash effects of the losses could be shown as a single amount in the statement of cash flows. For example, an extraordinary loss of property and equipment and a loss of property and equipment that was not extraordinary could be reported as a single line item with a caption such as “Undepreciated cost of property and equipment destroyed.”

**Extraordinary Items—Cash.** Although extraordinary items are not required to be disclosed in statements of cash flows, as explained previously, cash flows related to extraordinary items should be appropriately classified as operating, investing, or financing activities. Thus, for example, cash payments to settle a lawsuit probably would be classified as an operating activity, while cash paid to extinguish debt probably would be classified as a financing activity. To illustrate, assume that a nonprofit organization’s creditors agreed to accept \$100,000 in settlement of debt in the amount of \$130,000 and the debt extinguishment met the FASB

ASC 225-20-45-2 (formerly APB Opinion No. 30) criteria for classification as an extraordinary item. The nonprofit organization reported the transaction in its statement of activities as follows:

INCREASE IN UNRESTRICTED NET ASSETS BEFORE EXTRAORDINARY ITEM	140,000
EXTRAORDINARY ITEM—gain on extinguishment of debt	<u>30,000</u>
INCREASE IN UNRESTRICTED NET ASSETS	170,000

Assuming that the increase in unrestricted net assets before extraordinary item in the amount of \$140,000 had been received in cash and that there were no other transactions, including no changes in temporarily restricted or permanently restricted net assets, the nonprofit organization's statement of cash flows under the indirect method would be presented as follows:

CASH FLOWS FROM OPERATING ACTIVITIES	
Change in net assets	\$ 170,000
Adjustment to reconcile change in net assets to net cash provided by operating activities:	
Gain on extinguishment of debt	<u>(30,000)</u>
NET CASH PROVIDED BY OPERATING ACTIVITIES	140,000
CASH FLOWS FROM FINANCING ACTIVITIES	
Cash paid to extinguish debt	<u>(100,000)</u>
NET INCREASE IN CASH	40,000
CASH AT BEGINNING OF YEAR	<u>—</u>
CASH AT END OF YEAR	<u>\$ 40,000</u>

Under the direct method, only the cash actually received or paid would be reflected in the statement of cash flows. Using the preceding example and assuming that cash flows from operating activities resulted entirely from cash received from contributors net of cash paid to employees and suppliers, the statement of cash flows using the direct method would be presented as follows:

CASH FLOWS FROM OPERATING ACTIVITIES	
Cash received from contributors	\$ 225,000
Cash paid to employees and suppliers	<u>(85,000)</u>
NET CASH PROVIDED BY OPERATING ACTIVITIES	140,000
CASH FLOWS FROM FINANCING ACTIVITIES	
Cash paid to extinguish debt	<u>(100,000)</u>
NET INCREASE IN CASH	40,000
CASH AT BEGINNING OF YEAR	<u>—</u>
CASH AT END OF YEAR	<u>\$ 40,000</u>

**Cumulative Accounting Adjustments.** Like most extraordinary items, most cumulative accounting adjustments are noncash items. Accordingly, under the direct method of reporting cash flows from operating activities, which only presents cash receipts and payments, noncash 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 operating activities by adding the noncash elements of expense amounts to, and subtracting the noncash elements of revenue amounts from, the change in net assets. FASB ASC 250-10-45-5 (formerly SFAS No. 154, *Accounting Changes and Error Corrections*) generally requires retrospective application of the change in accounting principle. Retrospective application does not apply when

a new accounting pronouncement includes specific transition provisions, such as a requirement to reflect adoption of the new pronouncement through a cumulative accounting adjustment. FASB ASC 825-10 (formerly SFAS No. 159, par. 25) is an example of one pronouncement, however, that requires adoption through a cumulative effect adjustment that is reported in the statement of activities. Accordingly, the following example illustrates a cumulative accounting adjustment that has been reported in a nonprofit organization's statement of activities.

Assume that a nonprofit organization will report the effect of its adoption of a new accounting pronouncement, in accordance with the transition provisions of that new pronouncement, as a cumulative effect of a change in accounting principle in its statement of activities, and that statement includes the following:

	CHANGE IN UNRESTRICTED NET ASSETS BEFORE CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE	55,000
Cumulative effect of adopting new accounting principle		<u>8,000</u>
	CHANGE IN UNRESTRICTED NET ASSETS CHANGE IN PERMANENTLY RESTRICTED NET ASSETS BEFORE CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE	63,000 14,000
Cumulative effect of adopting new accounting principle		<u>26,000</u>
	CHANGE IN PERMANENTLY RESTRICTED NET ASSETS	40,000

FASB ASC 825-10 (formerly SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*) provides entities an election to use fair value measurement for certain financial assets and liabilities upon their initial recognition or events that give rise to new-basis accounting.

Similar to extraordinary items, GAAP does not require cumulative accounting adjustments to be presented separately in the statement of cash flows. Accordingly, it is recommended that the adjustment be classified according to the nature of the change. In this case, assume that the nature of the cumulative accounting adjustment relates to unrealized gains or losses, which is an existing adjustment to the change in net assets under the indirect method. As a result, the total amount of the cumulative effect of adopting the new accounting principle of \$34,000 would be combined with total unrealized gains and reported as a single adjustment on the statement of cash flows. Assuming that unrealized gains for the period totaled \$10,000 and that there were no other transactions that would require a reconciling adjustment in the statement of cash flows, 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:	
Unrealized gains on investments	<u>(44,000 )</u>
NET CASH PROVIDED BY OPERATING ACTIVITIES	59,000

Cumulative effect adjustments that affect operating assets and liabilities are rare. It is believed that GAAP requires the noncash effects of the cumulative adjustment to be shown separately from the change in the operating asset or liability attributable to operating cash receipts and payments.

**Discontinued Operations.** Experience shows, discontinued operations of nonprofit organizations are uncommon. However, they could occur, for example, if a for-profit subsidiary was sold or an entire component of a nonprofit organization's activities was abandoned or sold. As a result, the treatment of discontinued operations in the statement of cash flows is discussed in the following paragraphs.

GAAP does not require net operating cash flows from discontinued operations to be reported separately as a single line item within the operating activities section of the statement of cash flows. However, that information could be disclosed in the statement itself or in a separate schedule if it was considered relevant. (Because discontinued operations of a component of an entity 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.)

If the operating cash flows of discontinued operations are reported separately, cash flows of discontinued operations should be presented separately, for all periods affected, which may include periods long after sale or liquidation of the operation. Assuming the disposal of a component of a nonprofit organization, an example of cash flows from operating activities classified by continuing and discontinued operations is as follows:

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	<u>7,250</u>
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	<u>5,800</u>
NET CASH USED BY DISCONTINUED OPERATIONS	<u>(10,000)</u>
NET CASH PROVIDED BY OPERATING ACTIVITIES	53,100

Although not required, cash flows from investing and financing activities may be allocated to continuing and discontinued operations if that information is relevant. The information may be presented (a) in a separate schedule, (b) on the face of the statement of cash flows under captions such as "Continuing operations" and "Discontinued operations," or (c) on the face of the statement of cash flows identified by a caption such as "Proceeds from disposal of property and equipment—discontinued operations."

**SELF-STUDY QUIZ**

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

14. Lonnie Looker is considering how best to report the agency transactions paid to his nonprofit organization, SeeMeRunOrg. Consider each scenario below and choose the one that FASB ASC 230 would support and would be recommended by best practices.
  - a. Because SeeMeRunOrg receives significant resources from agency transactions and Lonnie wants fund-raising efforts to show, Lonnie chooses to use the indirect method.
  - b. Lonnie, using the indirect method, nets the cash inflows and outflows and reports them under one caption.
  - c. Lonnie, using the direct method, reports only the changes in the assets and corresponding liabilities under one caption.
  - d. Lonnie reports only the net changes in the agency transactions.
  
15. ColoradosBestOrg (CBO) experienced an extraordinary item this fiscal year. An agreement was made with one of CBO's creditors to extinguish an outstanding debt of \$260,000 for a \$200,000 cash payment. The debt extinguishment met all of the FASB ASC 225-20-45-2 criteria to be classified as an extraordinary item. CBO's increase in unrestricted net assets before extraordinary item is \$280,000 cash. There are no other transactions, including no changes in temporarily restricted or permanently restricted net assets, If CBO uses the direct method to prepare their statement of cash flows, what would the statement look like?
  - a. Only the cash paid of \$200,000 would be reflected in the statement of cash flows.
  - b. An adjustment of \$60,000 would be made to change in net assets, and \$200,000 would be listed under "Cash Flows from Financing Activities."
  - c. Only the adjustment of \$60,000 would be made to change in net assets.
  - d. An adjustment of \$60,000 would be made to change in net assets, and \$200,000 would be listed under "Cash Flows from Investing Activities."
  
16. BlessingsOrg must report the effect of its adoption of a new accounting principle as it relates to unrealized gains. BlessingsOrg uses the indirect method to prepare their statement of cash flows. What is the proper treatment of the cumulative accounting adjustment?
  - a. Due to the requirements of GAAP, BlessingsOrg presents the cumulative accounting adjustment separately in the statement of cash flows.
  - b. BlessingsOrg should combine the total cumulative effect of adopting the new accounting principle with total unrealized gains and report it as a single adjustment on the statement of cash flows.
  - c. Because BlessingsOrg uses the indirect method of reporting cash flows from operating activities, cumulative accounting adjustments would be excluded.

**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. Lonnie Looker is considering how best to report the agency transactions paid to his nonprofit organization, SeeMeRunOrg. Consider each scenario below and choose the one that FASB ASC 230 would support and would be recommended by best practices. **(Page 272)**
- Because SeeMeRunOrg receives significant resources from agency transactions and Lonnie wants fund-raising efforts to show, Lonnie chooses to use the indirect method. [This answer is not correct. To more completely reflect fund-raising results, the direct method should be used. If the indirect method is used, cash received from agency transactions would not be reported so the fund-raising efforts would not be visible.]
  - Lonnie, using the indirect method, nets the cash inflows and outflows and reports them under one caption. [This answer is not correct. This describes the direct method of reporting. As an alternative, under the direct method, they could be reported gross as separate cash outflows and cash inflows.]
  - Lonnie, using the direct method, reports only the changes in the assets and corresponding liabilities under one caption. [This answer is not correct. This describes the indirect method of reporting.]
  - Lonnie reports only the net changes in the agency transactions. [This answer is correct. 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, agency transactions may be reported gross or net in the statement of cash flows.]**
15. ColoradosBestOrg (CBO) experienced an extraordinary item this fiscal year. An agreement was made with one of CBO's creditors to extinguish an outstanding debt of \$260,000 for a \$200,000 cash payment. The debt extinguishment met all of the FASB ASC 225-20-45-2 criteria to be classified as an extraordinary item. CBO's increase in unrestricted net assets before extraordinary item is \$280,000 cash. There are no other transactions, including no changes in temporarily restricted or permanently restricted net assets. If CBO uses the direct method to prepare their statement of cash flows, what would the statement look like? **(Page 274)**
- Only the cash paid of \$200,000 would be reflected in the statement of cash flows. [This answer is correct. According to FASB ASC 230, under the direct method, only cash actually received or paid is reflected in the statement of cash flows.]**
  - An adjustment of \$60,000 would be made to change in net assets, and \$200,000 would be listed under "Cash Flows from Financing Activities." [This answer is not correct. This would be the correct presentation if CBO was using the indirect method.]
  - Only the adjustment of \$60,000 would be made to change in net assets. [This answer is not correct. Under the direct method, the cash paid to extinguish the debt will have to be presented in the cash flow statement.]
  - An adjustment of \$60,000 would be made to change in net assets, and \$200,000 would be listed under "Cash Flows from Investing Activities." [This answer is not correct. Extinguishing an outstanding debt is not an investment activity, but would be listed in the financing activities.]
16. BlessingsOrg must report the effect of its adoption of a new accounting principle as it relates to unrealized gains. BlessingsOrg uses the indirect method to prepare their statement of cash flows. What is the proper treatment of the cumulative accounting adjustment? **(Page 275)**
- Due to the requirements of GAAP, BlessingsOrg presents the cumulative accounting adjustment separately in the statement of cash flows. [This answer is not correct. GAAP does *not* require separate presentation of the cumulative accounting adjustment in the statement of cash flows.]

- b. BlessingsOrg should combine the total cumulative effect of adopting the new accounting principle with total unrealized gains and report it as a single adjustment on the statement of cash flows. [This answer is correct. Classifying the cumulative accounting adjustment according to the nature of the change is the recommended approach detailed in FASB ASC 825-10.]**
- c. Because BlessingsOrg uses the indirect method of reporting cash flows from operating activities, cumulative accounting adjustments would be excluded. [This answer is not correct. If the *direct* method of reporting cash flows from operating activities was used, the cumulative accounting adjustment would be excluded because the direct method only presents cash receipts and payments.]

## 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 from operating activities. 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. When the direct method is used, the following items should be excluded from 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.)

**Operating Assets and Liabilities.** Noncash entries to 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 or liability is recording a provision for uncollectible promises to give and recognizing a decrease in the amount of cash expected to be received. To illustrate, assume that a nonprofit organization's activities related to promises to give, not restricted for long-term purposes, are summarized as follows:

	Promises Receivable	Allowance for Uncollectible Promises
Balance 1/1/X6	\$ 50,000	\$ 10,000
Promises received	300,000	—
Cash collected	(250,000)	—
Provision for uncollectible promises to give	—	25,000
Write-offs	<u>(20,000)</u>	<u>(20,000)</u>
Balance 12/31/X6	<u>\$ 80,000</u>	<u>\$ 15,000</u>

Assuming a \$50,000 increase in net assets, the operating activities section of the statement of cash flows would be presented as follows:

<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>	
Increase in net assets	\$ 50,000
Adjustments to reconcile increase in net assets to net cash provided by operating activities:	
Provision for uncollectible promises to give	25,000
Increase in promises receivable	<u>(50,000)</u>
<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>	<b>25,000</b>

The increase in promises receivable is calculated as the difference between net promises 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 provision for uncollectible promises to give already identified, resulting in an increase of \$50,000. If noncash entries are not material, it is appropriate to present only the net change in operating assets and liabilities.

**Provision for Uncollectible Promises to Give.** The example just presented assumes that 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 *not* considered operating assets and, as a result, it is believed any related provision that may be required for a decrease in the amounts expected to be collected should be considered a noncash financing transaction. Under the indirect method, the provision would be deducted from the change in net assets to arrive at cash flows from operating activities. No additional disclosure in a supplemental schedule or notes to the financial statements should be necessary in that case. Under the direct method, the provision would be excluded

from 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. Therefore, the provision would be reflected as a reconciling item, and it is believed that additional disclosure in a supplemental schedule or notes to the financial statements is also unnecessary.

It is also believed that to clearly identify noncash financing transactions, any provision for uncollectible promises to give reflected on the statement of cash flows should be segregated between amounts relating to unconditional promises to give that are restricted for long-term purposes and other unconditional promises to give.

**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 measure fair value, the organization recognizes the amortization of the associated discount in the statement of activities, and the only cash effects of the transaction are 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 transactions. Consequently, it is believed amortization of the discount on such promises to give also should be considered a noncash financing transaction. Under the direct method, the amortization of the discount would be excluded from cash flows from operating activities, but would be reflected as an adjustment to reconcile changes in net assets to cash flows from operating activities. Accordingly, additional disclosure in a supplemental schedule or notes to the financial statements unnecessary. Similarly, under the indirect method, the amortization must be deducted from the change in net assets to arrive at cash flows from operating activities. Again, additional disclosure in a supplemental schedule or notes to the financial statements is believed to be unnecessary.

Amortization relating to unconditional promises to give that are *not* restricted for long-term purposes would represent an operating activity, not a financing activity. Therefore, it is believed that to clearly identify noncash financing transactions, any amortization reflected on the statement of cash flows should be segregated between amounts relating to unconditional promises to give that are restricted for long-term purposes (considered noncash financing transactions) and other unconditional promises to give (considered operating transactions).

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.

	Promises Receivable Restricted for Long-term Purposes	Other Promises Receivable
	<u>                    </u>	<u>                    </u>
Balance 1/1/X6	\$ 115,000	\$ 94,000
Promises received, at present value	240,000	165,000
Amortization of discount	21,000	14,500
Cash collected	<u>(184,000)</u>	<u>(129,000)</u>
Balance 12/31/X6	<u>\$ 192,000</u>	<u>\$ 144,500</u>

Assuming a \$350,000 increase in net assets, the operating activities section of the statement of cash flows would be presented as follows:

<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>	
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)
<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>	<b>38,500</b>

**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 change. Some examples of intangible assets are goodwill, copyrights, franchises, licenses, trademarks, formulas, mailing lists, and film rights. Experience indicates that those types of items are uncommon on the statement of financial position of a nonprofit organization. However, a nonprofit organization might purchase a mailing list or copyright, and, as a result, it would have an intangible asset that would require amortization and treatment in the statement of cash flows as described. The amortization or impairment of intangible assets and deferred charges do not use cash, and 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.

Recognition of goodwill in an acquisition by a nonprofit organization after the effective date of FASB ASC 958-805 (formerly SFAS No. 164) depends on whether or not 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. *Predominantly supported* by means that the amount of contribution revenue and investment return is significantly more than the total amount of revenue from all other sources. If the total of all other sources of revenue (for example, fees, tuition, or other earned revenue) is expected to be significantly greater than contributions and investment returns, goodwill should be recognized at the acquisition date. 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 amount that would otherwise be recorded as goodwill should be recognized as a separate charge in the statement of activities. That charge does not use cash, and the amount recognized should be added back to the change in net assets to arrive at cash flows provided by operating activities.

**Cash Value of Life Insurance.** Similar to intangible assets and deferred charges, nonprofit organizations rarely own the cash value of life insurance of key employees. 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. 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. However, the primary reason for life insurance is believed to be the reduction of the risk of decreases in net assets resulting from the death of a key employee. Consistent with the requirement of FASB ASC 230-10-45-22 (formerly Paragraph 24 of SFAS No. 95) to classify a transaction based on the nature of the activity that is likely to be predominate, it is believed that all life insurance transactions should be classified as operating activities. The following is an example of the operating activities section of the statement of cash flows in those circumstances.

<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>	
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)
<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>	<b>36,000</b>

Increases in cash value that are used to reduce payments of insurance premiums (instead of accumulating) reduce a liability (for premium obligations) rather than increase an asset (cash value of life insurance). In that case, the guidance in the paragraph titled “Operating Assets and Liabilities” applies. In most circumstances, the noncash aspects of the change in accounts payable is believed to be attributable to the increase in cash value would not be material. Accordingly, the adjustment to the change in net assets would be included in the net change in accounts payable, and the increase in cash value would not be disclosed as a separate item.

Loans against the cash value of life insurance policies are discussed later in this lesson.

**Restricted Contributions and Investment Income.** Contributions and investment income that are donor-restricted for long-term purposes are considered financing transactions, not operating transactions. Accordingly, when the indirect method is used, those items must be subtracted from the change in net assets to arrive at cash flows from operating activities and then, to the extent such items represent cash collections, they would be reflected as cash flows from financing activities. If restricted contributions are in the form of unconditional promises to give or if the organization received current-year payments on prior-period promises to give related to restricted contributions, 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. If the direct method is used, collections of such items would only be included in cash flows from financing activities. (However, the items would be shown in the reconciliation of change in net assets to net cash provided by operating activities.)

**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 related goods are delivered or services are performed). 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 ticket sales 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	<u>5,000</u>
NET CASH PROVIDED BY OPERATING ACTIVITIES	40,000

Deferred revenue may represent both cash collected in advance and a related accounts receivable. 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 since only supplemental disclosure of noncash *investing* and *financing* transactions is required. Under the indirect method of presenting cash flows from operating activities, cash received would be reflected as the increase in deferred revenue in excess of any related receivables.

**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 provided 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 or added back 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:

	<u>20X7</u>	<u>20X6</u>
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	<u>(35,000)</u>	<u>20,000</u>
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 or market 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 (formerly APB Opinion No. 18). 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 (formerly APB Opinion No. 18) need 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.

**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 (or market 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, such 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 under the direct method, it is believed 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 (or market 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.

<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>	
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	<u>2,500</u>
<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>	<b>—</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>	
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 previous discussions and illustration are appropriate whether the gain or loss is classified in the statement of activities as unrestricted, temporarily restricted, or permanently restricted. No distinction between the three categories of net assets is required to be made in the statement of cash flows.

**Noncontrolling (Minority) Interests [Prior to the Adoption of FASB ASC 810-50-1A (formerly SFAS No. 160)].** FASB ASC 958-810 (formerly SOP 94-3) addresses investments in majority-owned for-profit subsidiaries and related but separate nonprofit organizations. Consolidation of investments in majority-owned for-profit entities is required under most circumstances, which may give rise to noncontrolling (minority) interests. Consolidation of related nonprofit organizations meeting certain criteria is also required. Minority interests in the earnings of a nonprofit organization's consolidated subsidiaries are noncash items, which generally are reported as an expense in the consolidated statement of activities. Thus, minority interests should be added back to the consolidated change in net assets to arrive at cash flows from operating activities, as illustrated in the following example:

	<u>20X7</u>	<u>20X6</u>
CASH FLOWS FROM OPERATING ACTIVITIES		
Change in net assets	\$ 41,500	\$ (29,700)
Adjustment to reconcile change in net assets to net cash provided by operating activities:		
Minority interests in net income (loss) of consolidated for-profit subsidiaries	<u>8,300</u>	<u>(5,940)</u>
NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES	49,800	(35,640)

**Noncontrolling Interests [Based on FASB ASC 810-50-1A (formerly SFAS No. 160)].** Subsequent to the adoption of FASB ASC 810-10-50-1A (formerly ARB No. 51, Consolidated Financial Statements, Paragraph 38, as amended by SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51*), 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 noncontrolling interest. Rather, the cash flow statement begins with the consolidated change in net assets. The following example uses the prior presentation and modifies it as needed.

	<u>20X2</u>	<u>20X1</u>
CASH FLOWS FROM OPERATING ACTIVITIES		
Change in net assets	\$ 49,800	\$ (35,640)
Adjustment to reconcile change in net assets to net cash provided by operating activities:		
NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES	<u>—</u> 49,800	<u>—</u> (35,640)

FASB ASC 958-805, *Not-for-Profit Entities—Business Combinations* (formerly SFAS No. 164, *Not-for-Profit Entities: Mergers and Acquisitions*) makes the amendments to previous guidance originally introduced by SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements*, and codified in FASB ASC 810, applicable for nonprofit organizations for periods beginning on or after December 15, 2009. Early application is prohibited. Nonprofit organizations should continue to apply the guidance in FASB ASC 958-810 (formerly ARB No. 51) until the effective date of FASB ASC 958-805.

**Noncontrolling Interests—Consolidation of a Related but Separate Organization.** If consolidation of a related but separate nonprofit organization is the result of a controlling financial interest through ownership of a majority voting interest, it may also give rise to noncontrolling (minority) interests. However, minority interests will not always result from consolidations of related nonprofit organizations. If consolidation is required because an organization has an economic interest in a related nonprofit organization and controls it through a majority voting interest in its board, no minority interests are recorded. For example, assume that a reporting nonprofit organization has control of 80% of the board of another nonprofit organization and meets the conditions for consolidation under FASB ASC 958-810 (formerly SOP 94-3). In that case, the consolidated financial statements would not reflect a minority interest for the remaining 20% of the board because there is no *ownership interest* in that organization.



**SELF-STUDY QUIZ**

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

17. WhaleWatchOrg (WVO) had a balance at the beginning of the year in promises receivable of \$50,000. During the year WVO received \$300,000 in promises to give and collected \$250,000 by the end of the year. Due to unfortunate circumstances, \$20,000 had to be written off as uncollectible. The balance of the allowance for uncollectible promises was \$10,000 at the beginning of the year. A provision for uncollectible promises to give of \$25,000 has already been identified. Calculate the increase in promises receivable.
- \$45,000
  - \$50,000
  - \$55,000
  - \$80,000
18. Refer to the scenario in question #17 and assume that all of WVO's activities related to promises to give are not restricted for long-term purposes. In that case what is the proper treatment of the increase in promises receivable?
- The promises to give are considered operating assets. Present only the net change in operating assets and liabilities.
  - The decrease in the amount expected to be collected should be considered a noncash financing transaction.
  - Using the indirect method, deduct the provision from the change in net assets to arrive at cash flows from operating activities.
  - Using the direct method, exclude the provision from cash flows from operating activities, but reconcile changes in net assets to cash flows from operating activities.
19. How would a nonprofit organization report the amortization of a mailing list that it purchased and will be used over the next three years?
- The list should be expensed in the period in which it was purchased.
  - The amortization expense uses cash from the organization each period as it is expensed.
  - Amortization expense should be added back to the change in net assets to arrive at cash flows provided by operating assets.

20. Match the other adjustment to arrive at net cash flows from operating activities to the proper example and/or accounting treatment:

- |   |  |
|---|--|
| 1. Deferred Income Taxes                      | i. Cash received would be reflected as the increase in excess of any related receivables.  |
| 2. Deferred Revenue                           | ii. Add it back to the change in net assets in arriving at cash flows provided from operating activities.  |
| 3. Depreciation                               | iii. Could result from revenue producing assets that are economically useful for more than one year.   |
| 4. Disposal, Sale, and Retirement of Property | iv. Proceeds received are equal to the cash effects of the transaction.  |
|   | v. Add back to, or subtract from, the change in net assets to arrive at net cash flows from operating activities.  |
|   | vi. The change in the balance would be added to or subtracted from the change in net assets to arrive at net cash flows from operating activities.   |
|   | vii. Could result from unrealized appreciation on investment portfolios of private foundations.  |
|   | viii. Could result from receiving payment for season tickets.  |
|   | ix. Any proceeds should be shown as cash inflows from investing activities, and expenses incident to the sale should be added back to the change in net assets and shown as an investing activity. |

- a. 1 vi viii; 2 v vii; 3 iii; 4 ii iv ix
- b. 1 ii vii; 2 vi vii; 3 ii vi; 4 iii iv
- c. 1 v vii; 2 vi viii; 3 ii iii; 4 i iv
- d. 1 v vii; 2 i vi viii; 3 ii iii; 4 iv ix

## SELF-STUDY ANSWERS

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

17. WhaleWatchOrg (WWO) had a balance at the beginning of the year in promises receivable of \$50,000. During the year WWO received \$300,000 in promises to give and collected \$250,000 by the end of the year. Due to unfortunate circumstances, \$20,000 had to be written off as uncollectible. The balance of the allowance for uncollectible promises was \$10,000 at the beginning of the year. A provision for uncollectible promises to give of \$25,000 has already been identified. Calculate the increase in promises receivable. **(Page 280)**
- \$45,000 [This answer is not correct. The write-offs for the year were not considered in this calculation.]
  - \$50,000 [This answer is correct. The increase in promises receivable is equal to the difference between net promises receivable at the end of the year \$65,000 and the beginning of the year \$40,000 + the provision for uncollectible promises to give already identified of \$25,000. Calculations: Net promises at the beginning of the year = \$40,000 or \$50,000 in promises receivable – \$10,000 of allowance for uncollectible promises. Promises Receivable at the end of the year = \$80,000 or \$50,000 beginning balance + \$300,000 promises received – \$250,000 promises collected – \$20,000 in write-offs. End of year allowance for uncollectible promises equals \$15,000 or \$10,000 at beginning of year + \$25,000 identified provision for uncollectible promises to give – \$20,000 in write offs.]**
  - \$55,000 [This answer is not correct. The allowance for uncollectible promises was not considered in this calculation.]
  - \$80,000 [This answer is not correct. This represents the promises receivable at the end of the year, not the increase to promises receivable.]
18. Refer to the scenario in question #17 and assume that all of WWO's activities related to promises to give are not restricted for long-term purposes. In that case what is the proper treatment of the increase in promises receivable? **(Page 280)**
- The promises to give are considered operating assets. Present only the net change in operating assets and liabilities. [This answer is correct. Because the promises are not restricted for long-term purposes, only operating assets are affected.]**
  - The decrease in the amount expected to be collected should be considered a noncash financing transaction. [This answer is not correct. If the promises to give were restricted for long-term purposes, this would be correct.]
  - Using the indirect method, deduct the provision from the change in net assets to arrive at cash flows from operating activities. [This answer is not correct. Using the indirect method in this manner would be correct if the promises to give were restricted for long-term purposes.]
  - Using the direct method, exclude the provision from cash flows from operating activities, but reconcile changes in net assets to cash flows from operating activities. [This answer is not correct. The direct method applied in this manner would be correct if the promises to give were restricted for long-term purposes.]
19. How would a nonprofit organization report the amortization of a mailing list that it purchased and will be used over the next three years? **(Page 282)**
- The list should be expensed in the period in which it was purchased. [This answer is incorrect. Intangible assets (such as a mailing list) that are expected to yield benefits for several accounting periods are classified as assets and may be periodically charged to expense over some period of time.]
  - The amortization expense uses cash from the organization each period as it is expensed. [This answer is incorrect. Amortization expense does not use cash. The expense when the intangible asset was purchased would have used cash, but amortization expense is how an organization expenses off an asset over a period of time.]

**c. 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. In a nonprofit organization, any amortization expense recognized should be added back to the change in net assets to arrive at cash flows provided by operating assets as indicated in FASB ASC 230.]**

20. Match the other adjustment to arrive at net cash flows from operating activities to the proper example and/or accounting treatment: **(Page 283)**

- |   |  |
|---|--|
| 1. Deferred Income Taxes                      | i. Cash received would be reflected as the increase in excess of any related receivables.  |
| 2. Deferred Revenue                           | ii. Add it back to the change in net assets in arriving at cash flows provided from operating activities.  |
| 3. Depreciation                               | iii. Could result from revenue producing assets that are economically useful for more than one year.   |
| 4. Disposal, Sale, and Retirement of Property | iv. Proceeds received are equal to the cash effects of the transaction.  |
|   | v. Add back to, or subtract from, the change in net assets to arrive at net cash flows from operating activities.  |
|   | vi. The change in the balance would be added to or subtracted from the change in net assets to arrive at net cash flows from operating activities.   |
|   | vii. Could result from unrealized appreciation on investment portfolios of private foundations.  |
|   | viii. Could result from receiving payment for season tickets.  |
|   | ix. Any proceeds should be shown as cash inflows from investing activities, and expenses incident to the sale should be added back to the change in net assets and shown as an investing activity. |

a. 1 vi viii; 2 v vii; 3 iii; 4 ii iv ix [This answer is not correct. Although proceeds received from the sale of property would equal the cash effects of the transaction, other examples and treatments are not matched correctly.]

b. 1 ii vii; 2 vi vii; 3 ii vi; 4 iii iv [This answer is not correct. Although deferred income taxes are matched to the correct example, they may need to be subtracted from, rather than added to, the change in net assets to arrive at net cash flows from operating activities.]

c. 1 v vii; 2 vi viii; 3 ii iii; 4 i iv [This answer is not correct. Although deferred revenue could result from receiving payment for season tickets (as well as sale of memberships), and depreciation should be added back to the change in net assets; cash received on the sale of property would not be affected by a receivable.]

**d. 1 v vii; 2 i vi viii; 3 ii iii; 4 iv ix [This answer is correct. Deferred income taxes can result from unrelated business taxable income subject to excise tax. These noncash expenses should be subtracted from or added back to the change in net assets to arrive at net cash flows from operating activities.]**

## INVESTING ACTIVITIES AND ASSOCIATED CASH FLOWS

Investing activities include the following:

- Lending money and collecting on loans.
- Acquiring and selling or disposing of securities that are not cash equivalents.
- 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 2-1 at the beginning of the lesson 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.

### Format Considerations

**Netting Certain Cash Flows.** While GAAP generally requires 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. (Amounts due on demand are considered to be loans with original maturities of three months or less.) In addition, it is believed 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 2-1 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. [Purchase and sale or disposal of long-lived assets generally are classified as investing activities. However, it sometimes may be appropriate to classify such transactions as operating activities (e.g., when long-lived assets are acquired or produced to be a direct source of a nonprofit organization's revenues, such as assets rented to others for a short period of time and then sold).] The amount to be reported in the statement of cash flows generally should consist of (a) assets purchased for cash and (b) down payment for assets purchased by assuming liabilities. Payments of liabilities, including capital lease obligations, and 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	<u>1,000</u>
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	<u>(10,000)</u>
NET DECREASE IN CASH	(4,000)
CASH AT BEGINNING OF YEAR	<u>24,000</u>
CASH AT END OF YEAR	<u>\$ 20,000</u>

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 previous paragraph 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	<u>(1,500)</u>
NET CASH PROVIDED BY OPERATING ACTIVITIES	16,000
CASH FLOWS FROM INVESTING ACTIVITIES	
Proceeds from sale of equipment	6,500
Purchase of equipment	<u>(10,000)</u>
NET CASH USED BY INVESTING ACTIVITIES	(3,500)
CASH FLOWS USED BY FINANCING ACTIVITIES	
Debt reduction	<u>(10,000)</u>
NET INCREASE IN CASH	2,500
CASH AT BEGINNING OF YEAR	<u>24,000</u>
CASH AT END OF YEAR	<u>\$ 26,500</u>

Note that the difference in the net change in cash between this example and the previous 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 previous illustrations for capital expenditures.

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		<u>50,000</u>
	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 contributions 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 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, it is believed that 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
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
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)
<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>	<b>8,000</b>	<b>—</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
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. If an organization's cash balances consist solely of cash on deposit and similar demand deposits that are effectively not subject to withdrawal restrictions or material penalties (e.g., certificates of deposit or money market accounts), they should be classified as cash in conformity with FASB ASC 230-10-20 (formerly footnote 1 of SFAS No. 95). It is believed that the disclosures described here need not be made in those circumstances because the amounts are considered to be cash rather than cash equivalents. [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 (formerly SFAS No. 95) (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 fewer. Certificates of deposit with original maturities of more than 90 days are classified as short-term investments. Cash equivalents and short-term investments are stated at cost, which approximates market value. At December 31, 20X7 and 20X6, cash equivalents 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 market 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 Short-term Investments

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 short-term investments are stated at cost, which approximates market 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.

Using the same logic, 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 believed to be 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. Rather, changes in such cash and cash equivalents should be considered investing activities. Accordingly, the net change in cash and cash equivalents designated or restricted for long-term purposes should 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. The following illustrates how investments that are not cash equivalents should be presented in statements of cash flows.

## CASH FLOWS FROM OPERATING ACTIVITIES

	\$	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)
		<u>720</u>
NET CASH PROVIDED BY OPERATING ACTIVITIES		720
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from sales of investments		19,600
Purchases of investments		(23,230)
		<u>(3,630)</u>
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. It is believed 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 have been used to increase an investment. Accordingly, best practices indicate that presenting the transaction as a cash activity is more appropriate than presenting it as a noncash activity. If presented as a noncash activity, unrestricted interest or dividend income 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.

### 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		<u>7,500</u>
	NET CASH PROVIDED BY OPERATING ACTIVITIES	38,800
CASH FLOWS FROM INVESTING ACTIVITIES		
Loans made		(27,700)
Collections on loans		<u>8,500</u>
	NET CASH USED BY INVESTING ACTIVITIES	(19,200)

### Purchase (Sale) of a Subsidiary

**Mergers and Acquisitions.** 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.

**Mergers.** When a business combination between two nonprofit organizations results from a merger [accounted for under the pooling of interests method prior to the adoption of FASB ASC 958-805 (formerly SFAS No. 164) or under the carryover method after the adoption of 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. 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.



**SELF-STUDY QUIZ**

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

21. Sally Rider has four non-profit clients who need her help in preparing their statement of cash flows. Which organization has cash flow that can be reported on the statement of cash flows on the gross basis?
  - a. Help4Uorg receives loan payments from individuals who were loaned funds to pay utility bills. These short term loans are expected to be paid back within 60 days of receipt.
  - b. MayWeAssistOrg purchased a new van to give rides to the elderly by taking out a five year loan.
  - c. BringUsNeedOrg received \$100,000 from a benefactor who restricted the funds for building new dormitories in the future.
  - d. MoneyComesEasyOrg invests its excess cash in 90-day certificates of deposit.
22. Which of the following statements concerning the treatment of collections in the financial statements is correct?
  - a. Contributions of collection items are noncash activities that are included on the statement of cash flows on a gross basis.
  - b. Purchases and sales of collection items are considered cash flows from investing activities only when a nonprofit organization has capitalized its collection.
  - c. Proceeds from insurance recoveries of lost or destroyed collection items should be reflected as adjustments to the change in net assets to arrive at net cash provided by operating activities.
  - d. Purchases and sales of collection items should be presented in the statement of cash flows as a net amount.
23. On June 28, 2009, Bob Atty contributed \$12,000 to LegalHelpOrg (LHO) to purchase laptop computers for the volunteer lawyers. The computers had not yet been purchased when the fiscal year ended June 30, 2009. How should this restricted contribution be reported on LHO's financial statements?
  - a. \$12,000 cash inflow from financing activities and \$12,000 cash outflow from investing activities.
  - b. \$12,000 will be included in cash and cash equivalents.
  - c. \$12,000 cash inflow from investing activities and \$12,000 cash outflow from financing activities.
  - d. \$12,000 cash inflow from operating activities and \$12,000 cash outflow from investing activities.
24. AnimalsSaved4UOrg (AS4U) made loans of \$27,700 and collected \$8,500 on loans this past reporting period. In addition, the organization purchased a subsidiary named FriendsOfAnimalsOrg (FOA) for \$90,000. How should Debbie Dawg, AS4U's controller, report these transactions on the statement of cash flows?
  - a. Report loans made, collections on loans, interest collected on loans, and acquisition of FOA as separate line items under "CASH FLOWS FROM FINANCING ACTIVITIES".
  - b. Report loans made, collections on loans, interest received on loans, and acquisition of FOA as separate line items under "CASH FLOWS FROM INVESTING ACTIVITIES".
  - c. Report interest received on loans under "CASH FLOW FROM OPERATING ACTIVITIES"; loans made and collections on loans as separate line items under "CASH FLOWS FROM FINANCING ACTIVITIES", and acquisition of FOA as separate line item under "CASH FLOWS FROM INVESTING ACTIVITIES".
  - d. Report interest received on loans under "CASH FLOW FROM OPERATING ACTIVITIES"; and loans made, collections on loans, and acquisition of FOA as separate line items under "CASH FLOWS FROM INVESTING ACTIVITIES".

**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. Sally Rider has four non-profit clients who need her help in preparing their statement of cash flows. Which organization has cash flow that can be reported on the statement of cash flows on the gross basis? **(Page 293)**
- a. Help4Uorg receives loan payments from individuals who were loaned funds to pay utility bills. These short term loans are expected to be paid back within 60 days of receipt. [This answer is not correct. Cash flows from loans with original maturities of three months or less may be reported net rather than gross.]
  - b. MayWeAssistOrg purchased a new van to give rides to the elderly by taking out a five year loan. [This answer is correct. The purchase of the vehicle is a noncash investing activity. Noncash investing activities are required to be reported separately to provide information on all investing activity.]**
  - c. BringUsNeedOrg received \$100,000 from a benefactor who restricted the funds for building new dormitories in the future. [This answer is not correct. A change in cash that is restricted for long-term purposes is an investment activity for purposes of the statement of cash flows and may be reported net.]
  - d. MoneyComesEasyOrg invests its excess cash in 90-day certificates of deposit. [This answer is not correct. Cash flows from short term investments with three month or less original maturities do not have to be reported gross.]
22. Which of the following statements concerning the treatment of collections in the financial statements is correct? **(Page 295)**
- a. Contributions of collection items are noncash activities that are included on the statement of cash flows on a gross basis. [This answer is not correct. Because contributions of collection items are noncash activities they should be excluded from the statement of cash flows and separately disclosed.]
  - b. Purchases and sales of collection items are considered cash flows from investing activities only when a nonprofit organization has capitalized its collection. [This answer is not correct. These are investing activities regardless of whether a nonprofit organization has capitalized its collection.]
  - c. Proceeds from insurance recoveries of lost or destroyed collection items should be reflected as adjustments to the change in net assets to arrive at net cash provided by operating activities. [This answer is correct. These are presented separately in the statement of activities.]**
  - d. Purchases and sales of collection items should be presented in the statement of cash flows as a net amount. [This answer is not correct. Purchases and sales of collection items should be presented in the statement of cash flows similarly as purchase and sales of capital purchases and sales, as a cash outflow from investing activities.]
23. On June 28, 2009, Bob Atty contributed \$12,000 to LegalHelpOrg (LHO) to purchase laptop computers for the volunteer lawyers. The computers had not yet been purchased when the fiscal year ended June 30, 2009. How should this restricted contribution be reported on LHO's financial statements? **(Page 295)**
- a. \$12,000 cash inflow from financing activities and \$12,000 cash outflow from investing activities. [This answer is correct. LHO still holds cash restricted for the purchase of the laptops at the financial statement date. The cash inflow may be captioned "Contributions restricted for purchasing property and equipment" and the corresponding cash outflow may be captioned "Purchase of assets restricted to investment in property and equipment".]**
  - b. \$12,000 will be included in cash and cash equivalents. [This answer is not correct. For purposes of the statement of cash flows, restricted cash must be excluded from cash and cash equivalents.]

- c. \$12,000 cash inflow from investing activities and \$12,000 cash outflow from financing activities. [This answer is not correct. The \$12,000 cash outflow is an investing activity.]
  - d. \$12,000 cash inflow from operating activities and \$12,000 cash outflow from investing activities. [This answer is not correct. Bob Atty restricted this contribution for long-term purposes and thus the cash inflow is considered a financing activity. If the contribution did not have any restrictions, it would be a cash inflow from operating activities.]
24. AnimalsSaved4UOrg (AS4U) made loans of \$27,700 and collected \$8,500 on loans this past reporting period. In addition, the organization purchased a subsidiary named FriendsOfAnimalsOrg (FOA) for \$90,000. How should Debbie Dawg, AS4U's controller, report these transactions on the statement of cash flows? **(Page 298)**
- a. Report loans made, collections on loans, interest collected on loans, and acquisition of FOA as separate line items under "CASH FLOWS FROM FINANCING ACTIVITIES". [This answer is not correct. One reason this answer is not correct is that purchasing, as well as selling, a subsidiary is an investing activity.]
  - b. Report loans made, collections on loans, interest received on loans, and acquisition of FOA as separate line items under "CASH FLOWS FROM INVESTING ACTIVITIES". [This answer is not correct. One reason this answer is not correct is that interest collected on loans made by the nonprofit organization should be shown as an operating activity.]
  - c. Report interest received on loans under "CASH FLOW FROM OPERATING ACTIVITIES"; loans made and collections on loans as separate line items under "CASH FLOWS FROM FINANCING ACTIVITIES", and acquisition of FOA as separate line item under "CASH FLOWS FROM INVESTING ACTIVITIES". [This answer is not correct. One reason this answer is not correct is that making loans is an investing activity.]
  - d. Report interest received on loans under "CASH FLOW FROM OPERATING ACTIVITIES"; and loans made, collections on loans, and acquisition of FOA as separate line items under "CASH FLOWS FROM INVESTING ACTIVITIES". [This answer is correct. Both making loans and purchasing and selling subsidiaries are considered investing activities. Interest collected on loans is considered an operating activity.]**

## FINANCING ACTIVITIES AND ASSOCIATED CASH FLOWS

Financing activities include the following:

- Obtaining resources from owners and providing them with a return on, and a return of, their investment.
- Receiving restricted 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.

Since nonprofit organizations are typically not "owned" by any one individual or group of investors, the first financing activity noted above is not generally applicable to nonprofit organizations and will not be addressed in this course Exhibit 2-1 lists some typical examples of cash flows provided by financing activities. The following paragraphs discuss how to present cash flows from financing activities in statements of cash flows.

### Format Considerations

**Netting Certain Cash Flows.** Cash receipts and payments are generally required to be reported on a gross rather than a net basis. However, loans with original maturities of three months or less may be reported net rather than gross. All other financing activities should be reported gross.

**Noncash Financing Activities.** Certain financing activities, such as obtaining a building by receiving a gift, do not involve cash receipts or payments. (Exhibit 2-1 lists other typical examples of noncash financing activities.) Nevertheless, financing activities that do not involve cash are required to be reported separately so that information is provided on all financing activities.

### Restricted Contributions

Receipts of contributions that have been restricted for long-term purposes by the donor 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 permanent or term endowment. Under the direct method, those types of restricted contributions would be included in cash flows from financing activities. However, under the indirect method, the contributions must be deducted from the change in net assets to arrive at cash flows from operating activities and then reflected as cash flows from financing activities. To illustrate both methods, assume that \$100,000 was received to establish a permanent endowment, \$25,000 was received to acquire land, and \$200,000 was received as unrestricted contributions. 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)

<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>	
Proceeds from contributions restricted for:	
Investment in permanent endowment	100,000
Investment in land	<u>25,000</u>
	<b>NET CASH PROVIDED BY FINANCING ACTIVITIES</b>
	<u>125,000</u>
	<b>NET INCREASE IN CASH</b>
	200,000
<b>CASH AT BEGINNING OF YEAR</b>	<u>—</u>
	<b>CASH AT END OF YEAR</b>
	<u><u>\$ 200,000</u></u>

The following example illustrates the indirect method of presenting the statement of cash flows:

<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>	
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	<u>(125,000)</u>
	<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>
	200,000
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>	
Purchase of land	(25,000)
Purchase of investments	<u>(100,000)</u>
	<b>NET CASH USED BY INVESTING ACTIVITIES</b>
	<u>(125,000)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>	
Proceeds from contributions restricted for:	
Investment in permanent endowment	100,000
Investment in land	<u>25,000</u>
	<b>NET CASH PROVIDED BY FINANCING ACTIVITIES</b>
	<u>125,000</u>
	<b>NET INCREASE IN CASH</b>
	200,000
<b>CASH AT BEGINNING OF YEAR</b>	<u>—</u>
	<b>CASH AT END OF YEAR</b>
	<u><u>\$ 200,000</u></u>

Had the \$100,000 received to establish a permanent 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 restricted contributions are in the form of unconditional promises to give or if the organization received current-year payments on prior-period promises to give related to restricted contributions, 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.

### Restricted Investment Income

Similar to contributions restricted 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 permanent endowment but required all investment income to be reinvested until the endowment reached a specified amount. At that point, investment income would become unrestricted or only temporarily restricted depending upon the donor stipulations. 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 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 permanent endowment; \$200,000 was received as unrestricted contributions; and no other transactions occurred.

<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Change in net assets		\$ 212,000
Adjustment to reconcile change in net assets to net cash provided by operating activities:		
Interest and dividends restricted for long-term investment		<u>(12,000)</u>
	<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>	200,000
<b>CASH FLOWS USED BY INVESTING ACTIVITIES</b>		
Purchase of investments		(12,000)
<b>CASH FLOWS PROVIDED BY FINANCING ACTIVITIES</b>		
Interest and dividends restricted for permanent reinvestment		<u>12,000</u>
	<b>NET INCREASE IN CASH</b>	200,000
<b>CASH AT BEGINNING OF YEAR</b>		<u>—</u>
	<b>CASH AT END OF YEAR</b>	<u><u>\$ 200,000</u></u>

### 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 loans 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 paid 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:

<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
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		<u>(20,100)</u>
	<b>NET CASH PROVIDED BY FINANCING ACTIVITIES</b>	134,900

Proceeds from short-term debt consist of the net cash flows from loans 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.** It is believed bank fees and other costs incurred in obtaining financing or refinancing should be offset against the debt and charged to interest expense over the life of the debt, generally using the interest method. All of the costs are therefore accounted for as discount on the debt. Because debt issue costs have both operating and financing characteristics, the Emerging Issues Task Force considers whether such costs should be shown as an operating activity or as a financing activity in the statement of cash flows. In FASB ASC 230-10-45-15 (formerly Issue No. 95-13, “Classification of Debt Issue Costs in the Statement of Cash Flows”), the EITF reached a consensus that cash payments for debt issue costs should be classified as a financing activity. Accordingly, the amounts reported as a financing activity are the proceeds (the face amount of the debt less the bank fees and other costs incurred) and repayment of that amount (the reduction in the net liability reported in the financial statements). No adjustment is needed to reconcile change in net assets with net cash provided by operating activities. 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, the proceeds of \$97,000 less the payments of \$38,724), and a portion of the statement of cash flows would be as follows:

<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>	
Change in net assets and net cash used in operating activities	\$ (10,198 )
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>	
Proceeds of long-term debt	100,000
Payments for debt issue costs	(3,000 )
Principal payments of long-term debt	(28,526 )
<b>NET CASH PROVIDED BY FINANCING ACTIVITIES</b>	<b>68,474</b>
<b>NET INCREASE IN CASH</b>	<b>58,276</b>

**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 previous guidance. Generally, however, the loans are considered to be permanent, and, in those cases, the recommendation is to treat 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 (which is offset against cash value in the nonprofit organization’s financial statements), and cancels the policy. If the loan were treated as a distribution, the following amounts would be reported in the statement of cash flows, assuming no other transactions:

	<u>20X7</u>	<u>20X6</u>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
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)
<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>	<b>7,000</b>	<b>2,000</b>

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).

<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
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		<u>10,000</u>
<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>		<b>240,000</b>

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.

### **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.

**SELF-STUDY QUIZ**

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

25. ElephantOrg (EO) received \$200,000 from a donor who stipulated that all investment income was to be reinvested until the endowment reached \$300,000 at which point the investment income would become unrestricted. Ellie Fant, controller for EO, is using the indirect method, and correctly reports this transaction on the statement of cash flows by which of the following actions?
- a. Include the investment income in cash flows from financing activities.
  - b. Include the investment income in cash flows from investing activities.
  - c. Deduct the investment income from the change in net assets. Reflect the investment income as a cash flow from financing activities.
  - d. Deduct the investment income from the change in net assets. Reflect the investment income as a cash flow from investing activities.
26. How should debt issue costs be reflected on the statement of cash flows?
- a. Cash payments for debt issue costs are operating activities.
  - b. Cash payments for debt issue costs are financing activities.
  - c. Cash payments for debt issue costs are investing activities.
  - d. Cash payments for debt issue costs are cash management activities.
27. MathConcernsOrg (MCO) has a life insurance policy on its key executive employees. The nonprofit organization borrows \$2,000 against the \$9,000 accumulated cash value of the life insurance policy as a long-term liability, and then cancels the policy. Choose the best way for this loan to be accounted for on the statement of cash flows.
- a. As a loan.
  - b. As a distribution.
  - c. As a cash flow from investing activities.
  - d. As a cash flow from financing activities.

**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.)**

25. ElephantOrg (EO) received \$200,000 from a donor who stipulated that all investment income was to be reinvested until the endowment reached \$300,000 at which point the investment income would become unrestricted. Ellie Fant, controller for EO, is using the indirect method, and correctly reports this transaction on the statement of cash flows by which of the following actions? **(Page 305)**
- Include the investment income in cash flows from financing activities. [This answer is not correct. This is using the direct method.]
  - Include the investment income in cash flows from investing activities. [This answer is not correct. This is using the direct method and classifying the activity in the wrong category.]
  - Deduct the investment income from the change in net assets. Reflect the investment income as a cash flow from financing activities. [This answer is correct. The \$200,000 would first be subtracted from change in net assets and then shown as a cash flow used by investing activities, as well as a cash flow provided by financing activities when the investment income becomes unrestricted.]**
  - Deduct the investment income from the change in net assets. Reflect the investment income as a cash flow from investing activities. [This answer is not correct. Although this reflects the current method, the investment income is not an investing activity.]
26. How should debt issue costs be reflected on the statement of cash flows? **(Page 307)**
- Cash payments for debt issue costs are operating activities. [This answer is not correct. FASB ASC 230-10-45-15 (formerly Issue No. 95-13) notes that cash payments for debt issue costs should not be reflected as operating activity on the statement of cash flows.]
  - 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.]**
  - Cash payments for debt issue costs are investing activities. [This answer is not correct. Because debt issue costs are related to a financing activity, they do not fall under investing activities.]
  - Cash payments for debt issue costs are cash management activities. [This answer is not correct. Cash management activities include purchases and sales of investments that are classified as cash equivalents, not debt issue costs.]
27. MathConcernsOrg (MCO) has a life insurance policy on its key executive employees. The nonprofit organization borrows \$2,000 against the \$9,000 accumulated cash value of the life insurance policy as a long-term liability, and then cancels the policy. Choose the best way for this loan to be accounted for on the statement of cash flows. **(Page 307)**
- As a loan. [This answer is not correct. Because the policy is cancelled without paying the loan back, the loan is considered to be permanent and there is a better way to treat this transaction than as a loan.]
  - As a distribution. [This answer is correct. Because this loan is considered to be permanent, treating the transaction as a distribution is recommended.]**
  - As a cash flow from investing activities. [This answer is not correct. Because this loan is considered permanent, it is not recommended that it be treated as a cash flow from investing activities.]
  - As a cash flow from financing activities. [This answer is not correct. Although the loan could have been accounted for as a long-term debt if the policy was not cancelled, the best way to treat this transaction is not as a financing activity.]

## FINANCING ACTIVITIES AND NONCASH INVESTING

FASB ASC 230-10-50-3 (formerly SFAS No. 95) 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 reported separately. Obtaining a building or investment assets by receiving a gift as 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 \$850 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 included. It is recommended that accountants use a worksheet that reconciles noncash investing and financing transactions. As previously mentioned, investing and financing transactions for nonprofit organizations generally involve the following activities:

#### Investing Activities

- Lending money and collecting on loans.
- Acquiring and selling or disposing of securities that are not cash equivalents.
- 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.

#### Financing Activities

- Borrowing money and repaying amounts borrowed, or otherwise settling the obligation.
- Obtaining and paying for other resources from creditors on long-term credit.
- Receiving restricted resources that by donor stipulation must be used for long-term purposes.

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, presenting it at the bottom of the statement of cash flows is recommended.

<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
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		<u>(14,150)</u>
	<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>	<b>61,400</b>
<b>CASH FLOWS USED BY INVESTING ACTIVITIES</b>		
Purchase of equipment		(30,000)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Proceeds of long-term borrowings		25,000
Repayment of long-term borrowings		(5,000)
	<b>NET CASH PROVIDED BY FINANCING ACTIVITIES</b>	<b><u>20,000</u></b>
	<b>NET INCREASE IN CASH</b>	<b>51,400</b>
<b>CASH AT BEGINNING OF YEAR</b>		<b><u>67,800</u></b>
	<b>CASH AT END OF YEAR</b>	<b><u>\$ 119,200</u></b>
<b>SUPPLEMENTAL DISCLOSURES</b>		
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.)

Best practices indicate that all noncash investing and financing transactions should be disclosed either in a separate schedule or in the notes to the financial statements. In other words, they recommend against disclosing some noncash transactions in a separate schedule and other noncash transactions in the notes.

### **Assets Acquired by Assuming Liabilities**

Assets acquired by assuming liabilities, including capital lease obligations, are noncash transactions that should be disclosed separately. (Those 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	<u>(60,000)</u>
Cash down payment for equipment	<u>\$ 10,000</u>

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, it is believed that, 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 market 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.

Only contributed collection items that are capitalized are recognized as revenue or gains in the statement of activities. Accordingly, this paragraph refers only to collection items that are capitalized. Contributed

collections items that are not capitalized are *not* recognized as revenue or gains in the statement of activities. (Purchases of collection items not capitalized and proceeds from sales of collection items not capitalized are reported as changes in net assets in the statement of activities, however.) Therefore, such contributions would not be reported as adjustments to reconcile the changes in net assets to cash flows from operating activities in the statement of cash flows since they are not included in the change in net assets. Contributions of collection items that are not capitalized should be disclosed as noncash transactions, however.

### 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 through 50-5 (formerly SFAS No. 95) only requires the fair value of assets acquired and the fair value of liabilities assumed to be disclosed as a noncash transaction. It 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	<u>(77,000)</u>
Liabilities assumed	<u>\$ 90,000</u>

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	<u>(90,000)</u>
Cash paid to acquire ABC Entity	<u>\$ 77,000</u>

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	<u>(20,000)</u>
Cash paid to acquire ABC Entity	<u>\$ 57,000</u>

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 minority interests in ABC Company	<u>\$ 10,000</u>
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**Mergers.** When a business combination between two nonprofit organizations results from a merger [accounted for under the pooling of interests method prior to the adoption of FASB ASC 958-805 (formerly SFAS No. 164) or under the carryover method after the adoption of 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 (formerly SFAS No. 164, paragraph 18) requires disclosure (for each merging entity) 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, it is believed they resemble noncash investing and financing activities and should be classified as such. However, it is also believed the transactions need not be disclosed separately in a supplemental schedule or note. Since each item 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).

**Amortization of Discount on Unconditional Promises to Give.** Amortization of the discount on unrestricted unconditional promises to give 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 a noncash financing transaction.

**Provision for Uncollectible Promises to Give.** The provision for an uncollectible promise to give that is donor-restricted for long-term purposes should be considered a noncash financing transaction, 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, market value, or lower of cost or fair value. As a result of carrying investments at fair (or market) 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.

**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, best practices indicate 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.)



**SELF-STUDY QUIZ**

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

28. LoveKittensOrg (LKO) asked one of its benefactors, Kevin Katman, for a loan to purchase land for their new office building. Mr. Katman wrote a check to LKO for \$35,000 and LKO deposited the funds into their checking account; loan documents were signed; and the following week, LKO purchased the land by writing a check. What is the correct treatment of this transaction on the statement of cash flows?
- The \$35,000 should be shown as cash used by investing activities in the statement of cash flows.
  - The \$35,000 does not have to be disclosed separately.
  - The \$35,000 should be reported as a noncash investing and financing activity.
29. Due to the tax advantages given to donors on the contribution of appreciated property, nonprofit organizations often receive property and equipment, securities, or collection items. What is the proper treatment of such a gift?
- Recognize at market value in the statement of activities.
  - Using either the direct or indirect method of presenting cash flows from operating activities, the contribution is reported as an adjustment to reconcile the change in net assets to cash flows from operating activities.
  - Contributed collection items that are not capitalized are recognized as revenue or gains in the statement of activities.
  - Are not disclosed as a contribution in a supplemental schedule or the notes to the financial statements.
30. SunOrg purchased MoonOrg for \$77,000 in cash and \$167,000 in assumption of liabilities. MoonOrg's assets had a fair value of \$167,000. The following year \$10,000 of common stock was issued to reduce minority interests in MoonOrg. What disclosures are required under SFAS No. 95?
- Report \$77,000 as cash used by financing activities.
  - Per the requirements of FASB ASC 230, disclose the major categories and the fair values of assets obtained and liabilities assumed.
  - In a supplemental schedule report \$167,000 as fair value of assets acquired and \$77,000 as cash paid to acquire the company with the net shown as liabilities assumed.
  - Issuance of common stock is not shown anywhere on statement of cash flows.

**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.)**

28. LoveKittensOrg (LKO) asked one of its benefactors, Kevin Katman, for a loan to purchase land for their new office building. Mr. Katman wrote a check to LKO for \$35,000 and LKO deposited the funds into their checking account; loan documents were signed; and the following week, LKO purchased the land by writing a check. What is the correct treatment of this transaction on the statement of cash flows? **(Page 313)**
- The \$35,000 should be shown as cash used by investing activities in the statement of cash flows. [This answer is not correct. Although \$35,000 was received by the organization, there were tax reasons that Mr. Katman sent the money through the organization rather than purchase the land directly. The substance of this transaction dictates different treatment on the statement of cash flows.]
  - The \$35,000 does not have to be disclosed separately. [This answer is not correct. Assets acquired by assuming liabilities are noncash transactions that should be disclosed separately.]
  - The \$35,000 should be reported as a noncash investing and financing activity. [This answer is correct. Virtually, the substance of this transaction is one of the organization purchasing the land with a note to Mr. Katman. The fact that the cash passed through the checking account does not change the fact that this transaction should be reported as a noncash investing and financing activity.]**
29. Due to the tax advantages given to donors on the contribution of appreciated property, nonprofit organizations often receive property and equipment, securities, or collection items. What is the proper treatment of such a gift? **(Page 313)**
- Recognize at market value in the statement of activities. [This answer is not correct. The contribution would be reflected at fair value in the statement of activities.]
  - Using either the direct or indirect method of presenting cash flows from operating activities, the contribution is reported as an adjustment to reconcile the change in net assets to cash flows from operating activities. [This answer is correct. Because these items are considered noncash investing and financing transactions, the reconciling item must be presented using either method.]**
  - Contributed collection items that are not capitalized are recognized as revenue or gains in the statement of activities. [This answer is not correct. In the statement of activities, these items are recognized as revenue or gains if capitalized. If collection items are purchased and not capitalized, they should be reflected as changes in net assets in the statement of activities.]
  - Are not disclosed as a contribution in a supplemental schedule or the notes to the financial statements. [This answer is not correct. The contribution needs to be disclosed in a supplemental schedule or a note to the financial statement because it is a noncash transaction and won't be seen on the statement of cash flows in any other way.]
30. SunOrg purchased MoonOrg for \$77,000 in cash and \$167,000 in assumption of liabilities. MoonOrg's assets had a fair value of \$167,000. The following year \$10,000 of common stock was issued to reduce minority interests in MoonOrg. What disclosures are required under SFAS No. 95? **(Page 314)**
- Report \$77,000 as cash used by financing activities. [This answer is not correct. The \$77,000 needs to be reported as cash used by investing activities.]
  - Per the requirements of FASB ASC 230, disclose the major categories and the fair values of assets obtained and liabilities assumed. [This answer is not correct. A nonprofit organization can choose to disclose this information, but FASB ASC 230 does not require it.]

- c. **In a supplemental schedule report \$167,000 as fair value of assets acquired and \$77,000 as cash paid to acquire the company with the net shown as liabilities assumed. [This answer is correct. FASB ASC 230 does not require the major categories of assets obtained and liabilities assumed to be disclosed. The requirement is for the fair value of assets acquired and the fair value of liabilities assumed to be disclosed as a noncash transaction.]**
- d. Issuance of common stock is not shown anywhere on statement of cash flows. [This answer is not correct. This transaction needs to be disclosed in a schedule of noncash investing and financing transactions. The caption can read "Issuance of common stock to reduce minority interests in MoonOrg.]

**EXAMINATION FOR CPE CREDIT****Lesson 2 (NFSTG103)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

6. Based on FASB ASC 230-10-15-3 and the information presented in the answer choices, which organization is required to present a statement of cash flows?
- a. SailAwayOrg prepares GAAP financial statements which include a statement of financial position and a statement of activities.
  - b. BoatWithUsOrg prepares cash basis financial statements which include a statement of financial position and a statement of activities.
  - c. ShippingOutOrg prepares GAAP financial statements for internal use which include a statement of financial position and a statement of activities.
  - d. CasualCanoeOrg prepares tax basis financial statements which include a statement of financial position and a statement of activities.
7. Which of the following items should be disclosed separately rather than within the body of the statement of cash flows?
- a. Receipt of grant.
  - b. Equipment acquisition by liability assumption.
  - c. Short-term borrowings.
  - d. Installment sale.
8. Sandra Deena is reporting cash flows from several activities of Rockin50sOrg. FASB ASC 230 requires certain cash flows to be reported gross rather than net. Looking at the following list, which activities should be recorded at gross?
- i. Loan collection
  - ii. Cash receipts from agency funds
  - iii. Securities purchase
  - iv. Short-term debt cash settlement
  - v. Repayment of capital lease obligation
  - vi. Cash receipt related to investments
- a. ii, vi
  - b. i, iii, v
  - c. i, iii, iv, v
  - d. ii, iv

9. Which of the following should be completed by the preparer of a statement of cash flows?
- a. The operating, investing and financing activities should each have their own page in the statement of cash flows, so not to confuse the reader.
  - b. 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.
  - c. The cash flow statement is required by GAAP to be organized into three sections in the following order—operating, investing, and financing.
  - d. Subtotals should be shown for each section (operating, investing, and financing) of the statement of cash flows.
10. Kelly Sue discovers that due to a violation of restrictive covenants, she needs to reclassify a long-term liability to a current liability. The amount is material. What is her correct course of action concerning this reclassification?
- a. Show the reclassification in the schedule summarizing noncash investing and financing transactions.
  - b. Show the reclassification in the statement of cash flows under financing activities.
  - c. Disclose the reclassification in the notes to the financial statements.
  - d. Do not select this answer choice.
11. Operating activities must meet three criteria. Which of the following is **not** one of those criteria?
- a. Amount represents the cash effect of a transaction.
  - b. Amount results from organization's normal operations.
  - c. Amount is derived from an activity that enters into the determination of a net increase or decrease in net assets.
  - d. Amount results from donor stipulation concerning a long-term purpose.

12. Two basic formats are allowed for presenting cash flows from operating activities, the direct method or the indirect method. Match the descriptions below to the proper method.

- |                    |  |
|--------------------|--|
| 1. Direct Method   | i. Begins with gross cash receipts and deducts gross cash payments for operating costs and expenses.                                 |
| 2. Indirect Method | ii. Reconciliation within the statement of cash flows should show all major classes of operating items.                              |
|                    | iii. Adjusts for non-cash items and changes in operating assets and liabilities.   |
|                    | iv. Requires a separate schedule showing the reconciliation of the change in net assets to net cash flows from operating activities. |
|                    | v. Lists the cash effects of each major type of operating activity.  |
|                    | vi. Begins with the change in net assets.  |
|                    | vii. Adjustments for noncash revenues and expenses are not necessary.  |
|                    | viii. Encouraged by both FASB ASC 958 and FASB ASC 230.  |

- a. 1. i, iv, v, vii, viii; 2. ii, iii, vi
- b. 1. i, iii, v, viii; 2. ii, iv, vi, vii
- c. 1. ii, iii, vi; 2. i, iv, v, vii, viii
- d. 1. ii, iv, vi, vii; 2. i, iii, v, viii

13. Emily Eagle is deciding which method to use in preparing the statement of cash flows for NestingOrg. Under which of the following circumstances would it be preferable to use the indirect method over the direct method?

- a. Emily has the required information readily available.
- b. NestingOrg receives significant resources from agency transactions.
- c. Emily needs the statement for the bank to consider loaning NestingOrg funds.
- d. Emily does not have much time to prepare the statement.

14. Camille Smith is preparing the financial statements for TeleFriendOrg. Which of the following items is she required to separately disclose on the statement of cash flows?

- a. Extraordinary items
- b. Agency transactions
- c. Cumulative accounting adjustments
- d. Discontinued operations

15. Care4CaninesOrg experienced both an extraordinary noncash loss and an ordinary noncash loss to their buildings in the same fiscal year. How should the noncash effects of these losses be shown in the statement of cash flows?
- If using the direct method, the losses should be presented individually and separately.
  - If using the direct method, the losses should be added to the change in net assets.
  - If using the indirect method, the losses should be presented as a single amount.
  - If using the indirect method, noncash extraordinary items would be excluded.
16. OnlyYouOrg sold subsidiary BothOfUsOrg at the end of July 2008. Receipts from BothOfUsOrg's accounts receivable continued for fifteen months after the sale. Payments on an equipment loan continued as well. The loan was expected to be paid off at the end of March 2010. How should the cash flows from this discontinued operation be reported on OnlyYouOrg's statement of cash flows?
- BothOfUsOrg's operating cash flow must be reported separately as a single line item within the operating activities section of OnlyYouOrg's statement of cash flows.
  - Because the receipts and payments were relevant to OnlyYouOrg's cash flow, the organization chose to disclose the discontinued operation cash flow separately on their statement of cash flows.
  - Although the loan payments are relevant and clearly from an investing activity, all cash flows from discontinued operations are considered operating only.
  - Because cash flow from BothOfUsOrg is due to a discontinued operation, separate presentation of the cash flows is only needed for the first period affected.
17. What is the proper treatment of the amortization of discount on unconditional promises to give on the statement of cash flows?
- When using the indirect method, exclude the amortization from cash flows from operating activities. Reflect adjustment to reconcile changes in net assets to cash flows from operating activities.
  - When using the direct method, include the amortization on the statement of cash flows. No disclosure is necessary.
  - When using the indirect method, include the amortization of the discount in cash flows from operating activities. No disclosure is necessary.
  - When using the direct method, do not include the amortization on the statement of cash flows, do include the amortization on the reconciliation, and include as an additional disclosure in the notes.
18. SusieSmilesOrg owns life insurance on one of its key employees. The life insurance policy continues to earn cash value. If Susan Que, controller, wants to present the life insurance's cash value correctly, which method below would she want to use?
- Present the face value less cash value of the life insurance policy as an asset on the statement of financial position.
  - Add the increase in cash value of the life insurance policy that is allowed to accumulate to the change in net assets to arrive at cash flow from operating activities.
  - If cash value is used to reduce payment of insurance premium, a liability gets reduced and the adjustment to the change in net assets would be included in the net change in accounts payable.
  - Cash value that is allowed to accumulate provides cash and thus would be shown as an adjustment on the statement of cash flow when using the direct method.

19. What is the proper accounting treatment of realized and unrealized gains and losses on investments if using the indirect method of presenting the statement of cash flows?
- A distinction between unrestricted, temporarily restricted, or permanently restricted must be made in the statement of cash flows as it is in the statement of activities.
  - Any gain or loss associated with investment sales should be subtracted from or added back to the change in net assets in arriving at net cash flows from investing activities.
  - The proceeds from the sale of investments should be shown as cash inflows from operating activities if the investments were short-term.
  - Adjust the change in net assets for the effects of unrealized gains and losses by adding back unrealized losses and subtracting unrealized gains to arrive at cash flows from operating activities.
20. Investments in majority-owned for-profit subsidiaries and related but separate nonprofit organizations are addressed by FASB ASC 958-810. Certain required consolidations covered by this statement may give rise to noncontrolling (minority) interests. What is correct about noncontrolling (minority) interests?
- Noncontrolling (minority) interests in the earnings of a nonprofit organization's consolidated subsidiaries are cash items.
  - Generally, minority interests in the earnings of a nonprofit organization's consolidated subsidiaries are reported in the consolidated statement of activities as revenue.
  - It is common for consolidations of related nonprofit organizations to give rise to minority interests.
  - To arrive at cash flows from operating activities, minority interests should be added back to the consolidated change in net assets.
21. On July 1, 2007 Need4FoodOrg (N4F) purchased a new machine listed at \$72,000. To pay for the machine, N4F gave the dealer \$12,000 down and financed the balance with an installment loan to be paid in six annual installments of \$10,000 plus interest at the rate of 14%. N4F sold their used machine for \$6,500. The used machine had an undepreciated cost of \$4,000. Which item should be listed under operating activities?
- \$2,500 gain on sale of equipment.
  - \$12,000 down payment for purchase of equipment.
  - \$10,000 annual payment on the loan.
  - \$6,500 proceeds from sale of equipment.
22. Using the same information in question #21, which item should be listed under investing activities?
- \$2,500 gain on sale of equipment.
  - \$3,000 annual depreciation.
  - \$10,000 annual payment on the loan.
  - \$6,500 proceeds from sale of equipment.

23. Christmas4KidsOrg (C4K) sold its office building for \$70,000. They received \$20,000 as a cash down payment and required payment of the \$50,000 balance in five annual installments of \$10,000 plus interest at the rate of 16%. The building was originally purchased for \$100,000, and \$40,000 of depreciation had accumulated on the building. Which items would be classified as cash provided by investing activities on C4K's statement of cash flows for the first two years of this transaction?
- a. Year 1: \$20,000 for collection on installment sale. Year 2: \$10,000 for collection on installment sale.
  - b. Year 1: \$20,000 for collection on installment sale and \$10,000 for gain on sale of building. Year 2: \$10,000 for collection on installment sale.
  - c. Year 1: \$20,000 for collection on installment sale. Year 2: \$18,000 for collection on installment sale.
  - d. Year 1: \$38,000 for collection on installment sale. Year 2: \$18,000 for collection on installment sale.
24. ClimbWithUsOrg (CWU) has established 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. Martha Hill, the controller for CWU, calculates the net change in cash and cash equivalents restricted for long-term purposes. Under which activity should Ms. Hill classify this change on the statement of cash flows?
- a. Operating activity
  - b. Investing activity
  - c. Financing activity
  - d. Cash management activity
25. Which of the following financing activities may be reported on a net basis?
- a. Obtaining a building by gift.
  - b. Repaying an amount borrowed.
  - c. Loans with original maturities of three months or less.
  - d. Issuing membership shares.
26. Go2CampOrg received \$100,000 as a permanent endowment, \$25,000 to acquire land, and \$200,000 for unrestricted contributions. Go2CampOrg purchased the land for \$25,000 and invested the \$100,000 in equity securities. Using the direct method, which items need to be reported under "CASH FLOWS FROM FINANCING ACTIVITIES" on the statement of cash flows?
- a. Cash received from contributors.
  - b. Purchase of land.
  - c. Purchase of investments.
  - d. Investment in land.

27. What is the amount of net cash provided by financing activities in the following example?

ProtectFishOrg (PFO) acquired a boat in a capital lease transaction for which the obligation was \$168,000. PFO borrowed \$20,000 of short-term debt payable in less than three months; \$80,000 of other short-term debt; and \$250,000 of long-term debt. PFO paid back \$16,200 on the capital lease obligation; \$10,000 on short-term debt payable in less than three months; \$30,000 on other short-term debt; and \$24,000 on long-term debt.

- a. \$269,800
  - b. \$101,800
  - c. \$437,800
  - d. \$213,800
28. Wendy Watch has several nonprofit organizations as clients. While preparing their statements of cash flows, she varied the method used in reporting the noncash investing and financing activities. Which method does **not** meet the requirements of FASB ASC 230?
- a. Ms. Watch includes a narrative disclosing a capital lease assumed by FreeBirdOrg to purchase equipment in the notes to the financial statements.
  - b. Ms. Watch summarized the disclosure of a contribution of land to EaglesNestOrg in a schedule at the bottom of the statement of cash flows.
  - c. Ms. Watch disclosed MigrationNowOrg's interest and unrelated business income on the face of its statement of cash flows.
  - d. Ms. Watch included a gift of a building to FriendsForFowlOrg in its statement of cash flows, so she wouldn't have to report it separately.
29. Linda LouAnn is preparing the schedule of supplemental disclosures for the statement of cash flows. She considers the following transactions and decides that only one of these needs to be listed in this schedule. Using best practices, which of the following would be included in this schedule?
- a. The net unrealized investment gain on an investment in an equity security with a readily determinable fair value.
  - b. An uncollectible promise to give that is donor-restricted for long-term purposes.
  - c. The amortization of the discount on an unconditional promise to give that is donor-restricted for long-term purposes.
  - d. The equipment purchased as a result of signing a capital lease.
30. XYZ Country Club is a nonprofit organization which has members equity in the form of membership shares. Membership capital shares were issued this year in several transactions. Which of the following transactions should be shown as cash inflows from financing activities?
- a. Capital shares were issued to DandyDental in exchange for a \$2,500 receivable.
  - b. Capital shares were issued to new homeowners for \$15,600.
  - c. Capital shares were issued to Grant Thomas to settle a debt for golf course maintenance.
  - d. Capital shares were issued to Lake Access in exchange for two boats.

## 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 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:** 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 expense.

**Functional expense classification:** Represents the purpose of 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 or 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 expenses:** 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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## TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

### Companion to PPC's Guide to Preparing Nonprofit Financial Statements— Course 1—Liabilities and Other Topics Related to the Statement of Financial Position (NFSTG101)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

**ONLINE GRADING.** Log onto our Online Grading Center at **OnlineGrading.Thomson.com** 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 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 mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. 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.

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation**, and payment to:

**Thomson Reuters  
Tax & Accounting—R&G  
NFSTG101 Self-study CPE  
36786 Treasury Center  
Chicago, IL 60694-6700**

You may fax your completed **Examination for CPE Credit Answer Sheet** and **Course Evaluation** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

Please allow a minimum of three weeks for grading.

**Note:** The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are 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. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of \$79. Discounts apply for 3 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 \$225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is \$284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is \$336 (a 15% discount on all five courses or more).
4. To receive CPE credit, completed answer sheets must be postmarked by **April 30, 2011**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional \$24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.
5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **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

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The 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 each lesson, 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.

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**EXAMINATION FOR CPE CREDIT ANSWER SHEET**

**Companion to PPC's Guide to Preparing Nonprofit Financial Statements—Course 1—  
Liabilities and Other Topics Related to the Statement of Financial Position (NFSTG101)**

**Price \$79**

First Name: \_\_\_\_\_

Last Name: \_\_\_\_\_

Firm Name: \_\_\_\_\_

Firm Address: \_\_\_\_\_

City: \_\_\_\_\_ State /ZIP: \_\_\_\_\_

Firm Phone: \_\_\_\_\_

Firm Fax No.: \_\_\_\_\_

Firm Email: \_\_\_\_\_

Express Grading Requested:  Add \$24.95

Signature: \_\_\_\_\_

Credit Card Number: \_\_\_\_\_ Expiration Date: \_\_\_\_\_

Birth Month: \_\_\_\_\_ Licensing State: \_\_\_\_\_

**ANSWERS:**

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ○ ⊗ ⊙

- | a           | b           | c           | d           | a | b | c | d | a | b | c | d | a | b | c | d |
|-------------|-------------|-------------|-------------|---|---|---|---|---|---|---|---|---|---|---|---|
| 1. ○ ○ ○ ○  | 11. ○ ○ ○ ○ | 21. ○ ○ ○ ○ | 31. ○ ○ ○ ○ |   |   |   |   |   |   |   |   |   |   |   |   |
| 2. ○ ○ ○ ○  | 12. ○ ○ ○ ○ | 22. ○ ○ ○ ○ | 32. ○ ○ ○ ○ |   |   |   |   |   |   |   |   |   |   |   |   |
| 3. ○ ○ ○ ○  | 13. ○ ○ ○ ○ | 23. ○ ○ ○ ○ | 33. ○ ○ ○ ○ |   |   |   |   |   |   |   |   |   |   |   |   |
| 4. ○ ○ ○ ○  | 14. ○ ○ ○ ○ | 24. ○ ○ ○ ○ | 34. ○ ○ ○ ○ |   |   |   |   |   |   |   |   |   |   |   |   |
| 5. ○ ○ ○ ○  | 15. ○ ○ ○ ○ | 25. ○ ○ ○ ○ | 35. ○ ○ ○ ○ |   |   |   |   |   |   |   |   |   |   |   |   |
| 6. ○ ○ ○ ○  | 16. ○ ○ ○ ○ | 26. ○ ○ ○ ○ | 36. ○ ○ ○ ○ |   |   |   |   |   |   |   |   |   |   |   |   |
| 7. ○ ○ ○ ○  | 17. ○ ○ ○ ○ | 27. ○ ○ ○ ○ | 37. ○ ○ ○ ○ |   |   |   |   |   |   |   |   |   |   |   |   |
| 8. ○ ○ ○ ○  | 18. ○ ○ ○ ○ | 28. ○ ○ ○ ○ | 38. ○ ○ ○ ○ |   |   |   |   |   |   |   |   |   |   |   |   |
| 9. ○ ○ ○ ○  | 19. ○ ○ ○ ○ | 29. ○ ○ ○ ○ | 39. ○ ○ ○ ○ |   |   |   |   |   |   |   |   |   |   |   |   |
| 10. ○ ○ ○ ○ | 20. ○ ○ ○ ○ | 30. ○ ○ ○ ○ | 40. ○ ○ ○ ○ |   |   |   |   |   |   |   |   |   |   |   |   |

You may complete the exam online by logging onto our online grading system at **OnlineGrading.Thomson.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

**Expiration Date: April 30, 2011**

## 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 1—Liabilities and Other Topics Related to the Statement of Financial Position Course Acronym: NFSTG101

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?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

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 [trainingcpe.thomson.com](http://trainingcpe.thomson.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 \_\_\_\_\_

## TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

### Companion to PPC's Guide to Preparing Nonprofit Financial Statements— Course 2—Notes to the Financial Statements (NFSTG102)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

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Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation**, and payment to:

**Thomson Reuters  
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Please allow a minimum of three weeks for grading.

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<b>CPE Examination Questions (Lesson 3)</b> .....	<b>224</b>

**EXAMINATION FOR CPE CREDIT ANSWER SHEET**

**Companion to PPC's Guide to Preparing Nonprofit Financial Statements—Course 2—  
Notes to the Financial Statements (NFSTG102)**

**Price \$79**

First Name: \_\_\_\_\_

Last Name: \_\_\_\_\_

Firm Name: \_\_\_\_\_

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Firm Phone: \_\_\_\_\_

Firm Fax No.: \_\_\_\_\_

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Express Grading Requested:  Add \$24.95

Signature: \_\_\_\_\_

Credit Card Number: \_\_\_\_\_ Expiration Date: \_\_\_\_\_

Birth Month: \_\_\_\_\_ Licensing State: \_\_\_\_\_

**ANSWERS:**

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ○ ⊗ ⊙

- | a           | b           | c           | d           | a | b | c | d | a | b | c | d | a | b | c | d |
|-------------|-------------|-------------|-------------|---|---|---|---|---|---|---|---|---|---|---|---|
| 1. ○ ○ ○ ○  | 11. ○ ○ ○ ○ | 21. ○ ○ ○ ○ | 31. ○ ○ ○ ○ |   |   |   |   |   |   |   |   |   |   |   |   |
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| 4. ○ ○ ○ ○  | 14. ○ ○ ○ ○ | 24. ○ ○ ○ ○ | 34. ○ ○ ○ ○ |   |   |   |   |   |   |   |   |   |   |   |   |
| 5. ○ ○ ○ ○  | 15. ○ ○ ○ ○ | 25. ○ ○ ○ ○ | 35. ○ ○ ○ ○ |   |   |   |   |   |   |   |   |   |   |   |   |
| 6. ○ ○ ○ ○  | 16. ○ ○ ○ ○ | 26. ○ ○ ○ ○ | 36. ○ ○ ○ ○ |   |   |   |   |   |   |   |   |   |   |   |   |
| 7. ○ ○ ○ ○  | 17. ○ ○ ○ ○ | 27. ○ ○ ○ ○ | 37. ○ ○ ○ ○ |   |   |   |   |   |   |   |   |   |   |   |   |
| 8. ○ ○ ○ ○  | 18. ○ ○ ○ ○ | 28. ○ ○ ○ ○ | 38. ○ ○ ○ ○ |   |   |   |   |   |   |   |   |   |   |   |   |
| 9. ○ ○ ○ ○  | 19. ○ ○ ○ ○ | 29. ○ ○ ○ ○ | 39. ○ ○ ○ ○ |   |   |   |   |   |   |   |   |   |   |   |   |
| 10. ○ ○ ○ ○ | 20. ○ ○ ○ ○ | 30. ○ ○ ○ ○ | 40. ○ ○ ○ ○ |   |   |   |   |   |   |   |   |   |   |   |   |

You may complete the exam online by logging onto our online grading system at **OnlineGrading.Thomson.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

**Expiration Date: April 30, 2011**

## 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—Notes to the Financial Statements Course Acronym: NFSTG102

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:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
2. How would you rate the examination related to the course material?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
3. Does the examination consist of clear and unambiguous questions and statements?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
4. Were the stated learning objectives met?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
5. Were the course materials accurate and useful?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
7. Was the time allotted to the learning activity appropriate?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
8. If applicable, was the technological equipment appropriate?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
10. If applicable, how well did the audio/visuals contribute to the program?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

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 [trainingcpe.thomson.com](http://trainingcpe.thomson.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 \_\_\_\_\_

## TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

### Companion to PPC's Guide to Preparing Nonprofit Financial Statements—Course 3—Statements of Functional Expenses and Cash Flows (NFSTG103)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

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Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation**, and payment to:

**Thomson Reuters  
Tax & Accounting—R&G  
NFSTG103 Self-study CPE  
36786 Treasury Center  
Chicago, IL 60694-6700**

You may fax your completed **Examination for CPE Credit Answer Sheet** and **Course Evaluation** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

Please allow a minimum of three weeks for grading.

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

## EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The 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 each lesson, 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.

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**EXAMINATION FOR CPE CREDIT ANSWER SHEET**

**Companion to PPC's Guide to Preparing Nonprofit Financial Statements—Course 3—Statements of Functional Expenses and Cash Flows (NFSTG103)**

**Price \$79**

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**ANSWERS:**

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this  not like this    .

- | a                        | b                     | c                     | d                     | a                         | b                     | c                     | d                     | a                         | b                     | c                     | d                     | a                         | b                     | c                     | d                     |
|--------------------------|-----------------------|-----------------------|-----------------------|---------------------------|-----------------------|-----------------------|-----------------------|---------------------------|-----------------------|-----------------------|-----------------------|---------------------------|-----------------------|-----------------------|-----------------------|
| 1. <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | 9. <input type="radio"/>  | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | 17. <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | 24. <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> |
| 2. <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | 10. <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | 18. <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | 25. <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> |
| 3. <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | 11. <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | 19. <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | 26. <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> |
| 4. <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | 12. <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | 20. <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | 27. <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> |
| 5. <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | 13. <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | 21. <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | 28. <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> |
| 6. <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | 14. <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | 22. <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | 29. <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> |
| 7. <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | 15. <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | 23. <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | 30. <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> |
| 8. <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | 16. <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> |                           |                       |                       |                       |                           |                       |                       |                       |

You may complete the exam online by logging onto our online grading system at **OnlineGrading.Thomson.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

**Expiration Date: April 30, 2011**

## 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—Statements of Functional Expenses and Cash Flows Course Acronym: NFSTG103

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:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
2. How would you rate the examination related to the course material?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
3. Does the examination consist of clear and unambiguous questions and statements?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
4. Were the stated learning objectives met?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
5. Were the course materials accurate and useful?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
7. Was the time allotted to the learning activity appropriate?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
8. If applicable, was the technological equipment appropriate?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
10. If applicable, how well did the audio/visuals contribute to the program?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

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**

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